SHORTCOMINGS OF MANAGEMENT OVERSIGHT MECHANISMS IN ISE-LISTED COMPANIES AND A PROPOSAL FOR REINFORCEMENT THROUGH SHAREHOLDER CONTROL

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ABSTRACT

Stock exchanges are markets that enable the pricing-in of expectations and allow for sudden fluctuations in share prices. The share price of a listed public company is formed and affected primarily by information stemming from the company. Meanwhile, investments in capital markets are driven mainly by considerations of shareholder value and the dividend profitability. Investors on a global scale expect foremost that companies they invest in provide, through effective management and good governance, a high shareholder value and a profitable stream of dividend payments. Therefore, it is important for investors to receive information that will instantly affect share prices, in a timely and satisfactory manner, especially in light of the basic nature of the capital markets, namely the requirement to flexibly and quickly open, switch or close a position.

The main set of rules set forth by the Turkish legal system for the protection of investor shareholders is the Turkish Capital Market Law (CML), which is designed to protect the rights and interests of shareholders, whether they are institutional investors or individuals, and whether they bring foreign or domestic capital. In addition, the Turkish Commercial Code (TCC) provides the general framework for all commercial entities. However, the essence of rights and interests protected by the CML differs in substance from those protected under the TCC. The CML applies to a wide spectrum of investors, functioning in an environment of sudden price changes, whereas the TCC applies mostly to closely-held companies. This difference highlights the need for a specific mechanism for protection of public company shareholders' rights and interests.

The Istanbul Stock Exchange (ISE) may be described as a market where a majority of the listed companies have a low non-affiliate public float. Furthermore, management of ISE-listed companies is generally in the hands of controlling owners with non-public shares or with preferred shares having voting privileges regarding board of directors' elections. Under the Turkish legal system and practice, the board of directors "manages" the company. In other words, the board of directors is empowered to make strategic, financial and operational decisions regarding the company, as well as to execute these decisions and to monitor their execution. Therefore, the substantive governance of a company belongs, in effect, to the board of directors. However, Turkish law approach towards unitary ownership sometimes conflicts with the requirements of widespread ownership, harming investors' expectations of high shareholder value and dividend profitability. On the other hand, to fulfill shareholder expectations, companies must behave competitively and take certain risks, in accordance with the requirements and the pace of the business environment. As a result, in order for companies to both succeed in such an environment and protect the rights and interests of non-affiliated public shareholders, the companies must find a balance between **management** and **oversight**.

Legal systems throughout the world are making a continuous effort to strike a balance between management and oversight. Both the unitary board of directors mechanism envisioned by the Anglo-Saxon system and the dual board mechanism envisioned by the Continental European system have been continuously developing towards a balance between management and oversight. The Turkish system is engaged in a similar effort. However, none of these systems have been entirely successfully, despite all attempts. On the contrary, some of the newer efforts may be said to have brought about results contrary to their aim. Analyzed from this perspective, current mechanisms of management oversight pose the main following problems:

The **internal audit mechanism** mandated by the TCC provides, in theory, the opportunity for effective management oversight. However in practice, it has failed to deliver effective results due to the problematic election process of internal auditors. In addition, the outcome of such audits is often proved inadequate. Therefore, the Draft Turkish Commercial Code has adopted an independent audit mechanism for management oversight of publicly held companies.

Similarly, the **independent audit mechanism** is largely insufficient in protecting the rights and interests of investors since it analyzes a company, generally periodically and by means of document review. As a result, an independent audit may not reveal sophisticated non-compliance, fraud or other revenue diverting schemes; and even if it were to reveal such problems, it may do no more than cast light on past practices. Therefore, an independent audit mechanism is unlikely to prevent non-affiliated public shareholders from an information asymmetry that might subject them to sudden price changes. Independent audits may only provide an after-the-fact remedy.

Furthermore, the supervision function delegated to the **Capital Market Board** (CMB) focuses on management oversight by the CMB itself, an administrative authority and a non-stakeholder in companies. Such an oversight mechanism may be inadequate in the protection of shareholders' rights and interests as the approach and incentives of an administrative authority may not align with shareholders. In addition, the CMB lacks a sufficient number of officers to conduct thorough oversight; and the CMB's supervision measures do not proceed simultaneously and in parallel with a company's management activities.

Likewise, the **audit committee mechanism** contained in Turkish securities laws, fails to capture the much sought-after balance between management and oversight because the committee members also serve on and report to the very board they are under a duty to monitor.

Comparatively, the Anglo-Saxon system has resorted to the **independent director** mechanism as a means to protect the rights of shareholders. While this solution appears to be geared towards markets where there is an agency problem due to the separation of ownership and control, it seems less likely to apply in ISE-listed companies, which, on the contrary, reveal a concentration of power and a low non-affiliate public float. Therefore, the independent director solution may prove ineffective in protecting the rights and interests of non-affiliated public shareholders of ISE-listed companies.
The Continental European System, generally envisioning a **supervision board** separate from a management board, appears to have found a balance between management and oversight. However, in doing so, it has focused on both the shareholders and other non-shareholder constituencies. Moreover, it has designated non-shareholder constituencies to construct the very balance between management and oversight. The authors of this article believe that shareholders, the genuine owners of risk, should not be replaced or overshadowed by other constituencies in an effort to reach a balance management and oversight. In our opinion, such an approach may lead away from shareholder-focus and result in the undermining of profitability.

In sum, the above-stated mechanisms do not appear to completely prevent management decisions and practices that decrease shareholder value and profitability. Furthermore, they seem relatively inadequate in accommodating capital market requirements regarding quick asset repositioning. Therefore, the management oversight process needs to be supported by other mechanisms, but by those that will not hinder a company's economic development.

Accordingly, we propose that, in listed companies with a low non-affiliate public float, the management oversight process be reinforced by a specialized control mechanism. Efficiency, shareholder-focus and discretion are the pillars on which the control mechanism should be founded.

We define **efficiency** as the ability to (i) closely and continuously monitor for fraud and other management attempts to divert revenue away from the company and to (ii) prevent such attempts without intervening with the substantive governance role of the board of directors. If prevention proves impossible, then an efficient mechanism should allow for immediate disclosure to public as well as to the related authorities; and consequently enable shareholders to liquidate their investment.

By **shareholder-focus,** we refer to the utilization of the mechanism by those who stand to benefit the most from effective oversight, namely the shareholders lacking adequate capital or voting power to control the company. Through this principle, we aim to eliminate aspects or influences that may adversely affect efficiency or inhibit company development.

Finally, we define **discretion** as the voluntary nature of the shareholder control mechanism. In other words, shareholders' power to control management oversight must be contractual, and therefore based on the articles of association. The control mechanism must be utilized voluntarily and in accordance with corporate governance principles by companies that believe to gain from its deployment. By the term "discretion," we also refer to the absence of mandatory laws, rules and regulations that might limit companies' or investors' freedom to take risk. A rise in such mandatory rules may adversely affect the availability of public offerings, as well as encourage delistings and minority shareholder squeeze-outs. In other words, a rise in mandatory rules may cause companies to become introverted. This trend may eventually result in the weakening of capital markets and damage its very foundations, while depriving investors of attractive investment opportunities.

In sum, we propose that ISE-listed companies with a low non-affiliate public float create and utilize, voluntarily, an oversight board consisting of non-affiliated shareholders owning public stock, to monitor revenue-diverting schemes of management, deter such attempts or acts, and enable their disclosure.

Different from the supervision board, which is envisioned in some Continental European systems and which includes non-shareholder constituencies, the oversight board we propose consists only of shareholders. Therefore, it empowers shareholders to closely monitor management. Furthermore, only those shareholders owning publicly-held shares may be eligible for oversight board elections. Such a limitation allows for an effective and democratic balance between shareholders who retain control of the company through their capital and voting power and the remaining non-affiliated shareholders, who are the best candidates for safeguarding their own interests. Such a balance eliminates the problem of subjectivity and other shortcomings posed by the mandatory internal audit system.

Moreover, the oversight board mechanism provides the ability to continuously monitor management and to stop fraud or other violations at its source. If prevention proves impossible, then the mechanism enables immediate disclosure. Therefore, it alleviates inefficiencies resulting from the independent audit system, which may help discover such problems after shareholders bear the opportunity cost of a more profitable position.

The oversight board must remain autonomous and must not be under a duty to report to the board of directors. Similarly, members of the oversight board may not come from or serve on the board of directors. Adopting the oversight board mechanism eliminates the need to resort to other mechanisms such as the independent director mechanism, where (i) there is no consensus on characteristics or quantitative manner of representation on the board; which (ii) lacks strong rationale for benefiting the shareholders of companies with a low non-affiliate

public float; which (iii) may be influenced by the controlling shareholders, especially considering the ownership structure of ISE-listed companies; and which consequently (iv) may do more harm then good. Furthermore, adoption of the oversight board may help to prevent the incomplete and questionable monitoring conducted by independent directors, who are neither directly nor personally interested in creating shareholder value and dividend profitability, the *raison d'être* of public companies. As a result, the shareholder basis of the oversight board may allow shareholders to benefit from certain corporate operations and opportunities, which may possibly be circumvented by independent directors.

The contractual nature of the oversight board model and its foundation on the articles of association, as well as the voluntary adoption of the model by **willing companies,** may provide **such companies** a competitive advantage in obtaining capital from a wide source of investors. This advantage may be more pronounced for companies having a low non-affiliate public float and managed by shareholders having superiority in terms of capital or voting power.

Accordingly, **the institutional investors** may choose to invest in companies willing to adopt an oversight board mechanism; they may encourage the development of voluntary control of oversight in public companies; and they may provide their own investors with different investment alternatives in this regard.

The legislature and the administrative authorities also benefit from the voluntary adoption of the shareholder oversight board model. Encouraging a balance, within market dynamics, between the prerequisites of commercial profitability and the necessity of protecting shareholders' rights absolves the legislature and authorities from the burden of enacting mandatory norms whose substance may entail questionable mechanisms and whose respectability may be, therefore, in doubt.

Such encouragement may also help prevent against unfair competition resulting from subjecting companies of different structures and characteristics to **ratings** or stock exchange listing requirements which may pose mandatory and uniform norms.

Voluntary rules that assist in the development of the articles of association jurisprudence and in the protection of shareholder rights and interests, without damaging the competitive nature of companies, may play an affirmative role in the structuring of real sectors. Through the use of such rules, ISE-listed companies may reach global equity faster, cheaper and in a more satisfactory manner.

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INTRODUCTION

Emerging market companies that wish to compete globally must strengthen their capitalization. In pursuing this aim, management of such companies should look to meet investor expectations of shareholder value and dividend profitability, while refraining from violating their rights and interests. At the same time, management must preserve a company's entrepreneurial character and risk appetite, in order to function profitably in the highly competitive markets of today. Accordingly, achieving an effective balance between management and oversight carries great importance, especially for emerging market companies.

This Article discusses the current management oversight in the Turkish legal system and in companies listed at the Istanbul Stock Exchange (ISE), and focuses on certain shortcomings of the existing system. A majority of ISE-listed companies have a low non-affiliate public float, with affiliated or controlling shareholders who, from time to time, engage in revenue-diverting schemes. Taking this into account, the Article proposes a supplementary reinforcement structure for attaining a balance between management and oversight in ISE-listed companies.

First, the Article considers the relevant provisions of Turkish company law. Second, it summarizes the relevant law and practice in developed countries. Finally, it proposes a supplementary mechanism for management oversight in ISE-listed companies and explains, in general terms, how such a mechanism may be structured.

1. THE PURPOSE OF MANAGEMENT OVERSIGHT

1.1. The relationship between management role and management structure

Shares traded at the ISE belong to companies that have issued their stock by a public offering, via registration with the Turkish Capital Market Board (CMB), or to other companies that are deemed public, with over 250 owners.[1] To be traded, shares must be quoted on the Exchange.[2] As of the beginning of the year 2007, there were 323 ISE-listed companies, which have been classified in different groups by various indices.[3] While the total market value of ISE-listed companies is $ 163.6 billion, the market value of the companies' ISE-traded shares remains only at $ 51.4 billion. A majority of the ISE-listed companies are, or have been, owned by either a founding family or a parent company; and accordingly, have a low non-affiliate public float. While some shares of ISE-listed companies have been publicly offered for the purpose of acquiring capital, the remaining shares have stayed with the founding families or parent companies, enabling them to retain control of the company. Control has also been retained through the ownership of preferred shares with voting privileges regarding board of directors' elections. The shares of only a small percentage of 9,755 foreign-capital-companies are currently traded at the ISE.[4] By contrast, foreign investors trade or own approximately 67 % of or approximately $ 35 billion worth of all ISE tradable shares.

In the Turkish legal system, joint stock corporations, including public companies, are managed by the board of directors.[5] Members of the board must also be shareholders in the company. The board, responsible for "all activities" related to the company's purpose and scope of business,[6] has the power and the duty to make decisions regarding the company as well as to execute its own decisions. The board duties may be delegated, in part or full, to certain members of the board,[7] or to an outsider manager who does not serve on the board. However in practice, decisions regarding the company business are generally taken by family members, or by board members elected by family members. The same is true for the execution of board decisions. Consequently, in the Turkish system, decision-making and execution - two different roles - are conducted by the same organ, the board.

The direct involvement of the board in management, as well as the structure of the board in companies with a low non-affiliate public float, may lead to certain loopholes in the protection of the rights and interests of shareholders that have acquired public shares through secondary markets. Such loopholes are created by board actions that negatively affect share prices. Since the commencement of ISE activities in 1986, foreign and domestic investors have primarily complained of corporate activities, such as transfer-pricing or constructive dividend payments, which have diverted company profits or assets.[8] Despite enforcement mechanisms and various criminal or monetary penalties envisioned in the Turkish tax and

securities laws, such corporate activities persisted. Furthermore, coupled with inadequate management oversight, such fraudulent conduct has substantially damaged the purpose of the Capital Market Law (CML), the "protect[ion of] the rights and benefits of investors."[9] As a result, the amount of funds invested in the capital market has been considerably less than desired.

Different legal systems have approached the issue of safeguarding investors' rights and interests (from board/management fraud) differently, depending on the substantive governance model of companies. As explained below, the Unites States system envisions a unitary board scheme, whereby the board is separated from management and is given mainly the responsibility of management oversight. The management of a company is delegated to the executive branch, which runs the daily, operational activities of the company. The unitary board system is supported with the "independent director" mechanism. On the other hand, the German system envisions a dual board scheme, balancing the supervision board with the management board. In the dual board scheme, the supervision board is responsible for both the election of the managing members and for the oversight of the management board. Due to shareholder-focus of the US system, management's role and responsibility is shaped primarily in accordance with shareholder goals regarding shareholder value and dividend payments. However, in Continental Europe, management oversight involves a broader range of stakeholders, such as non-shareholder constituencies.

Similarly, the structural characteristics of the Turkish board carry great importance in the monitoring and oversight of management activities. In the Turkish system, generally the board, and not an executive team, manages the company. Unlike in the US, where there is an agency problem due to dispersed ownership, and where the day-to-day business of a company is managed by the executive team with a strong presence, in the Turkish governance structure, such a team is generally absent.

As a result, management fraud, adversely affecting shareholder rights and interests, stems from the board, which directly "manages" the company. Lawsuits and other legal proceedings verify this problem. Therefore, we believe that the focus of management oversight should be based on understanding that problems arise from the board, its decisions and applications.

1.2. Management oversight broadly defined in Turkish Law

Turkish law mandates management oversight in both closely-held and publicly-held companies. Primarily, under the Turkish Commercial Code (TCC), activities of joint stock companies are monitored by the "internal auditor(s)",[10] as discussed in detail below. It is sufficient to note here that the related provisions of the TCC, dating back to 1956, have become ineffective with time and due to the fact that

internal auditors are elected by the board, consisting of the non-public owners. Therefore, questions regarding the strength of an internal audit have led to the abandonment of the internal auditor mechanism. Instead, the Draft Commercial Code adopts, for quoted public companies, the independent audit system, whereby approved institutions carry out audits in accordance with audit provisions contained in the CML.

Furthermore, Article 15 of CML titled "Principles Concerning the Distribution of Dividends and Bonus Shares" states

> *"In the case of transactions with another enterprise or individual with whom there is a direct or indirect management, administrative, supervisory, or ownership relationship, publicly held joint stock corporations shall not impair their profits and/or assets by engaging in deceitful transactions such as by applying a price, fee or value clearly inconsistent with similar transactions with unrelated third parties."*

In other words, a public company may not enter into transactions with other "related parties" at clearly non-market prices, for the purpose of diverting revenue or assets. The Law defines constructive dividend payment activity as a criminal offense.

The main practices regarding constructive dividend payments, as discovered in listed companies, are as follows:

- Transfers of real or personal property between parent and subsidiary companies as well as between subsidiary companies or between the company and its controlling shareholders, at prices clearly diverging from market value;
- Interest payments between the above-stated entities or parties, at rates varying from customary commercial or banking practice;
- Salary payments and fees of excessive amounts to certain entities or individuals; and
- Pledging company assets as security, in a manner inconsistent with commercial custom and practice and with the intention of personal gain; or making unfair use of corporate opportunities.

Following-up on complaints submitted, the CMB inquires into alleged violations of Article 15 and upon sufficient findings, it may order that certain measures be taken to cure the problem, and that the unfairly-gained profit be disgorged and returned to the company. At the same time, the CMB may request from the prosecutors to initiate criminal prosecution, as well as facilitate public disclosure regarding the matter. The following are a few CMB decisions on Article 15 violations:

- In a case, where the official company records were false, the CMB requested that "*criminal proceedings be initiated against the chairman of the board of directors and the general manager of the company.*"[11]

- In a case, where one company purchased 20 % shares of another company at a price exceedingly higher than market value, the CMB decided that "*the companies are interrelated from a management and capital perspective and that there has been a constructive dividend payment from one company to the other.*" Accordingly, the CMB ordered that (i) profits be disgorged and returned to the company, with interest; (ii) in case profits are not returned, proceedings be initiated against the liable directors and officers, in accordance with the CML; and (iii) the matter be disclosed to the shareholders and investors of the company."[12]

- In another case of constructive dividend payments involving a lease, the CMB held that "*the related payment amount be returned to the company, with . . . interest, and in case payment is not returned, criminal proceedings be initiated against company directors and officers.*"[13]

In sum, management oversight actors in Turkish legal practice are predominantly the internal auditors, the independent auditors, and the administrative authority, the CMB. The management oversight of listed companies in accordance with TCC and CML constitute oversight in a broader sense. The scope of management oversight also includes, for instance, (i) audit by a specific auditor, as provided for by the TCC; (ii) audits conducted by the Ministry of Finance, regarding constructive dividend payments and money-laundering; (iii) other ministerial assessments on whether companies comply with relative laws, rules and specific provisions of their articles of association; and (iv) certain activities of the Turkish Banking Regulation and Supervision Agency.

1.3. Management oversight narrowly tailored to meet investor expectations

The above-summarized management oversight mechanisms support the functioning of the market. It is important to note that Turkish law on public companies is developing in parallel with European Union law and is on par with the laws of developed countries, at least as far as the protection of shareholders' rights are concerned. However, the current mechanisms remain inadequate in meeting investor needs as they neither deter fraud, nor enable its discovery and disclosure, in a manner that allows investors to effectively use information to reposition their assets. For securities transactions purposes, current mechanisms, in their broader sense, fall short of providing effective management oversight, and need to be

supplemented with additional tools tailored for market dynamics and investor preferences.

At stock exchanges, the creation and fluctuation of share prices are sudden, as market players instantly price-in their expectations. Accordingly, the CMB has mandated the timely, accurate and complete public disclosure of management activities that might create certain expectations and lead to price fluctuations.[14] Despite the CMB's approach, management attempts or acts related to revenue diversion or transfer-pricing are generally undisclosed, violating investors' right to receive timely and accurate information. The discovery of such management conduct through periodical audits carried out afterwards, does not sufficiently address the problem because it obstructs investors' equal opportunity to receive timely, accurate, and complete information. Furthermore, the requirement that the audit findings be represented to those who might have committed the fraud renders oversight less effective. Finally, the election of TCC-mandated auditors by company-affiliated or controlling owners results in the intentional deterioration of the auditors' not-so-minor powers.

Accordingly, from the perspective of globally-dispersed investors, the public companies' management activities that affect share price and dividend profitability should be monitored closely and continuously. Furthermore, such monitoring should provide effective results for shareholders, without hindering the competitive advantage of the company. Therefore, an additional mechanism that shares some commonalities with the current oversight mechanisms, but remains different from them in certain regards, is needed.

2. MANAGEMENT OVERSIGHT MECHANISMS IN THE TURKISH LEGAL SYSTEM

The main mechanisms of management oversight, as envisioned in the Turkish legal system, are as follows:

2.1. Turkish Commercial Code

2.1.1. Provisions regarding management structure: Unitary Board

Under Article 317 of the TCC, the power and the duty to make decisions (in accordance with the directives of the general assembly) regarding company strategies and policies, as well as to execute these decisions rest with the board of directors. In effect, the board acts as both the directing and the executive branch of a company. While under Article 319 of the TCC, executive duties may be delegated to officers or managers, the general Turkish practice has been to join all duties of directors and managers at the board level. Furthermore, this practice has concentrated the three different roles of decision-making, execution, and even

supervision, all in the same organ, the board. Research verifies that most ISE-listed companies demonstrate this type of board structure.[15]

In a majority of ISE-listed companies, which have a low non-affiliate public float, the board consists of the representatives of affiliated shareholders that retain control of the company through either capital or voting power. It is almost impossible to elect representatives of public shareholders to the board. Therefore, activities and operations conducted by the board are shaped by the controlling shareholders' preferences or inclinations despite all oversight mechanisms. However, this poses some dangers: (i) controlling shareholders' management activities may not be monitored closely and contemporaneously; (ii) controlling shareholders' fraud or other violations may not be prevented or stopped; and (iii) such fraud or violation may not be timely reported to the related authorities or disclosed to the public.

2.1.2. Provisions regarding management oversight: Mandatory internal auditor and special auditor

The TCC envisions a mandatory internal audit system for the monitoring and oversight of a company's business and activities; no independent audit mechanism is provided for in the TCC.[16] The mandatory audit may be carried out by a single auditor or a panel of auditors, who are elected and terminated by the general assembly. A director or a close family member of a director may not be elected as an auditor.

Under Article 353, the general duties and responsibilities of the auditors are specified as follows:

- To decide on the format and structure of company balance sheets, in cooperation with board members;
- To obtain information regarding company transactions, and to examine books and records of the company, at least once every six months, to ensure proper bookkeeping;
- To conduct frequent (at least once every three months) and unannounced inspections at the company cashier's office;
- To investigate and note any mortgages or pledges in the company books or records, as well as to determine the existence of any negotiable instruments kept in the company cashier's office, at least once every month;
- To determine whether the conditions for attending the general annual meeting, as specified in the articles of association, have been met by the shareholders;
- To inspect the budget and the balance sheet;
- To oversee the liquidation of the company;

- To call shareholders to a general or special shareholders' meeting, in case of board inaction or neglect;
- To attend the annual general meeting; and
- To monitor board compliance with the law and the specific provisions of the articles of association.

In addition to the above-stated general duties and responsibilities, the auditors have the following duties, in accordance with Articles 354-357:

- To report yearly to the general assembly, as well as to render an opinion on the company, its financials, and the board's dividend policy suggestion;[17]
- To call a special meeting, if certain urgent circumstances arise;[18]
- To review shareholder complaints regarding directors and officers;[19] to include any actual problems in the yearly report submitted to the general assembly; and in some cases, to call a special shareholders' meeting, if the source of discovery was a minority shareholder complaint;
- To attend board of directors' meetings (without taking part in discussions or voting) and to cause certain issues to be included in the agenda of the board meeting as well as of the general annual meeting.[20]

The auditors are under a duty to report any fraud or violation of law or provisions of the articles of association to the related company office or authority, and also to the chairman of the board. In significant cases, the auditors are under a further duty to report such conduct to the general assembly.[21] The auditors are liable for any damage caused by the incomplete rendering of their duties, unless they can prove they were not negligent.[22]

In addition to the mandatory internal auditor, the TCC envisions a "special auditor" mechanism for the investigation of certain issues, such as those related to the abuse of management power or substantial violations of law or provisions of the articles of association.[23] This opportunity may be viewed, especially by minority shareholders, as an important means to protect their rights and interests, since it allows the general assembly to request the special auditor to investigate such issues.

It is important to note that the powers of TCC-auditors are wide-ranging. Even the power to monitor board compliance with the law and the specific provisions of the articles of association, alone, demonstrates this fact. Furthermore, the auditors must investigate the complaints of shareholders regarding directors and officers.[24] However, since the results of such investigations are documented in an annual report submitted to the general assembly,[25] they fall short of timely and effectively protecting shareholder rights and interests. In addition, the reporting of audit results to the chairman of the board carries the risk that discovery of fraud or non-compliance is simply reported to the individuals engaged in such activity; and that

the audit is rendered without effect. The requirement to report to the general assembly does not provide for much support due to the fact that auditors are elected by the controlling shareholders. As a result, the auditor system, as envisioned by the TCC, has not delivered the benefits expected from it.

2.2. Draft Commercial Code

As the TCC has become outdated and increasingly inadequate in meeting the current needs in company law, the Turkish legislator has prepared a Draft Commercial Code, to replace the TCC currently in effect. The Draft code, currently awaiting legislative approval, puts forth a series of developments in the area of company law, bringing Turkish and EU law closer. In addition, the Draft Code, if approved, codifies several corporate governance notions and principles. The specific provisions of the Draft Code, related to management and management oversight, may be stated as follows:

2.2.1. Provisions regarding management structure

The Draft Code provisions regarding the management structure of a company may be analyzed in three sections.

2.2.1.1. Separation of board and management

The most striking provisions of the Draft Code regarding management structure are Articles 367 and 374, providing for a unitary board, but a separation of board and management, similar to the US governance system. According to these provisions, the board may delegate, in part of in full, the day-to-day management of a company, as well as the execution of some board decisions, to a number of directors or to non-director third parties. However, in the absence of any delegation, the board remains responsible for management.[26] In any case, under Article 365, the board is responsible for management, whether or not a delegation has been made. Two conclusions may be drawn from these provisions: First, the board of directors is ultimately empowered and liable for the management of the company. Two, despite a possible separation of management from the board, the Draft Code remains inadequate in ensuring effective shareholder control of management activities.

2.2.1.2. Representation of minority shareholders

Article 360 states that, if articles of association permit, specified classes of shareholders, specified groups of shareholders or minority shareholders (as defined in the law) may have the right to be represented on the board. Furthermore, Article 360 states that directors may be elected directly from the above-stated shareholders, or from a group of candidates nominated by such shareholders. If the articles of association provide such a right, then the election of a director from such

shareholders or their nominees may only be refused with just cause. The Article further explains that the number of directors elected in such a manner may not exceed two-thirds of the board.

The non-controlling, public shareholders' right to be elected appears, on its face, to support shareholder democracy and profitability. However, it entails some problems: First, the representation right provided by Article 360 may lead to confusion as it may be deemed as a privilege, given to all groups of shareholders, including minorities. Second, the vagueness of the term "just cause" may lead to disputes. Third, the possibility that certain non-controlling groups may acquire a two-thirds-seat at the board may endanger main shareholders' interests. All of these potential problems may, in the end, harm the competitive advantage of a company and decrease its commercial profitability. In conclusion, it is unclear how Article 360 may contribute to shareholder oversight of management.

2.2.1.3. Risk detection committee

Under Article 378, it is mandatory for publicly traded company boards to have an expert committee for the purpose of early detection and prevention of any risks that may endanger the existence, the continuation and the development of the company. The risk detection committee must report to the board once every two months.

It is inarguable that risk management has become increasingly important on a global level and that almost all legal systems and market players, especially financial institutions, have been paying more attention to the issue. This trend is also reflected in the Draft Code, as for the first time in the Turkish legal system, a corporate governance principle regarding risk management is offered to be codified and mandated at a board level. However, risk management is not an area of oversight; on the contrary, it is an area of management. Risk, a notion which defines the nature of commerce and serves as the building block of corporate entities, should not be managed by auditors or monitors; it should be managed by directors or executives. Therefore, it is unclear whether shifting the role of risk management from the board or management to a committee would lead to effective results. In any case, since the risk detection committee, as envisioned in the Draft Code, reports to the board, it may not succeed in achieving the desired outcome in management oversight.

2.2.2. Provisions regarding management oversight: Independent auditor

The Draft Code, eliminating the outdated internal auditor mechanism mandated by the current Commercial Code, envisions an external auditor mechanism, whereby an independent auditor must audit joint stock companies, in accordance with international auditing standards.[27] The Draft Code envisions three types of auditors

who inspect (i) a company's financial records, inventory and accounting; (ii) fundamental corporate events or changes, such as incorporation, recapitalization, corporate combinations, and public offering or sale of corporate securities; and (iii) specific fraud or non-compliance issues.[28]

Under Article 398 of the Draft Code, an audit is based on the financial statements of a company[29] and includes the inspection of the following: (i) annual reports and financial statements of the company; (ii) annual board reports; (iii) internal accounting controls and risk detection committee reports. Accordingly, the auditor prepares several post-audit reports, to be submitted to the board: First, it prepares a report based on the financial statements of a company. The report compares the current financial statements with the previous years' statements. Second, it prepares a comparative report regarding the board reports and the financial statements. Third, the auditor reports its findings regarding risk management, if any.[30]

The general assembly may take various actions following the submission of the auditor's written opinion: If the auditor renders a positive opinion, the general assembly may vote freely on the issues of annual financial statements and the use of profits and losses. If the auditor renders a limited positive opinion, the opinion is still deemed positive; however, the general assembly may only vote after the financial statements are corrected. If the auditor renders a negative opinion, the shareholders may not take any decisions based on the financials and the board must resign thereafter.[31] The non-rendering of an audit opinion is interpreted as a negative opinion, and brings about the same consequences.[32]

Independent auditing is an important oversight tool for investors as it allows for compliance control of as well as for an assessment of whether the assets, profitability and the financial situation of the company are truly and accurately represented.[33] However, it is essentially a periodical review. Therefore, it is inadequate in preventing fraud or non-compliance, or in timely warning the investors about such conduct. Referring to the language of the Draft Code, an audit provides a "picture" after-the-fact and reflects on whether or not the situation of the company has been honestly portrayed.[34] Finally, it is not clear whether an audit of internal controls and the creation of the risk detection committee, as prescribed by Article 398(4), involve a substantive oversight of company risks or problems, or simply a procedural review of these mechanisms.

2.3. Capital Market Law

The CML of 1981, relatively more recent than the TCC, includes some provisions regarding management oversight, although it is incomplete when compared with the developed countries' securities laws. Therefore, the Law is supplemented with the CMB *Communiqués*, which expand in parallel with the securities jurisprudence of developed countries.

2.3.1. Provisions regarding management structure

The CML does not entail any rules on management structure as far as oversight is concerned. Under Turkish law, except for banking companies, public companies are formed in accordance with the TCC. The separation of management from the board, as contained in the EU and Anglo-Saxon systems, as well as the OECD Principles of Corporate Governance,[35] has not been reflected in the CML. However, as discussed below, these developments have been incorporated in the Draft CML and the CMB's published Principles of Corporate Governance.[36] The CML in force entails provisions mostly regarding management oversight and protection of investors' rights.

The only important mechanism regarding management structure, the audit committee, is incorporated into Turkish securities jurisprudence through the *Communiqué* series X, no. 22, which mandates audit committees for publicly traded companies.[37] Committee members are elected from and serve on the board; either most or all of the members must be non-executive or non-delegated directors. The audit committee is responsible for the oversight and the efficacy of the company's accounting methods, public disclosures of financial information, independent audits and internal controls. Moreover, the committee plays an important role in the selection and oversight of independent audit firms.

However, the audit committee, which has important responsibilities from the perspective of management oversight, reports periodically to the board of directors. The committee meets at least four times annually and submits a meeting record, along with any findings or recommendations to the very board it is under a duty to monitor and oversee. Furthermore, the committee members are elected by the board. Due these factors, the committee may not adequately serve as a shareholder tool for close control of management and most audit committees are created simply for compliance purposes.

2.3.2. Provisions regarding management oversight

Provisions regarding management oversight may be classified in three groups: Provisions regarding independent audit, the CMB's enforcement powers and recourse for shareholders.

2.3.2.1. Independent audit

The independent audit mechanism, not envisioned in the TCC, was introduced into the Turkish legal system and mandated by the CML and related regulations for all publicly held and listed companies.

The *Communiqué* regarding independent audit defines "independent audit" as the inspection, review, and reporting of whether a company's annual financial documents or other information, which is to be disclosed to public or requested by the CMB, are accurate and comply with the financial reporting standards.[38] According to the definition, the audit is to be conducted my means of reviewing the "books, records and documents of the company".[39] Also according to the *Communiqué*, the purpose of an independent audit is to enable an independent opinion on the issue of whether company financials truly and accurately represent the company's financial situation in all material respects.[40]

In the Turkish legal system, an independent audit is conducted in accordance with International Standards on Auditing. Accordingly, the scope of an audit covers public disclosures of whether risks, affecting financials,[41] have been represented; as well as inspection of any fraud or non-compliance, specifically intentional and illegal conduct of management, such as tunneling or revenue diversion.[42]

Under article 16 of the CML,

> "*issuers and capital market institutions shall have the financial statements which are identified by the [Capital Market] Board audited by independent auditing firms, . . . with respect to the compliance with the principle of fair reflection of the accuracy and reality of information.*"

Communiqués X(22) and (XI)1 contain detailed information regarding accounting standards and independent auditing. Accordingly, auditing serves to explain, through a periodic report prepared by an independent auditor, whether the company accurately and truthfully reflects the "general financial situation" and the "business results" of the company. However, it does not serve to prevent or to disclose immediately, board conduct that may cause a price change.

Turkish securities law, while having detailed regulation regarding auditing, fails to provide an adequate tool which enable the shareholders to timely learn about or deter fraudulent conduct that may decrease share prices or dividend payments and to switch positions.

Independent audit, carried out by means of document review, focuses on whether the accounting entries have been accurately reflected on financial records. However, as widely known, it is possible in practice, to properly document constructive payment or transfer-pricing transactions. It is becoming increasingly difficult to uncover bad-faith conduct, given the expanding range and complexity of financial instruments, as also acknowledged by *Communiqué* X(22).

Accordingly, the *Communiqué* states, for instance that (i) it is rather difficult to uncover any abuse of company assets as such as it may be well disguised;[43] (ii) there

is a higher probability that fraud or non-compliance of management will remain undiscovered, when compared with similar conduct of company officers or employees;[44] (iii) independent auditing may not be expected to uncover all securities violations;[45] (iv) independent audit carries an inherent risk that substantial wrongdoings will remain undiscovered;[46] (v) an independent auditor may not be responsible for the prevention of wrongdoings and violations, but may only serve as a deterrent.[47] Such language demonstrates that, due to the complexity and difficulty of the subject matter, a review of financial statements may not completely and adequately meet investor expectations.

In addition, independent audit is conducted periodically, and audit findings are revealed after the audit is complete. In effect, an audit is a snap-shot of a period in a company. It reveals what has happened during that period, but not at the time of the occurrence of the events. This time lapse causes investors to received delayed information. Furthermore, an independent auditor is not under a duty to further investigate company financials after it has submitted its audit report. The auditor is only under a duty to discuss with management (or board) and take necessary precautions which could materially affect financials before the date of their publication.[48] Therefore, periodic auditing and related measures fall short of investor expectations regarding timely receipt of sufficient information.

In conclusion, any findings of fraud or wrongdoing, even if eventually causing irreparable damage to investors, must first be disclosed to and discussed with company authorities. However, such an obligation enables those who engage in fraud or wrongdoing through meticulous methods to abuse even the best-devised financial audit or oversight mechanisms, as demonstrated by the recent developments such as Enron, Parmalat.[49]

2.3.2.2. The CMB's intervention and enforcement powers

Article 22 of the CML confers to the CMB, the regulatory and supervisory capital market authority, a wide range of duties and powers, including the power conduct inquiries regarding public company activities – certainly, management activities – and compliance with securities laws and regulations. For example, the CMB may request from a company any financial statements, reports and other documents, in addition to those already required to be submitted to the CMB. If deemed necessary, the CMB may request additional reports from the internal company auditor or its independent auditor.[50] Furthermore, the CMB may request from the company and its subsidiaries any information deemed to be related to securities laws and regulations, as well as request and investigate any books, records financial statements or documents of the company and its subsidiaries. After reviewing such documents or conducting any other inquiries stated in Article 22, the CMB may take any of the measures – some very effective – listed in Article 46. For instance, the CMB may

- file an annulment suit (with an injunction request) regarding any board decision abusing corporate powers;[51]
- request the annulment of corporate transactions that lead to loss of capital and that are contrary to law, the provisions of the articles of incorporation or the business purpose or scope of the company; request from the related parties that measures be taken to cure such problems; and if necessary, report such problems or non-compliance to the related authorities;[52]
- order the disclosure of transactions regarding constructive payments or revenue-diverting schemes to shareholders;[53] and
- order the public disclosure of all company information that should have been disclosed.[54]

As for publicly traded capital market institutions, such as listed trading intermediaries, brokerage houses, investment funds, and clearing houses, the CMB may, in addition, take the following measures in accordance with Article 46:

- order that alleged violations of securities laws and provisions of articles of association be cured; if necessary, halt trading or other securities activities of such institutions temporarily or permanently; and revoke their trading and securities licenses or permits;[55]
- order measures to strengthen the materially weak financial situation of such institutions; if deemed necessary, take related measures *ex officio*; halt their trading or other securities activities, temporarily or permanently; and revoke their trading and securities licenses or permits; initiate bankruptcy proceedings;[56] and
- in certain cases, also initiate bankruptcy proceedings for the directors and certain individual owners of these institutions.[57]

One of the most important provisions regarding the protection of shareholders' rights and interests, as well as the prevention of illegal management conduct, is Article 15 on constructive dividend payments. Article 47 attaches criminal liability for engaging in constructive dividend payments, which may be defined as diminishing profits or assets of a public company through deceitful transactions with another enterprise or individual with whom there is a direct or indirect relationship. In such cases, the CMB makes inquiries, either *ex officio* or based on complaints received. If the CMB determines that there has been a violation of Article 15, it may either order disgorgement of profits, or convey the violation to the related judicial authorities.

The CML imposes criminal liability for certain conduct such as (i) insider trading, (ii) manipulation of share prices, (iii) constructive dividend payments, and (iv) omission of, dissemination of, reporting or commenting on, false or misleading

information that may affect share prices.[58] Under Article 47 (A), such conduct is punishable by imprisonment and heavy fines. Moreover, under Article 47(B), conduct such as (i) intentionally preparing or enabling the preparation of false or misleading independent audit reports; (ii) failure or refusal to submit certain documents or information; (iii) keeping false or misleading records; and (iv) engaging in accounting fraud are criminal offenses punishable by imprisonment and heavy fines. The CMB does not have jurisdiction to commence a criminal action, but must refer to government prosecutors to initiate criminal proceedings. Finally, administrative monetary fines are imposed directly by the CMB in cases where publicly traded companies violate the CMB's regulations, standards, forms, and general or specific opinion-decisions.[59]

All of these demonstrate that the CMB is empowered to engage in an extensive and detailed oversight of publicly- traded companies. The enforcement mechanisms conferred to the CMB, as well as the civil and criminal liabilities put forth in the Law, are far-reaching, effective and of a deterring nature.

However, the CMB inquiries conducted periodically and through document review prevent investors to take timely precautions since the inquiries take place after-the fact. In addition, the broad and complex corporate structure of parent and subsidiary companies, all within the scope of CMB's investigative jurisdiction, hinder the CMB's ability to carry out effective investigations. Finally, a public company challenge of a CMB enforcement measure may take years to finalize in court, a duration which conflicts with the requirements and the nature of quick asset repositioning. In conclusion, the CMB's powers of enforcement do not adequately address the issue of effective management oversight.

2.3.2.3. Recourse for shareholders

In addition to granting the CMB a wide range of enforcement tools which can be applied *ex officio* or through individual complaints, the CML has also allowed shareholders a certain recourse mechanism. Compared to the TCC, which defines minority shareholders as 10% of all shareholders, the CML sets the threshold for minority status at 5%; therefore enabling the use of minority rights, made available to shareholders by the TCC, for a broader number of investors.

Minority shareholders may make use of the following rights, in accordance with the 5% threshold:

- To demand the commencement of a lawsuit against board members;[60]
- To demand the appointment of a "special auditor" to review alleged violations of law, specific provisions of the articles of association, or abuse of management power;[61]

- To make a complaint to the auditor, regarding directors or officers; and if certain conditions are satisfied, to call a special meeting, via the auditor;[62]
- To call a special meeting, via the board, and have related items incorporated in the agenda;[63]
- To stay annual general meeting discussions on the approval of the balance sheet.[64]

In conclusion, all of the above-explained mechanisms fall short of preventing bad-faith management activities from damaging investors' market-oriented rights.

2.4. Draft Capital Market Law

2.4.1. Provisions regarding management structure

The Draft Law contains some noteworthy developments regarding management oversight, one of which is the change in the board elections procedure of companies with registered capital. Accordingly, in such companies, the privilege to nominate a member to the board may only be used in elections of at most one-thirds of the board.[65] In other words, if the Draft Law is enacted, regardless of the percentage of public or private ownership, two-thirds of the boards will be elected by shares without the privilege.

2.4.2. Provisions regarding management oversight

Another important development contained in the Draft CML regarding management oversight is Article 21, which along with Article 23, enlarges liability for financial reports. Accordingly, the board is responsible for submitting timely, true and accurate information. The audit firms are jointly and severally liable for any harm caused by misstatement or omissions contained in the reports.

The Draft CML further bolsters the investigation and enforcement powers of the CMB by incorporating into text the powers to (i) review any electronic documents, to conduct searches at the business place of issuers, as well as the residences of certain individuals related to issuers; (ii) request questioning of individuals from government prosecutors; (iii) conduct electronic surveillance, such as wiretapping or bugging; (iv) request, from the court, documents regarding telephones and other communication devices.[66]

The Draft CML broadens the range of Article 46 measures. For instance, the CMB's power to request the annulment of certain corporate transactions, as currently put forth in Article 46(c) of the CML, has been widened. Under Article 61(c) of the Draft Law, corporate transactions that result in the loss of capital may

be the subject of an annulment case if they violate the business purpose or scope of the company.

As for the management oversight of publicly traded capital market institutions, the Draft Law contains some developments, as well. In the current Law, the CMB may, under Article 46, order that alleged violations of securities laws and provisions of articles of association be cured; if necessary, the CMB may halt trading or other securities activities of such institutions temporarily or permanently; and revoke their trading and securities licenses or permits.[67]

Under the Draft Law, the CMB may additionally request, from the local court, (i) the removal of any directors or officers found liable for securities violations, or the revocation of their authority to sign on behalf of the company; (ii) if necessary, change management and oversight bodies of the company; and (iii) the appointment of a director, who has the rights and duties of a director elected by the general assembly of shareholders.[68]

Furthermore, the Draft CML allows the CMB to take similar measures against publicly traded capital market institutions as well as joint stock companies, in cases where a corporate transaction that is beyond the business purpose and scope of the company or the institution has led to the loss of capital or where there has been a violation of the law or the specific provisions of the articles of association.[69]

The Draft CML envisions additional criminal liability for transactions regarding constructive dividend payments, obstruction of inquiries and oversight, false information in company books and records, and certain problems in audit reports.[70] At the same time, however, the Draft Law includes a settlement option: If the individuals liable for such violations deposit, to the Investors' Protection Fund, the profited amount together with treble damages, then the CMB does not request the initiation of criminal proceedings against responsible individuals.[71] The complete amount must be deposited within a month of the profiting and prior to any request for the initiation of criminal proceedings.[72]

Finally, the definitions of "substantive information" ("*nitelikli bilgi*") and "information which may materially affect share price" ("*fiyat üzerinde önemli etki yapabilecek bilgi*"), as contained in Article 3 of the Draft Law, are important developments in strengthening the legal basis of capital markets as well as in underlining the difference of securities laws from other fields. The existence of these definitions proves, in our opinion, the very importance of timely receipt of information by investors. The efficacy of management oversight (achieved either through provisions regarding management structure or directly through provisions regarding management oversight) depends on whether, in the background of sudden price fluctuations, investors receive information in a timely manner. Timely

receipt of information, along with the ability to prevent violations or wrongdoings at the same time, is key for efficiently well-functioning capital markets.

2.5. Corporate Governance Principles of the Capital Market Board

Finally, Corporate Governance Principles of the CMB (the CMB Principles) contain some provisions directly related to management oversight. The CMB Principles, consisting of four sections, prescribe non-mandatory rules for effective corporate governance and aim to enable shareholders to closely monitor management activities. Although adoption of the Principles is currently voluntary, it may likely become mandatory due to rating requirements and the CMB practice and approach. In fact, the text contains rather strong language despite an admission by the CMB that there is more than one correct model of corporate governance.[73]

2.5.1. Provisions regarding management structure

First, the CMB Principles are the first set of rules in Turkish Law to separate the board of directors from management or "executives" as is termed in the Principles. Accordingly, the Principles view the board as the ultimate decision-maker and representative of a company,[74] while deeming the executives as individuals responsible for ensuring that "*the company conducts its business within the framework of its mission, vision, goals, strategies and policies*" as set out by the board.[75] In contradictory language, however, the board is also defined as the ultimate executive body of the company.[76] In addition, the board is also responsible for close monitoring and supervision of company operations.[77] In conclusion, the board appears to be responsible for decision making, execution and supervision.

The CMB Principles envision an "independent director" mechanism, appearing to accept *a priori* that independent directors are in a position to make objective decisions regarding the company and also to prioritize shareholders' rights and interests above all else. The Principles recommend that at least one-thirds of the board (and at least two members) consists of independent directors,[78] with a suggestion that the number of independents may be increased in the future. Criteria for independence and other additional conditions for elections are specifically pointed out.[79]

In addition, the Principles make a distinction between executive and non-executive members and recommend that the majority of the board should consist of non-executive members.[80] However, the efficacy of this distinction and of the recommendation that a commercial business be run by elected individuals not bearing the risk of the business is debatable. Moreover, it is difficult to ascertain the theoretical or practical basis for a ratio of independents and non-executives to non-independents or executives. Accordingly, we are of the opinion that the utilization

of "independent" or "non-executive" member mechanisms do not necessarily lead to healthy governance or the effective protection of shareholder rights.

Moreover, the Principles envision several board committees, such as the audit committee, corporate governance committee, strategic planning committee, human resources committee, remuneration committee, conciliation committee, and ethics committee. It is recommended that all committee members are elected from independent members and that a majority comes from non-executive directors. The audit committee is among the most important committees recommended by the Principles and is also mandated by a CMB *Communiqué*. While the audit committee seems to have a powerful and important role in the vigorous oversight of a company's financial and operational activities, it is difficult to argue that it effectively enables minority or non-affiliated shareholders to closely monitor management activities since the committee meets only four times a year and reports directly to the board.[81]

2.5.2. Provisions regarding management oversight

An interesting provision contained in the Principles is the recommendation that "the agenda items should be discussed openly and thoroughly in board meetings."[82] The recommendation continues to state that "should a member of the board has a dissenting opinion, he/she should append the reasonable and detailed dissenting opinion to the records of the meeting and inform the company's auditors in writing."[83] Here, the Principles, with a strong tone, aim to take a further step than Article 338 of the TCC regarding non-liability of directors: The recommendation that any opposition and dissenting vote by an independent member at a board meeting should be disclosed in reasonable detail to the public aims to serve as a deterrent and as a disseminator of information.

The public disclosure and transparency recommendations, contained in Section II of the Principles, regarding a wide range of disclosures of the relationships between the company and its shareholders, the board and management, serve the same purpose. This is particularly true of the recommendations contained in Section II, Articles 2.3-2.5, regarding transactions of board members, executives and shareholders who directly or indirectly own at least 5% of the company capital. In accordance with the specific provisions, such individuals should immediately disclose to public (i) all transactions performed on company's securities; (ii) information about the purchase and sales of securities of other group companies or any other company with whom the company maintains a material commercial relationship; (iii) commercial and non-commercial transactions between the company and companies, where such individuals possess at least 5% and more of the shares or the control of the latter. These recommendations take into account that events which may guide securities transactions are closely related to board

decisions and activities; and accordingly, the recommendations enable investors to observe their investments as well as serve as an important deterrent.

Finally, the Principles support the protection of shareholder rights indirectly through the use of minority rights. The Principles define a minority as "less than 20% of the company's capital";[84] and therefore, reduce the above-analyzed CMB and TCC requirements for recourse by private individuals.

3. MANAGEMENT OVERSIGHT MECHANISMS IN INTERNATIONAL LEGAL SYSTEMS

3.1. MAIN MECHANISMS OF MANAGEMENT OVERSIGHT

3.1.1. Anglo-Saxon System: United States Framework

Unlike the Turkish capital market, the Anglo-Saxon markets are characterized by a large number of public companies with a high non-affiliated public float, in addition to strong secondary markets, effective regulation and enforcement. The shareholders of public companies are usually dispersed and own a small percentage of the company.

3.1.1.1. Unitary Board

In the United States, substantive governance of a company has generally been the subject of state corporate law. Under Delaware and other state laws, corporate powers are vested with the board of directors, who perform their duties to primarily advance shareholders' economic interests. Accordingly, the board of directors is elected by shareholders.

In practice, the board delegates much of its authority regarding the day-to-day business of the company to management, which is selected by and reports periodically to the board. The board focuses on the oversight of management while remaining ultimately liable for the management of the company.[85] Consequently in the unitary system, the board has two roles: (i) a management role, from a liability perspective; and (ii) an oversight role, from a practical perspective.

Additionally, the board serves as a bridge between management, which runs the company, and shareholders, who ultimately own the company. The separation of ownership from control, however, creates an agency problem and a risk that shareholder capital may be expropriated or wasted by ineffective or subjective management. Therefore, in the unitary system, the board addresses agency costs by overseeing management on behalf of the shareholders.

For effective oversight, a board must be engaged and knowledgeable about the operations and the business of the company. However in practice, the board relies on management to receive accurate, timely and sufficient information regarding company operations and financials. Furthermore, in many companies, the chief executive officer (CEO) serves also as the chairman of the board, a position which enables the CEO, if willing, to misguide the remaining board members on the company performance and consequently, inflate the stock price to extract personal monetary gains from the company.

The reliance of the board on management was one of the reasons why the Enron-like scandals occurred. For example, the misuse of markt-to-marketing accounting and the special purpose entities allowed Enron management to inflate earnings and consequently, the stock price.[86] The management, not properly monitored by the board, substantially profited from this practice; however, eventually led to the downfall of the company, as well as the erosion of investments.

In a more recent case, management actions not sufficiently monitored by the board decreased shareholder value greatly. The Disney Corporation paid $ 140 million to its ex-president as a result of a no-fault termination of employment contract. Some shareholder alleged, in a lawsuit, that the board did not adequately review the employment contract when CEO – Chairman, hired the president; and that such inadequate review constituted a failure of management oversight. However, the court held that even though the board's over-reliance on the CEO – Chairman fell significantly short of corporate governance best practices, it was within the limits of state corporate law.[87] In other words, the court implicitly acknowledged the limits of state corporate law in the area of management oversight, specifically regarding the board – management relationship.

3.1.1.2. Independent Audit

Independent audit is another mechanism of management oversight in public companies. Its main function is to measure performance of a company by auditing its financials and preparing an independent report regarding its financial health.

However, the independent audit mechanism has proven inadequate in the area of management oversight (at least, in the pre-Sarbanes-Oxley period) due to a pervasive conflict of interest: The auditors that were hired by the company to conduct an independent audit were also providing consulting services to the same company. Therefore, the audit companies were discouraged from conducting a tough audit on their clients who could, given a negative audit result, direct their consulting business elsewhere. For example, at Arthur Andersen, second guessing Enron would have jeopardized a multi-million consulting business.[88]

3.1.2. Continental European System: European Union Framework

Compared to the Anglo-Saxon markets, the ownership structure in the Continental European markets are more concentrated, and major banks play a dominant role in providing capital to public companies, by way of credit or share purchase.[89] The Continental European corporate model is a social one, focusing not only on shareholders, but also on other constituencies, such as companies' creditors, employees, suppliers, consumers and tax authorities, who are represented on the boards.[90]

3.1.2.1. Dual Board

Company laws in many Continental European countries envision a dual board structure with a supervision board of non-executive (or on-management) directors, and a management board of executive (or management) directors. The supervision board oversees the management board, which is responsible for the company's day-to-day operations. Supervisory directors are elected generally by shareholders, while managing directors are appointed by the supervision board.

This dual board system is also present in the German system, where the supervision board, the *Aufsichtsrat*, is mainly responsible for the appointment and oversight of the management board; and the management board, the *Vorstand*, is responsible for the management of the company.[91] The management board regularly reports to the supervision board with regard to current business operations and planning. The supervision board may also request special reports from the management board at any time. The supervisory directors may neither serve in the management, nor exercise any management powers.[92] In other words, supervisory directors are non-executive directors, by definition. Supervisory directors are elected by the shareholders and constituencies.[93] Specifically, pursuant to the Co-Determination Act, which gives employees half the board seats and a key role in strategic decisions, supervisory directors are elected by the shareholders and company employees in Germany.

The dual board system appears, at first, to be an effective management oversight mechanism since it may assert more influence on management. However, it is not without disadvantages. First, until recently, a supervision board position was largely an honorary position and long-time management members could expect to be automatically nominated and elected without opposition.[94] Second, the representation of non-shareholder constituencies, such as employees, may result in the inadequate focus on the interests of shareholders, the true bearers of risk.[95] Furthermore, the large size of the boards, generally consisting of 20 members, 10 of whom are employee representatives, do not always lead to effective discussions.[96]

These criticisms were proven true in the Holzmann case, in 1999, when the leading German construction company failed due to a lack of management supervision, only to be rescued with a substantial governmental package. In the 1999 Vodafone take-over of Mannesmann, it was argued that focus on non-shareholder constituencies eventually led to the shareholders' choice towards an Anglo-Saxon approach of corporate governance.[97] In a more recent case in 2007, the Siemens CEO was ousted due to alleged bribery problems. However, the opinion voiced by some executives in the German market suggests that the CEO has been ousted in efforts led by the domineering chairman of the company; and that the CEO was well-respected by the investors since he increased profits and shareholder value and was not implicated in the alleged bribery.[98]

3.1.2.2. Statutory Audit

Some Continental European countries, including Germany, envision both an internal and an external audit system. Generally, the internal auditor is appointed by the shareholders and investigates whether a company's financial documents comply with the laws, the articles of association and general rules.[99] However, the statutory or external auditor ("the independent auditor" in the US) is the more important aspect of the audit mechanism from a management oversight perspective.

The statutory audit system was supported (until it was repealed in 2006) by the 8th Council Directive.[100] While the 8th Directive detailed various aspects of auditing such as rules of approval, examinations and practical training of auditors, it failed to construct an effective notion of auditor independence that could adequately prevent conflicts of interest between auditors and the audited companies.[101] Consequently, the conflict of interest problems then prevalent in the US audit sector also became visible in the EU. For instance, the 2003 collapse of Parmalat, a giant Italian dairy and food company, dominated by its founding family, revealed massive accounting irregularities leading to a multi-billion euro fraud.

The shortcomings in the above-mentioned models came sharply into focus with the turmoil that began with Enron and Parmalat and set-off a search to find a better corporate governance framework with a more efficient management oversight model.

3.2. RE-EMERGENCE OF CORPORATE GOVERNANCE AND POST-ENRON/PARMALAT DEVELOPMENTS IN THE AREA OF MANAGEMENT OVERSIGHT

3.2.1. Globally: OECD Principles of Corporate Governance

An institutional guidance to the global search for effective governance and management oversight was provided by the OECD Principles of Corporate

Governance, which were endorsed in 1999 (later revised in 2004) and have since become an international benchmark for governments, investors and companies. The OECD Principles were intended to assist governments in their efforts to evaluate and improve the legal, institutional and regulatory framework for corporate governance in their countries, and to provide guidance and suggestions for stock exchanges, investors, companies.

Primarily, the OECD Principles recognize shareholders' right to obtain relevant and material company information on a timely and regular basis.[102] Furthermore, the Principles put forth, in section V, that the corporate governance framework should ensure timely and accurate disclosure on material information regarding the company. Specifically, the Principles state that (i) "information should be prepared and disclosed in accordance with high quality standards of accounting" and (ii) "an annual audit should be conducted by an independent, competent and qualified, auditor in order to provide an external and objective assurance to the board and shareholders that the financial statements fairly represent the financial position and performance of the company in all material respects."[103]

The Principles recommend, in section VI, that the board ensure (i) the effective oversight of management; as well as (ii) the integrity of the company's accounting and financial reporting systems, including the independent audit and the internal control systems. Furthermore, the Principles suggest that the board exercise independent judgment on corporate affairs, by assigning a sufficient number of non-executive board members. The rationale behind the suggestion is to enable the board to objectively carry out its oversight duty, prevent conflicts of interest and balance competing demands on the company.

3.2.2. The United States

The OECD Principles have been utilized in the US towards the goal of achieving a more effective corporate governance framework and, consequently, better management oversight. The best-practice recommendations of the Business Round Table, titled Principles of Corporate Governance, are an example of such efforts. However, it was the Enron-era scandals which brought about the most visible changes in the US legal system – the Sarbanes-Oxley Act.

3.2.2.1. Sarbanes-Oxley Act

The Sarbanes-Oxley Act of 2002[104] was adopted in the wake of corporate failures such as Enron, World Com, Adelphia, and various others. The Act focuses on establishing an independent accounting industry and redefining the responsibility of corporate executives, with the aim of increasing the quality of disclosure in public companies and achieving transparency.

The important difference of the Sarbanes-Oxley from previous securities legislation is that it also covers the field of state corporate law. Generally securities laws, as federal laws, regulate periodic reporting and disclosure, whereas state law focuses on the substantive governance of a company, in particular, on the relations among shareholders, managers and directors. Sarbanes-Oxley goes further than regulating reporting or disclosure; it mandates important structural corporate changes. However, the efficacy of the Act remains rather uncertain.

(a) Management certification

Under Section 302 of the Act, the chief executive officers (CEOs) and chief financial officers (CFOs) must certify annual or quarterly securities filings, stating that the filings fairly represent the financial situation of the company. Under Section 304(a), the CEO and the CFO forfeit to the company a certain part of their earnings if a restatement is later required.

The management must discuss and review certain reports with the audit committee, in other words, report to the audit committee, prior to certification. Section 302 and the related provisions may be a useful oversight tool in cases where corporate fraud or non-compliance stems from management and where the board is engaged and knowledgeable enough to determine the specifics of potential wrongdoings. However, in cases where the board still relies heavily on management for information, this rule may prove to have little effect. Another shortcoming of this mechanism is the time-lag problem since material information which may affect the share price only reaches the investor only periodically, through securities filings, and not instantaneously.

(b) Audit Committee

Sarbanes-Oxley mandates, in Section 301(2), that public companies establish independent audit committees responsible for "the appointment, compensation, and oversight of the work" of their independent auditors. Section 301 requires further that all members of the audit committee be independent and defines independence as "directors who do not accept any consulting, advisory or other compensatory fee and who are not affiliated persons of the corporate group." Moreover, under Section 202, to prevent conflicts of interest between the auditor and the company, the audit committee is required to pre-approve audit and permissible non-audit services.

Here, the Act presumes that an all independent committee will have the most objective and informed judgment regarding the performance of the company. However, independence by itself may not insure accurate and timely disclosure, as discussed below. Moreover, the audit committee reports periodically to the board

of directors. Therefore, the results of a committee oversight may still be filtered through the board.

(c) Public Accounting Oversight Board

As a reaction to the conflict of interest problems between auditors and companies, the Act establishes a new Public Accounting Oversight Board (PCAOB) and partially leads away from the self-regulatory culture of the accounting profession. The Act sets out the duties and the conditions for membership to the PCAOB and authorizes it to establish auditing, quality control, and independence standards and rules. Only an audit firm registered with the PCAOB may prepare an audit report for companies.[105]

(d) Independent audit mechanism

In addition to the creation of the PCAOB, the Act makes adjustments in the independent audit mechanism. First, it requires that the auditor of a company to refrain from providing non-audit services to the same company, for the duration of the audit. This requirement aims to neutralize the auditors and to shield them from the pressure of creating additional business with the very client they are auditing. Non-audit services are defined broadly and include the following: (1) bookkeeping or other services related to the accounting records or financial statements of the audit client; (2) financial information systems design and implementation; (3) appraisal or valuation services, fairness opinions; (4) actuarial services; (5) internal audit outsourcing services; (6) management functions or human resources; (7) broker or dealer, investment adviser, or investment banking services; and (8) legal services and expert services unrelated to the audit.[106]

Second, the Act requires that company's financial reports reflect all material adjustments identified by the auditor; and that the companies disclose off-balance sheet transactions and whether they have adopted a code of ethics for senior financial officers.[107] This requirement is tailored to prevent Enron-type manipulation of company financials and inflation of the stock price.

Third, the Act imposes criminal penalties for (i) destruction, alteration, or falsification of records; (ii) defrauding shareholders; (iii) impeding an official proceeding; and (iv) knowingly or willfully signing false certifications of periodic financial reports (imposed on CEOs and CFOs).[108]

While these changes brought about by the Act are welcomed by some, their influence on management oversight remains inconclusive because independent auditors, whether under Sarbanes-Oxley or any other statute, conduct their investigations periodically and by means of document review. Furthermore, the audit results are shared with management. Therefore, regardless of how

independently and objectively the audit may be conducted, it may still fail to prevent or immediately capture revenue diverting schemes of insiders.

(e) Internal Control Mechanism

Under the controversial Section 404 of the Act, management must (1) establish and maintain an adequate internal control structure and procedures for financial reporting and (2) assess the effectiveness of the company's internal controls over financial reporting and include its findings in the annual report. Furthermore, the annual report prepared by the management must be attested to by the independent auditor of the company. Internal control mechanisms are not new in US law, however, the obligation of management to assess and report on internal controls, as well as the obligation of the auditors the attest to such reports, is a change from pre-Sarbanes-Oxley practice.

It is far from clear whether Section 404 controls will provide effective management oversight, mainly because it is management itself, who is responsible for the establishment and the operation of the control mechanism. Section 404 requirements may simply result in more internal bureaucracy or cause companies to only focus on the specifics of compliance required by the Act, ignoring other types of potential misconduct.[109]

Requiring auditor attestation may not be a solution, especially when the auditors report to management, first, regarding what they have uncovered in their review of the internal controls, and then to the audit committee. Eventually, deficiencies or problems discovered in the internal control process are disclosed to public in quarterly or annual reports. However, by that time, the shareholders will have already been adversely and unfairly affected by the fluctuations in the share price and will have missed the opportunity to switch to a more profitable allocation.

In conclusion, while Sarbanes-Oxley may have helped reestablish the faith in the marketplace, it has significantly increased the cost of compliance and encouraged de-listings, especially of smaller and foreign companies.[110] Furthermore, the Act imposes the same internal controls and governance rules on all companies, without any substantive differentiation. The fact that a study has estimated the reduction in investors' overall wealth, due to the enactment of the Act, to be approximately $ 1.4 trillion,[111] demonstrates the seriousness of the Act's potential shortcomings.

3.2.2.2. NYSE Listed Company Manual

Following the enactment of the Sarbanes-Oxley Act and the increasing focus on corporate governance, US stock exchanges also mandated stricter governance and oversight requirements for domestic companies traded on their exchange. The

NYSE Listed Company Manual[112] (or Listing Standards) is an example of such tendency.

(a) Independent Director Mechanism

The independent director trend has characterized the US boards for the past 20 years with an increasing popularity and has been adopted in various statutes, rules and regulations. Different definitions of independence exist; however, the definition commonly excludes employment or other financial relationships with the company. It is believed, at least in theory, that independent directors, relatively free from conflicts of interest with the company, are better able to protect the shareholders' interests by diminishing the information asymmetry between management and shareholders. Furthermore, it is argued that if independent outsiders command a majority in the board, they will have better oversight of management.[113]

Accordingly, the NYSE Listing Standards has recently adopted a more current and tougher independence standard - a majority of independents in the board: Specifically, the Standards define independence as the lack of the following (with a three-year cooling-off period): (i) employment or management relationship with the company; (ii) receipt of more than $100,000 per year from the listed company, other than director fees; (iii) affiliation with or employment by a present or former internal or external auditor of the company; (iv) management relationship or employment in another company that makes payments to, or receives payments from, the listed company for property or services in an amount which exceeds, per year, $1 million or 2% of the other company's revenues.[114]

Comparatively, Britain demonstrated a somewhat parallel trend. For instance, the Combined Code on Corporate Governance,[115] which applies to London Stock Exchange (LSE) - listed companies, recommend that at least half the board, and the chairman, should be independent.[116] However, adopting a more flexible approach from the NYSE Listing Standards, the Combined Code recommends that listed companies either comply with the provisions or explain their non-compliance.

Despite these developments, criticisms of the independent director mechanism abound.[117] First, independence may simply mean indifference,[118] disengagement and lack of attention. The boards of companies such as Enron, Tyco and WorldCom had a significant number of directors who met even the current, tougher independence standards, yet their failures resulted from the disengagement and lack of attention of the board. For example, the Enron's directors, 86% of whom were independent, are faulted for the lack of inquiry and follow up on transactions between the company and senior managers. Similarly, WorldCom directors are faulted for their lack of care in the review of major business decisions involving multi-billion dollar commitments, and for unwillingness to challenge the CEO.

Distinguished, independent, yet socially remote directors may lack the commitment and the relationship to create and promote a constructive dialogue with management on behalf of shareholders.[119]

Second, strict definitions of independence may lead to the conclusion that independence is the "singular director virtue", whereas in reality, boards may be more effective with non-independent directors, who have a business relationship with the company and therefore have established a deeper understanding of the company's business.[120] Third, and as a practical point, private litigation against independent directors is rare, successful litigation is even less likely.[121]

On the other hand, recently, there has been an effort towards empowering shareholders to pressure and influence the company's day-to-day management. Shareholder activists, including public pension funds and labor unions are proposing initiatives to restrict the board's management discretion. Companies such as American International Group Inc., Bristol-Myers Squibb Co., Time Warner Inc., H.J. Heinz Co. have all come under attack of shareholder activists, who are trying to change the business of the company without management agreement. Eventually, all of these companies have been forced to make some changes in their operations and management to appease their dissident shareholders.[122]

Such one effort succeeded in the world's largest media Company, Time Warner Inc. in 2006. A group of investors, owning 3% of the company and led by an activist, attempted to overthrow the company's board and suggest a division of the company's business. While the attempt was not welcome by the management, eventually a settlement was reached and Time Warner appointed new independent board members and found ways to cut costs by $1 billion.[123]

Reviewed from dissident shareholders' perspective, shareholder activism can be very effective; however, it may lead to tension and distrust within the company. Moreover, it may change the dynamics of corporate governance by the introduction of the personal agendas of special-interest shareholders who may not care for the long-term interests of the company and its shareholders as a whole. Shareholder activism dismisses the importance of the oversight function of the board and pays little importance to the fundamental principle that companies are, and must be, risk-taking entrepreneurial entities. [124]

(b) Non-Management Director Mechanism

In addition to the independent director mechanism, the Listing Standards also require that directors who are not in management meet at regular intervals without management.[125] The purpose of the non-management director mechanism is to prevent the board from being unduly influenced by management or manager directors.

The efficacy of this mechanism is also debatable since the non-management director directly reports to the board. If the corporate misconduct is at the board level, then the non-management sessions may prove ineffective. Furthermore, since companies are dynamic risk-taking entities, the ability of non-managers to interfere with management must be carefully balanced to prevent the potentially over-zealous non-managers from impeding unnecessarily with the day-to-day business of the company.[126]

3.2.3. The European Union

3.2.3.1. Action Plan on Company Law and Corporate Governance

In May 2003, the Commission adopted, consistent with the 1999 OECD Principles of Corporate Governance, the Action Plan on Modernizing Company Law and Enhancing Corporate Governance in the European Union with the aims of (i) rebuilding investor confidence in the European markets in the wake of a wave of recent corporate governance scandals; (ii) defining a European corporate governance approach, tailored to Europe's own cultural and business traditions; and (iii) increasing the competitiveness of businesses in the EU.[127]

Accordingly, the Action Plan suggests that shareholders' rights be strengthened through the facilitation of effective shareholder access to information, communication and collective decision-making procedures.[128] Specifically, the Action Plan notes that shareholders (with a certain percentage of ownership in the company) should be granted special investigation rights to ask a court or administrative authority to authorize a special investigation into the affairs of the company.[129]

Moreover, the Action Plan proposes that in key areas where executive directors may have a conflict of interest, decisions should be made exclusively by non-executive, i.e., supervisory directors. However, the Action Plan recognizes that minimum standards of "independence" should be established at EU level. Additionally, the Action Plan recommends that director liability be enhanced through (i) the development of a wrongful trading rule, whereby directors are held personally accountable for certain company failures; and (ii) the imposition of EU-wide directors' disqualification rules in response to misleading financial statements or other misconduct.[130]

Most importantly, the Action Plan advocates, for listed companies, a choice between a unitary board structure, with executive and non-executive directors; and a dual board structure, with a supervision board and a management board.[131] Consequently, the Plan supports the idea of offering additional organizational freedom to listed companies. Organizational freedom, in our opinion, is a vital

aspect of effective oversight since it diversifies capital markets with different companies in which potential shareholders may invest, while bolstering the competition among them.

3.2.3.2. Commission Recommendation 2005/162 on Supervisory Directors

Following the Action Plan, in 2005, the Commission adopted a more specific set of recommendations regarding the non-executive or supervisory directors of listed companies, with the aims of achieving effective management oversight and protecting shareholders' interests. Accordingly, the Recommendation specifies two key responsibilities for the supervision board: (i) to ensure that the financial reports and other related information present an accurate and complete picture of the company's situation; and (ii) to monitor the internal control and external audit procedures, potentially with the help of an audit committee.

(a) Independent director mechanism

The Recommendation adopts the understanding that independent directors, capable of challenging management, may effectively oversee the company as a whole, and therefore serve to protect the interests of shareholders. Independence is broadly defined, in the Recommendation, as the absence of any close ties with the company, its management or controlling shareholders.[132] The determination of what constitutes independence and the issue of how they will be represented on the board is left to the Member States; however, the Recommendation provides some guidance on what constitutes independence.[133]

Specifically, the Recommendation suggests the following to be considered in defining independence: the lack of (i) management or employment position in the company or an associated company (except for cases arising out of workers' representation laws); (ii) receipt of significant remuneration from the company or an associated company, apart from a supervisory directors' fees; (iii) representation of a controlling shareholder; (iv) a significant business relationship with the company or an associated company; (v) ownership of or employment by the present or former statutory auditor of the company or an associated company; (vii) supervisory director position for more than three terms.[134] The term "significant business relationship" is very broad and covers from a wide spectrum, from supply to legal services to contributions.[135]

Different from its US counter-part, the Sarbanes-Oxley Act, the adoption of the Recommendation by the Member States is possible on a comply-or-explain basis. In other words, mandatory rules or legislation are not prescribed. Furthermore, the Recommendation suggests that the Member States should take into account the specific nature of companies allows them to reflect sector or enterprise-specific issues while enabling the market to make an individual assessment of companies. In sum, the Recommendation's flexible approach is a positive development in terms of enhancing competition in the markets

However, according to the Recommendation, the supervision board determines what constitutes independence and whether a particular director meets the criteria laid down at national level as well as criteria based on company-specific facts.[136] Therefore, the independent director mechanism envisioned in the EU framework may be viewed by some as more of a formal rule, rather than a substantive development in the area of management oversight.

(b) Audit committee

The Recommendation focuses also on board committees, specifically on the audit committee whose primary purpose, in terms of internal controls of a company, is to (i) monitor the integrity of financial information provided by the company, in particular by reviewing the relevance and consistency of the accounting methods used; (ii) review the internal control and risk management systems, in order to properly identify, handle and disclose main risks; (iii) ensure the effectiveness of the internal audit system.[137] Moreover, the recommendation defines the role of the audit committee, in terms of external audit, as follows: (i) monitoring the statutory auditor's independence and objectivity, in particular by reviewing the rotation of audit partners and the fees paid by the company; and (ii) keeping the nature and extent of non-audit services under review in order to prevent any material conflicts of interest from arising.[138] Different from the US approach, the Recommendation finds it sufficient that only a majority of audit committee members be independent.[139]

Compared with the Sarbanes-Oxley Act, the new Directive provide for a more flexible approach because it does not require the provision of detailed statements or extensive documentation of detailed controls. This flexibility may provide a cost advantage, as many commentators have expressed: In the words of the European Corporate Governance Forum, "there should be an adequate balance between the benefits of any additional requirements and the costs and other burdens for companies."[140]

However, in practice, the additional costs brought about with the formation and functioning of the audit committees has been the subject of criticism. Furthermore, the structural nature of the audit committee - a board sub-entity that reports ultimately to the board – may limit its oversight role in companies influenced by founding family members or other controlling owners.

3.2.3.3. Directive 2006/43 on Statutory Audits

As the US reacted to Enron and WorldCom, the Commission responded to Parmalat with the repeal of the 8th Council Directive on statutory audits and the adoption of Directive 2006/43 on statutory audits of annual accounts and consolidated accounts in 2006.[141] The purpose of the new Directive is to harmonize the approach to statutory auditing in the EU and to guide Member States to establish a framework for an ethical, independent, confidential and effective auditing mechanism.

Similar to the Sarbanes-Oxley creation of the PCAOB, the Directive calls for the designation, by Member States, of competent authorities responsible for approving statutory auditors and audit firms and subjecting to a system of public oversight. The authority established will be governed by non-practitioners and will be responsible for the oversight of (i) the approval and registration of statutory auditors; (ii) the adoption of professional ethics standards, internal quality control of audit firms and auditing; and (iii) continuing education, quality assurance and investigative and disciplinary systems.[142]

However, the most important provision of the Directive is article 22, regarding the independence and objectivity of the auditor. Accordingly, Member States are required to ensure that the statutory auditor is independent of the audited entity and does not have any direct or indirect financial, business, employment or other relationship with the company. If the statutory auditor's independence is affected by threats, such as self-review, self-interest, advocacy, familiarity or trust or intimidation, the statutory auditor must apply safeguards in order to mitigate those threats. If the auditor's independence is compromised nevertheless, then the auditor must stop carrying out the statutory audit.

Unlike Sarbanes-Oxley, the Directive does not specifically bar the rendering of non-audit services by statutory auditors during an audit. However, the concept of "independence of auditors" is bolstered by the rotation requirement of auditors, specifying rotation with an option to either change the key audit partner dealing with an audited company every five years, or a change of audit firm every seven years. Moreover, auditors' fees may not be influenced or the determined by the provision of additional services to the audited company.

Compared to Sarbanes-Oxley, the new Directive on statutory audits is generally a positive development as it supports the voluntary application of rules instead of imposing strict and mandatory rules on companies. The Directive may be considered as geared towards promoting business and investment, while searching for a balance between binding and non-binding measures. However, while it serves a useful purpose, statutory audit alone may not ensure the most effective management oversight due to the reasons elaborated in the earlier sections.

To summarize, while all of these developments have addressed, to some extent, problems existent in the US and EU markets, they may fall short of effectuating management oversight in emerging markets, namely in the Turkish capital market, where the listed companies have low non-affiliate public float and provide controlling owners with voting privileges. In other words, additional mechanisms tailored to the specifics of the Turkish market may be required to achieve effective management oversight at a local level.

4. PROPOSAL FOR REINFORCING MANAGEMENT OVERSIGHT IN ISE-LISTED COMPANIES

4.1. The need to reinforce management oversight in public companies with concentrated ownership

The main purpose of public offerings, whether through the issuance of new shares or transfer of outstanding ones, is to provide equity for companies. Emerging market companies that wish to compete globally look to bolster their capitalization.[143] As the pool for capital expands from local to global, due to technological developments and the ease with which equity finance may be transferred,[144] all companies aiming to obtain maximum capital must meet investor expectations of shareholder value and dividend profitability.[145] Investor-shareholders demand and expect foremost that prospective companies, through good governance, generate profits to be distributed without reductions. It is natural, therefore, that companies with effective governance reflect high share prices, which shareholders value as they aim to gain from quick asset repositioning.

The rights and interests of public shareholders, as protected by securities laws,[146] are in essence related to shareholder expectations of dividend income and high shareholder value,[147] as well as the ability to profit from quick asset repositioning based on these expectations. Therefore, public companies wishing to attract equity should keep a healthy balance between management and oversight.[148]

Accordingly, emerging market companies with a low non-affiliate public float, such as most ISE-listed companies, must be managed in accordance with the investor expectations. To achieve a win-win outcome in the long term, controlling or affiliated owners with concentrated capital or voting power, and professional

managers they elect, must take into account investor expectations in managing "other people's money" effectively. However usually in practice, such owners or professionals, not necessarily focused on investor expectations, violate non-affiliated shareholders' rights and interests through revenue-diverting schemes. These violations generally seem to stem from the board.[149] Furthermore, case-law and CMB enforcement actions regarding ISE-listed companies demonstrate that existing oversight mechanisms do not adequately protect the essence of non-affiliated shareholders' rights and interests. The main shortcomings of the existing oversight mechanisms may be summarized as follows:

Mandatory internal auditing, soon to be replaced by independent auditing, is inadequate despite a wide range of powers of internal auditor. This is due to the fact that auditors are elected, or rather appointed, by the controlling shareholders and therefore, may render biased opinions. In addition, the internal audit reports are submitted to the general assembly only annually and in a formal report, instead of being shared with shareholders instantly. As a result, non-affiliated shareholders are barred from exercising their rights arising from and shaped by the capital markets.

Similarly, independent auditing, as mandated by the CML and prescribed by the Draft Commercial Code, remains an inadequate mechanism for management oversight because independent audit findings are submitted to shareholders in an annual report. Furthermore, wrongdoings that may adversely affect shareholder rights may go undetected in independent auditing, which is conducted periodically and mainly by review of documents; and any problem that may be detected will be submitted to shareholders with delay, in the annual report. As a result of this delay, material information that may affect share prices are rendered without much relevance.[150] In conclusion, independent auditing fails to protect shareholders against sudden price fluctuations.

Likewise, CMB oversight remains inadequate because it does not focus on or facilitate continuous monitoring of company activities, timely prevention of revenue-diverting schemes and immediate public disclosure of such acts or attempts. Neither the CMB oversight nor the independent audit mechanism enables close control of management activities. In addition, both mechanisms authorize non-shareholder third parties to protect the rights and interests of shareholders, an unrealistic approach which gives the impression that third party individuals or entities are able to protect the rights and interests of shareholders better than shareholders themselves.

In addition, the audit committee, as envisioned in the CMB *Communiqué* X(22), may not be expected to provide significant results in effective management oversight since the committee members are elected from the very board they are under a duty to monitor and since the findings of the committee are reported to the board.

Moreover, the application of the independent director mechanism (as developed in the Anglo-Saxon legal system) in the Turkish system is exceedingly unlikely to yield positive results. In fact, research on ISE-listed companies shows that the independent director mechanism has not proved effective, so far.[151] This is due to several reasons: First, regardless of the terminology used, the board of a company with concentrated ownership may not gain genuine objectivity simply by incorporating outsiders into a body consisting of controlling shareholders or their nominees. Second, the existence of independent directors on the board may not be sufficient to prevent abuse of corporate power. It may be rather difficult for independent members to detect or stop acts or attempts of bad-faith, especially when they simply attend board meetings, held once a month and have a limited agenda, and are therefore not adequately informed about the company business. As seen in the *İmar Bankası* case and others, the difficulty faced by independent directors in deterring or stopping abuse of corporate powers may even become an impossibility.[152] Third, the enactment of mandatory rules regarding independent directors, an already uncertain solution from the point of view of corporate democracy and business efficacy, may only make the independent director mechanism more difficult to implement and put in question the regulatory role of the law.

The supervision board envisioned in the dual board system of Continental Europe, while appearing to be effective in management oversight, remains insufficient due to certain disadvantages of the system. For instance, the supervision board is structured so that, at times, non-shareholder constituencies, such as company employees and creditors, make up half of the board. However, as explained above, a company must, above all, serve the rights and interests of shareholders, the equity contributors who have different rights and interests from non-shareholder constituencies. Therefore, leaving management oversight partly to non-shareholder constituencies may lead to results that are contrary to the aim of protecting shareholder rights and interests. Requiring that management be elected by non-executive directors of the supervision board does not directly ensure the protection of shareholder rights and interests.

In sum, there is a need for additional board oversight that will not obstruct company business, but allow for the close and careful monitoring of management activities and compliance with laws protecting shareholders' rights and interests. Supplementing the generally known and implemented methods of oversight, a reinforcement mechanism is also imperative for the well-functioning of public companies in global markets. Such a mechanism should deter revenue-diverting schemes or attempts; and if deterrence proves impossible, then the reinforcement mechanism should enable the rapid public disclosure of these attempts or acts. In capital markets, certain information affects share prices immediately; and investors, differently from shareholders of closely-held companies, carry the financial risk of

these fluctuations. Therefore, public company shareholders should have an effective tool to guard themselves against sudden fluctuations of price or to be informed of attempts or events which are likely to affect prices.

4.2. Proposal for reinforcing management oversight mechanism: "The Shareholder Oversight Board"

In light of the shortcomings mentioned above, we propose a supplementary board oversight model for companies with a low non-affiliate public float. In our opinion, the supplementary model should (i) serve as reinforcement for management oversight, (ii) aim to achieve a sustainable balance between management and oversight, (iii) effectively protect the essence of the rights and interests of shareholders, (iv) be employed by the non-controlling shareholders themselves, and (v) be implemented voluntarily by companies, similar to the adoption of non-mandatory corporate governance rules. Accordingly, our proposed model for supplementary board oversight should be based on the principles of efficiency, shareholder-focus and discretion.

4.2.1. Efficiency

Mechanisms for the protection of capital market investors' rights and interests must differ from all other shareholder protection mechanisms since the market investors profit by taking or switching positions in accordance with information that may suddenly impact prices. Consequently, any reinforcement mechanism for the protection of investor shareholder rights must focus on deterrence and disclosure. To achieve efficiency, the focus on deterrence and disclosure should be supplemented with the close, simultaneous and continuous monitoring of management activities. The outcome of such monitoring must be timely submitted to the shareholders in a complete and accurate manner.

The qualifications of corporate monitors, their duties and liabilities, the procedure and the timing of monitoring, and the identity of those to whom the monitors report, carry great importance. In other words, a management oversight mechanism is efficient when (i) sources of "substantive information"[153] and "information which may materially affect share price"[154] are monitored closely, continuously and concurrently with management activities; and (ii) it enables deterrence or disclosure of revenue-diverting schemes or other violations that may affect share prices. Powers of corporate monitors should entail a modified version - in accordance with capital market requirements - of the powers of the TCC-mandated internal auditor.

4.2.2. Shareholder-focus

The efficiency of the proposed model should be supplemented by a shareholder-focus, which is the utilization of the model by those who stand to benefit most

from effective oversight, namely shareholders lacking adequate capital or voting power to control the company. Different from associations or foundations, companies are for-profit commercial entities. Therefore, shareholders are first and foremost interested in the profitability of a company, the share price and whether the share price reflects an accurate picture of the company and market expectations. Similarly, shareholders are directly and personally interested in protecting the profitability and the market value of the company.

The rights and interests of the non-shareholder constituencies are a secondary issue in consideration of the scope of duties owed to shareholders by public companies. In addition, non-shareholder constituencies' rights and interests may be adequately protected through certain existing procedures. For instance, company employees receive a certain level of wages or fees, regardless of profits. While the employees prefer or aim that a company achieves high profitability and shareholder value, they may not necessarily prioritize these preferences. The government, on the other hand, is interested in the profitability of a company from a tax perspective, and has means to facilitate the tax collection. Suppliers have various recourses against a company, such as pledges or security. Creditors, such as banks who lend to a company, may recall their credit based on economic or bank-related factors or problems which may not be directly or indirectly related to the company. Therefore, it may be said that, non-shareholder constituencies may even work against shareholders. In conclusion, it is appropriate that the proposed supplementary oversight mechanism be utilized directly by the very shareholders, who stand to benefit the most from it. It is also important that the supplementary mechanism is utilized without hindering the competitive advantage or the business opportunities of a company, in accordance with the requirements of economic democracy and commercial profitability.

In sum, a "shareholder oversight board" may be created in order to help supplement oversight in public companies and to achieve a much sought-after balance between management and oversight. A critical issue in creation of the shareholder oversight board is the election of members in companies with concentrated ownership. This issue may be addressed by specific provisions (to be included in the articles of association as explained below) similar to those contained in Article 360 of the Draft Commercial Code and other voting mechanisms to be employed in the general assembly, such as excluding affiliated shareholders from the process and allowing only the votes of non-affiliated public shareholders.

4.2.3. Discretion

Similar to shareholder-focus and its importance for realization of the model, discretion also plays a vital role. In our opinion, the legislature or the regulatory authorities should not mandate the use of this model, especially if the benefit of the market and respectability of legal norms are to be considered.

Like commerce, investment in capital markets is a trade based on risk and profitability is quantified by risks taken. Company profits and losses are mainly determined by the nature, degree and management of risk. The board manages company business by taking a stance based on company preferences of risk and in accordance with the directives of the general assembly. Therefore, a company's profitability, which is based on the ability to innovate and utilize corporate opportunities, may be obstructed when mandatory rules (i) interfere with a company's risk decisions or preferences; (ii) require, across the board, creation of committees and similar bodies, and (iii) impose on company's day-to-day business. Such interference not only stalls a company, but also limits investors' risk options.

In addition, mandatory rules may discourage public offerings for closely-held companies or encourage delistings and squeeze-outs in public companies. As a result, it becomes harder for companies to obtain capital through the market and expand in accordance with the broader economy; at the same time, investors forego important investment opportunities.

Accordingly, it is crucial that the proposed model be implemented voluntarily by willing companies who may include provisions for such a reinforcement mechanism in their articles of association.[155] Freedom of contract should be encouraged in capital markets, one of the strongest creations of the free market economy. Furthermore, in implementing the model, companies should be allowed to include supplementary and differing structures of shareholder oversight in their articles of association.

The voluntary nature of the model allows shareholders freedom to invest based on their risk appetite. It also enables regulatory authorities, rating agencies and exchanges to inform investors of the said structural differences so that investors may choose accordingly. The voluntary nature of the model may even allow, in the long-term, the creation of various markets or indices for companies with differing management oversight mechanisms. The key here is to balance the commercial necessities of companies and the rights of investors, within the boundaries of the articles of association, provide them alternatives and not burden them with mandatory rules.

We believe that a discretionary approach and a contractual basis (via the articles of association) for the implementation of the model may also help minimize the mandatory tone of the "comply-or-explain" method used by most corporate governance rules; instead it may lead to a "explain implementation" approach. Developed countries have already begun to demonstrate such a progression: The reactionary enactment of the Sarbanes-Oxley Act and the specific and mandatory approach of the Act, as well as the heavy liabilities contained in it, have not

completely been followed in the European Union, where a more flexible approach towards management oversight is being developed.

4.3. The basic framework of the proposed model

The shareholder oversight board may exhibit similarities with the mandatory internal auditor mechanism contained in the TCC, and with the supervision board mechanism contained in the Continental European system. However, at times, it differs from these mechanisms in an attempt to avoid their pitfalls. The shareholder oversight board may be formulated differently by each company wishing to employ the mechanism. However, the following main framework should exist in all of the different formulations for the model:

4.3.1. Formation of the shareholder oversight board

As a first requirement, all members of the shareholder oversight board must be elected from non-affiliated public shareholders. Since the purpose of the shareholder board is to deter or disclose revenue-diverting schemes of directors or managers, i.e., representatives of controlling owners, an oversight board consisting completely of non-controlling and non-affiliated shareholders would enable the most effective monitoring.

However, the election of shareholder oversight members is an issue due to the concentrated ownership structure in ISE-listed companies. A solution may be the adoption of an election method, in the articles of association, whereby only non-affiliated public shareholders are eligible for elections. For instance, in a public company with 30 % public ownership and 70% affiliated ownership, only those shareholders owning a part of the 30 % float may be designated as eligible to vote or to be elected for office. The remaining 70% of shareholders or those with voting privileges may be excluded from voting and from being elected. From a procedural point of view, this designation may be registered with the Central Registry, allowing proxy voting. Furthermore, qualifications of nominees, method of elections, duration of office, quorums, termination and related issues may all be specified in the articles of association, in compliance with the existing mandatory legal provisions.

4.3.2. Duties and liabilities of the shareholder oversight board members

As a second requirement, the shareholder oversight board must be independent of the board of directors. The shareholder oversight board should neither branch from the board of directors, nor report to it. In addition, it cannot veto board decisions. However, the shareholder oversight board should work autonomously, yet simultaneously and in close cooperation with the board of directors in

monitoring, deterring or disclosing revenue-diverting schemes or similar fraudulent acts. It is important for the shareholder oversight board to work closely with the board of directors in achieving effective oversight results as it may be necessary for the shareholder board to cooperate with the board of directors in the prevention or disclosure of fraud or revenue-diverting schemes. However, this does not mean that the oversight board is a sub-group of the board or directors or must report its findings to that board. On the contrary, the shareholder oversight board must report to and be liable to the general assembly.

The main duties of the oversight board, as to be specified in the articles of association, may be as follows: (i) to attend the board of directors' meetings (but without the right to vote); (ii) to request from the board of directors that attempts or acts in potential or actual violation of shareholders' rights be ceased; (iii) report discovered wrongdoings directly to the CMB; or (iv) disclose findings or wrongdoings to shareholders and the public.

In drafting the related provisions of the articles of association, care must be taken to ensure that the shareholder oversight board does not reveal confidential company information or engage in fraudulent or bad-faith activities in carrying out its duties.[156] The fiduciary duty standards of directors may be incorporated and applied, here. Accordingly, members of the shareholder oversight board may be held liable for violating confidentiality, disclosing misleading information and other abuses of power, in accordance with the specific provisions in the articles of association, as well as with the general liability provisions.

Furthermore, the existence of specific provisions regarding insider trading, such as Article 47(A)(1) of the CML, envisioning criminal and other heavy penalties, as well as Article 359 of the TCC regarding joint and several liability of internal auditors, may sufficiently deter shareholders from personally gaining from the use of any company information learned during the execution of their duties. Liability insurance, similar to directors and officers' liability insurance, contained in Article 361 of the Draft Commercial Code, may be envisioned for the members of the shareholder oversight board.

Compared to the mandatory internal auditor, who has a wide range of powers, but remains an inadequate monitor of management activities, and also compared to the supervision board of dual board systems, the proposed shareholder oversight board, structured in this manner, is expected to render more effective results than those in the past.

CONCLUSION

The close monitoring and control of management activities through the shareholder oversight board, which does not hinder commercial profitability, may effectively assist in the protection of investors' rights and interest and address the current shortcomings of existing management oversight mechanisms. Investors, especially institutional investors who have leverage in capital markets, may demand from companies to incorporate, in their articles of association, such a supplementary and balancing mechanism; and investors may invest accordingly in these companies.

The availability of a shareholder oversight board may help to prevent the estrangement of non-affiliated shareholders from public companies and encourage institutional investors to get more involved with the companies in which they invest. This together may cause an increase in the rate of public ownership, and also help in resolving agency problems in public companies.

An attempt to implement the shareholder oversight board uniformly and across the board may not be particularly helpful for public companies or investors. Given its purpose and characteristics, the oversight board must be implemented in accordance with the specific needs and preferences of companies. Consequently, exchanges may create various different markets or indices for companies with differing oversight mechanisms available for investors. In the long-term, restructuring of exchanges may even become possible, in reflection of the differences in company oversight mechanisms. Furthermore, listing rules and rating criteria that is being applied today may be revised in accordance with the more flexible and preference-oriented approach brought about by the shareholder oversight mechanism. Such an approach may assist to prevent unfair competition between companies, resulting from uniform or mandatory rules, on which ratings or classifications are based.

The shareholder oversight model supports the enrichment of articles of association jurisprudence and highlights a general preference for fact or risk-specific implementation, over mandatory rules which obstruct company efficiency and profitability. Consequently, it enables the law to develop in a compatible manner with financial and economic requirements and, therefore, to become more respected.

[1] Under Article 10/A of the Turkish Capital Market Law (CML), stock certificates and the rights related to them are kept in book entry form and in electronic format by the Central Registry. The actual stock certificates of companies traded in the Istanbul Stock Exchange (ISE) are no longer in circulation.

[2] The ISE Listing Regulation contains rules regarding listing procedures and standards for companies to be traded at the ISE. Specifically, the Regulation sets forth rules and procedures for the original and continued listing requirements for all companies, domestic or foreign; as well as the suspension, removal and delisting procedures for these companies; and reporting and disclosure to the Exchange. IMKB Kotasyon Yönetmeliği [ISE Listing Regulation], Official Gazette no. 25552, June 24, 2004.

[3] *See e.g.*, **INDUSTRIAL INDEX**: food-beverage, textile-leather, wood-paper-printing, chemical-petroleum-plastic, non-metal mineral products, basic metal, metal products, machinery; **SERVICES INDEX:** electricity, transportation, tourism, wholesale and retail trade, telecommunications, sport; **FINANCIAL INDEX:** banks, insurance, leasing, factoring, holding and Investment, real estate investment trusts; **TECHNOLOGY INDEX**: information technology, defense; **ISE INVESTMENT TRUSTS INDEX**; **ISE NEW ECONOMY INDEX,** *available at* http://www.ise.org/indices/stckinxd.htm.

[4] There has been a significant increase in the number of foreign investors and the volume of foreign investment in Turkey. It is estimated that, for the years 2006 and 2007, Turkey has attracted approximately $ 37.1 billion of foreign direct investment.

[5] Türk Ticaret Kanunu [Turkish Commercial Code], no. 6762, Official Gazette no. 9353, July 9, 1956, Art. 317 [hereinafter TCC].

[6] *Id.* Art. 321.

[7] *Id.* Art. 319.

[8] The Istanbul securities industry has a long history, starting from 1864, when the stock exchange entitled "*Dersaadet Tahvilat Borsasi*" was created. The Istanbul securities industry, therefore, has commenced capital market activities in less than 50 years after the creation of the NYSE in 1817. The banking industry, which was not officially organized in Istanbul, has a much longer history. However, careful researchers may discover that investor complaints regarding the Turkish market have generally been centered around revenue-diverting schemes since the beginning. *See generally* REHA TANÖR, TÜRK SERMAYE PIYASASI: TARAFLAR [TURKISH CAPITAL MARKETS: PARTIES], vol. 1, 18-41, 253-62 (Istanbul 1999).

[9] Sermaye Piyasası Kanunu [Capital Market Law], no. 2499, Official Gazette no. 17416, July 30, 1981 (as amended on March 6, 2007), Art. 1 [hereinafter CML].

[10] TCC, *supra* note 5, Art.s 347, 353.

[11] CMB, Weekly Bulletin no. 2004/1.

[12] CMB, Weekly Bulletin no. 2000/40.

[13] CMB, Weekly Bulletin no. 2004/51.

[14] CMB *Communiqué*, Series VIII, no. 39, Art. 10.

[15] Burak Koçer, Doctoral Dissertation, *İçsel Bir Yönetişim Mekanizması Olarak Yönetim Kurulları: İMKB'de İşlem Gören Şirketlerin Yönetim Kurulu Yapısı ve İşlevleri Üzerine Bir Araştırma, [Management Rules as an Internal Governance Mechanism: Research on the Structure and the Role of the Board of Directors in ISE-listed companies]*, 154 (Istanbul 2005).

[16] While the TCC also envisions other shareholder rights, we focus on those mechanisms directly related to our review.

[17] TCC, *supra* note 5, Art. 354.

[18] *Id.* Art. 355.

[19] *Id.* Art. 356.

[20] *Id.* Art. 357.

[21] *Id.* Art. 354.

[22] *Id.* Art. 359.

[23] TCC, *supra* note 5, Art. 348.

[24] *Id.* Art. 356.

[25] *Id.* Art.s 354, 356.

[26] Draft Commercial Code, Art. 367.

[27] *See id.* Art.s 397-406. Under the Draft Code, large or mid-size companies are audited by independent audit firms.

[28] *See id. Art.* 398.

[29] *Id.* Art. 402(3).

[30] *Id.* Art.s 402(1)-(3), (6)-(7).

[31] *Id.* Art. 403(1).

[32] Conference, Ünal Tekinalp, *Şirketler Hukukunda Yeni Gelişmeler: Kurumsal Yönetimde Trendleri Konuşmak [New Developments in Company Law: Discussing New Trends in Corporate Governance, Conference on Corporate Governance]*, 29 (Doğan Yayın Holding Corporate Governance Conference Publication, 2006).

[33] Draft Commercial Code, Art.s 398(1), 402.

[34] *Id.* Art. 398(1).

[35] OECD, CORPORATE GOVERNANCE PRINCIPLES, § II(A)(3) (2004).

[36] *See* CMB, CORPORATE GOVERNANCE PRINCIPLES (2003) (as amended in 2005) [hereinafter CMB Principles].

[37] CMB *Communiqué*, series X, no. 22, Art. 25.

[38] *Id.* Art. 4.

[39] *Id.*

[40] *Id.* Art. 3.

[41] *Id.* Art. 7.

[42] *Id.* Art. 4.

[43] CMB *Communiqué*, series X, no. 22, Art. 4(10).

[44] *Id.* Art. 6.

[45] *Id.* Art. 3.

[46] *Id.* Art. 5.

[47] *Id.*

[48] *Id.* Art.s 8-9, 12.

[49] *See* discussion *infra* Part 3.

[50] CML, *supra* note 9, Art. 22(h).

[51] *Id.* Art. 46(a).

[52] *Id.* Art. 46(c).

[53] *Id.* Art. 46(d).

[54] *Id.* Art. 46(e).

[55] *Id.* Art. 46(g).

[56] CML, *supra* note 9, Art. 46(h).

[57] *Id.* Art. 46(k).

[58] *Id.* Art. 47(A).

[59] *Id.* Art. 47/A. Since the CML has become insufficient in meeting today's needs, the CMB's other rules, especially its general and specific opinion-decisions, have played an important role in supplementing the CML.

[60] TCC, *supra* note 5, Art. 341.

[61] *Id.* Art. 348.

[62] *Id.* Art. 356.

[63] *Id.* Art. 366.

[64] *Id.* Art. 377.

[65] Draft CML, Art. 14.

[66] *Id.* Art. 60.

[67] *Id.* Art. 46(g).

[68] *Id.* Art. 61(g).

[69] *Id.* Art. 61(*l*).

[70] *Id.* Art.s 69, 73-74.

[71] Draft CML, Art. 78.

[72] *Id.*

[73] *See* CMB Principles, *supra* note 35, Introduction.

[74] *See id.* § (IV)(1.1) ("The board of directors is the strategic decision-making, executive and representation body of the company. The board of directors should define the mission/vision of the company and should disclose this to the public.")

[75] *Id.* § (IV)(6.2).

[76] *See id.* § (IV)(1.1).

[77] *See id.* § (IV)(1.4) ("The board of directors should closely monitor and supervise whether or not the company's operations comply with the relevant legislation, articles of association, in-house regulations and policies.")

[78] *See id.* § (IV)(3.3.1).

[79] The CMB Principles define independence differently from the CMB Communiqué, Series VI/11, Art. 4. See CMB Principles, *supra* note 35, § (IV)(3.1.1), (3.1.3), (3.1.5)-(3.1.6), (3.3.5)

[80] *See id.* § (IV)(3.2.1).

[81] *See id.* § (IV)(5.6.9).

[82] *See id.* § (IV)(2.16).
[83] *See id.*

[84] *See id.* § (I)(5).

[85] *See* AMERICAN LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE, ANALYSIS AND RECOMMENDATION (1994); THE BUSINESS ROUNDTABLE, PRINCIPLES OF CORPORATE GOVERNANCE (2005).

[86] *See generally* BETHANY MCLEAN & PETER ELKIND, THE SMARTEST GUYS IN THE ROOM: THE AMAZING RISE AND SCANDALOUS FALL OF ENRON (2004).

[87] The Walt Disney Company Derivative Litigation, C.A. No. 15452, (Del., June 8, 2006).

[88] *See* David A. Skeel, Jr., *Icarus and American Corporate Regulation*, BUS. LAW., Nov. 2005, at 161.

[89] *See* ALI PASLI, ANONIM ORTAKLIK KURUMSAL YÖNETIMI [CORPORATE GOVERNANCE], 62 (2nd ed. 2005).

[90] *See generally* Irene Lynch Fannon, *The European Social Model of Corporate Governance: Prospects for Success in an Enlarged Europe*, *in* INTERNATIONAL CORPORATE GOVERNANCE AFTER SARBANES-OXLEY (Paul U. Ali et al. ed. 2006); *see id.,* at 65.

[91] Aktiengesetz [AktG] [Stock Corporation Act] Sept. 6, 1965, Art. 76(1).

[92] *Id.* Art. 111(1).

[93] *Id.* Art. 102(1).

[94] *See* ROBERT A.G. MONKS & NELL MINOW, CORPORATE GOVERNANCE, 321-22 (2004); *see also* Richard Milne, *Misdirected? Germany's Two-Tier Governance System Comes Under Fire*, FIN. TIMES, May 9, 2007 at 9 (stating that German supervisory boards today are made up of people either from the industry who have no time or 67-year-old pensioners; and that an elite group of non-executive directors often sit on each other's boards.)

[95] A chairman of a DAX-30 company argues that directors side with the unions when they are in a weak position or do not agree with the investors. For instance, according to this chairman, the former chief executive of Daimler Chrysler used union support to stay in office. The chairman refers to this as the "unholy alliance of the losers." *See* Milne, *supra* note 93, at 9 (stating that union representatives who serve on boards further dilute investors' influence in the management of the company.)

[96] Milne, *supra* note 93, at 9 (citing the Heidrick & Struggles report which concludes that the very presence of workers on boards means the main issues are discussed and agreed upon beforehand.)

[97] *See* MONKS, supra note 93, at 324.

[98] Milne, *supra* note 93, at 9.

[99] PASLI, *supra* note 88, at 56.

[100] Council Directive 84/253/EEC on the approval of persons responsible for carrying out the statutory audits of accounting documents (1984).

[101] *See, e.g.*, Art. 24 ("Member States shall prescribe that persons shall not carry out statutory audits . . . if such persons are not independent in accordance with the law of the Member State.")

[102] *See* OECD, CORPORATE GOVERNANCE PRINCIPLES, § II(A)(3) (2004).

[103] *Id.* § V.

[104] Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11 U.S.C., 15 U.S.C, 28 U.S.C., and 29 U.S.C.) [hereinafter "SOX"].

[105] *Id.* §§ 101-03.

[106] *Id.* § 201.

[107] *Id.* §§ 406, 410.

[108] *Id.* §§ 802, 807, 906, 1102.

[109] *See* Skeel, *supra* note 87, at. 170.

[110] PriceWaterhouseCoopers, *EU Style Sarbox: Is It Really Needed?*, Governance and Corporate Reporting, World Watch, Issue 2, 2006, at 37.

[111] *See* Tamar Frankel, *Using the Sarbanes-Oxley Act to Reward Honest Corporations*, BUS. LAW., Nov. 2006, at 176-182.

[112] NYSE LISTED COMPANY MANUAL, §303A.07(b)(i)(A) [hereinafter NYSE Listing Standards].

[113] *See* MONKS, *supra* note 93, at 227; *see also* Robert V. Hale, *The Uncertain Efficacy of Executive Sessions Under the NYSE's Revised Listing Standards,* BUS. LAW., Aug. 2006, at 1383-88.

[114] NYSE Listing Standards, *supra* note 111, § 303A.02.

[115] FINANCIAL REPORTING COUNCIL, THE COMBINED CODE ON CORPORATE GOVERNANCE, §A.3 (2006) [hereinafter The Combined Code].

[116] *Id.* §§ A.2.2, A.3.2.

[117] *See* Hillary A. Sale, *Independent Directors as Securities Monitors*, BUS. LAW., Aug. 2006, at 1381; *see also* Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231-33 (2002) (using empirical data to show that a greater proportion of independent directors does not improve profitability).

[118] *See* MONKS, *supra* note 93, at 227.

[119] *See* John F. Olson and Michael T. Adams, *Composing a Balanced and Effective Board to Meet New Governance Mandates,* BUS. LAW., Feb. 2004, at 446; *see also* Frankel, *supra* note 110, at 180.

[120] *See* Olson, *supra* note 118, at 422.

[121] *See* Hale, *supra* note 112, at 1396.

[122] *See* Rachel Beck, *All Business: Investor Activism Not Welcome Globally***,** AP Newswires*,* Sept. 5, 2006, *available at* http://www.issproxy.com/pressroom/inthenews/090506ap.htm.

[123] *See* David Ho, *Settlement Ends Icahn Challenge To Time Warner*, Cox News Service, Feb. 24, 2006, *available at* http://www.coxwashington.com/reporters/content/reporters/stories/2006/02/24/BC_TIME_WARNER18_COX.html

[124] *See* Martin Lipton, *Twenty-Five Years After Takeover Bids in the Target's Boardroom*, BUS. LAW., Aug. 2005, at 1376-78 (explaining that other organizational forms, such as partnerships and limited liability companies, are available to those investors seeking micro-management by shareholders).

[125] *See* NYSE Listing Standards, *supra* note 111, § 303A.03; *cf.* The Combined Code, *supra* note 114, § 3 (recommending that that at least half the board be comprised of non-executive directors).

[126] *See* Hale, *supra* note 112, at 1420.

[127] European Commission, Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward COM 284 (2003) at 3-7.

[128] *Id.* Art. 3.1.2.

[129] *Id.* Art. 3.1.3.

[130] *Id.*

[131] *Id.*

[132] *Id.* Art. 13.1.

[133] Commission Recommendation on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board, Art. 4, 13.2 (2005) [hereinafter Recommendations].

[134] *Id.*, annex 2.

[135] *Id.*, annex 2, Art. 1(e).

[136] *See id.* Art. 13.2.

[137] *See id.*, annex 1, Art. 4.2.1

[138] *See id.*, annex 1, Art. 4.2.2.

[139] *See* Recommendations, *supra* note 132, annex 1, Art. 4.1.

[140] Statement of the European Corporate Governance Forum on Risk Management and Internal Control (2006), *available on* http://ec.europa.eu/internal_market/company/docs/ecgforum/statement_internal_control

[141] Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC (2006).

[142] *Id.* Art. 32.

[143] *See* Sinan Ülgen & Ulaş Öztürk, *Kayıtdışı Ekonomi: Türkiye Serüveni [Black Economy: The Turkish Adventure]* Deloitte CEO Series, at 8.

[144] *See* McKinsey Global Institute, Mapping the Global Capital Market Third Annual Report, Jan. 2007, at 8, 17 (explaining that the value of total global financial assets has expanded to $140 trillion by 2006, with Asia and Europe being the world's largest net suppliers of capital, followed by Russia and the Middle East.)

[145] *See* William Rhodes, *A Market Correction Is Coming, This Time For Real*, FIN. TIMES, Mar. 29, 2007 (explaining that extraordinary levels of liquidity pouring into opportunities around the world has led to a substantial reach for yield and caused a lack of differentiation among borrowers. However, as liquidity recedes over the years, lenders and investors will become more discriminating.)

[146] *See e.g.,* CML, *supra* note 9, Art. 1.
[147] *See id.* Art. 3.

[148] *See generally* Reha Tanör, *Devlet İç Borçlanma Senetlerinin Kaydi Değer Olarak İhracına İlişkin Yasal Düzenlemelerin Kendi İçlerinde ve Yasal Düzenlemeler ile Finansal Uygulama Arasında Gözlenen Örtüşmezliğin Hukuksal Sonuçları Üzerine Bir Değerlendirme [Issuance of Government Domestic Bonds Which Are Recorded In Book Entry Form: A Review of the Legal Consequences of the Internal Conflicts Within the Law and Between the Law and Financial Practice]* 2 GALATASARAY U.L.J., 204 (2002).

[149] An analysis of the current practice and the relevant provisions of the TCC, specifically those regarding the creation of the board and the duties and liabilities of directors, point that the board of directors are at a position to abuse their power.

[150] *See generally* Reha Tanör, *Sermaye Piyasası Kanununun Kamunun Aydınlatılmasına İlişkin Düzenlemeleri ve Bunların Bankalar Kanununa Tabi Kuruluşlara Uygulanabilirliği [Disclosure Provisions of the Capital Market Law and Their Applicability for Institutions Governed by the Banking Law]*, *in Liber Amicorum* in honor of Prof. Dr. Kemal Oğuzman, 1 GALATASARAY U.L.J., 663 (2002).

[151] Koçer, *supra* note 15, at 105, 155.

[152] *See generally* Reha Tanör, *Kurumsal Yönetim Arayışları Doğrultusunda Banka Yönetim Kurulunda Bağımsız Üyelik [Independent Directors in the Board The Search For Corporate Governance]*, 122 (Research Institute for Banking and Commercial Law, Ankara 2004).

[153] Article 3 of the Draft CML defines "substantive information" as information that may lead to reasonable expectations regarding the happening of certain events within the company and that may cause a change in the share price of that company.

[154] Shareholders may strongly rely on "information which may materially affect share price" in their investment decisions.

[155] *See* Reha Tanör, *Hisse Senetleri Borsada İşlem Gören Ortaklıklarda Denetim Mekanizmalarını Güçlendirmeye Yönelik Bir Model Önerisi [A Model For Reinforcing Oversight Mechanisms in Publicly Traded Companies]*, 2 GALATASARAY U.L.J. (2005).

[156] For a detailed discussion on the scope confidential information for companies and banks, see Reha Tanör, *Finansal Kriz ve Sermaye Piyasası [Financial Crisis and Capital Markets]*, 145 (TSPAKB publication no. 8, Istanbul 2003).