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ILLEGAL PRACTICES ON STOCK EXCHANGES:
EVIDENCE FROM THE ISTANBUL STOCK EXCHANGE

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ABSTRACT

Manipulation and insider trading are two main kinds of frauds that are incurred on securities trading in all countries.

Future events have a direct effect on stock prices in capital markets. For example, if it is understood that a petroleum refining company has found a new oil field which would increase the value of the firm 50 percent, the stock price is expected to increase some 50 percent before the oil has been extracted. So, ordinary investors must be notified of this sort of information through the fastest means of communication. Naturally, some persons¹ become possessors of this sort of information before ordinary investors, and can make purchases accordingly. And under some other circumstances they can make sales with best timings to avoid possible losses. As insiders handle trading indirectly, in cooperation with those whose possession of the information can not be proved, it is difficult to detect the fraud.

Manipulation refers to making profit by those who have the capability to form misleading convictions and opinions among the investors. Someone who wants to manipulate a share first chooses a target share, a certain portion of which could be accumulated with the money available to him/her, and starts purchasing when the price of the target share falls below a certain level². On the one hand, this enables them to accumulate a target portion of the share, and on the other, to force the price to the level at which they expect to sell. When they gathered a certain portion, they take necessary precautions in order to prevent a possible decline in the price³, and they⁴ also arrange transactions at generally increasing prices in order to lead to a further increase in the price⁵. To this end, they may also disseminate misleading and deceiving information by means of media or others.

¹ Such as directors, officers and accountants of companies.

² Sometimes they make sales to force the price to the desired level.

³ Such as placing passive buy orders just below the prevailing market price

⁴ Manipulative activities are usually carried out by groups of manipulators who take common action. This is also a factor that makes it further difficult to detect the fraud.

⁵ Trading volume of a share is a sign for the direction of price. An increasing trading volume is considered to indicate an increasing price trend. Manipulators can lead trading volumes while accumulating shares and by arranging trades afterwards.

In addition to manipulation and insider trading, lack of inspection and regulation, and nature of setting up a new system made it possible for some brokerage firms to engage in fictitious sales of securities and unauthorized use of client assets. After 1994 crisis, Customer Based Custodian System was introduced by Takasbank to solve the problem.

The Capital Markets Board is the highest authority responsible for preventing fraudulent activities, detecting and imposing necessary penalties in securities trading in Turkey. On the other hand, securities trading is monitored by the ISE Surveillance Department that utilizes advanced computer programs to detect irregular transactions. Then the ISE notifies the CMB of the circumstances if it is likely to be a manipulation or insider trading case. When the development of the regulations and regulatory authorities is considered, we see that regulatory authorities chased after the incidents rather than preempt them⁶.

In the first part of the study, mentioned illegal practices are explained with sample cases. In the second part, the regulations required for full disclosure and transparency of securities trading are introduced. The last part contains the regulatory authorities responsible for preventing and detecting illegal practices in Turkey, major problems that have occurred on the ISE so far today and the development of regulations in response to different forms of illegal practices, and a general overview of present situation of the market along with the plans and suggestions for a better regulated securities trading.

⁶ Until 1992, the Capital Market Law even did not cover the concepts of manipulation and insider trading. A Special Situations Communiqué, which is a very important factor for effective disclosure and transparency, was enforced only in 1994, and a separate department responsible for surveillance function was established within the ISE in mid-1994 although the exchange started its operation at the beginning of 1986.

ÖZET

Manipülasyon ve içerden bilgi olarak ticaret yapma bütün dünya borsalarında bütün zamanlarda var olmuş ve halende var olan iki temel hile türüdür. Sermaye piyasalarında gelecekte olacak hadiselerin fiyatlar üzerinde direk tesiri vardır. Örneğin yeni bir petrol kuyusu bulmuş bir şirketin, petrolü çıkardığında değerini % 50 arttıracığı anlaşılırsa, daha petrolü çıkarmadan hisse fiyatlarında % 50'ye yakın bir artış olması beklenir. Hisse fiyatlarını etkileyecek bu tür bilgilerin en hızlı iletişim imkanlarıyla yatırımcılara ilan edilmesi gerekir. Doğal olarak, konumları gereği, bazı insanlar¹ bu tür bilgilere diğer yatırımcılardan daha önce sahip olurlar veya ulaşırlar, ve daha fiyatlar artmadan alım yapabilirler. Tam tersi durumlarda ise mükemmel bir zamanlama ile kendilerini muhtemel bir zarardan koruyabilirler. İçerden bilgi olarak ticaret yapanların dolaylı yoldan, içerden bilgi alma konumu ispatlanamayacak kişiler aracılığıyla bu işlemleri gerçekleştirmeleri bu tür hadiselerin ortaya çıkarılmasını zorlaştıran temel faktörlerdendir.

Manipülasyon ise konumları gereği piyasaya tesir edebilme gücüne sahip kişilerin piyasa koşullarından kaynaklanmayan ve piyasa koşullarını yansıtmayan yanıltıcı kanaat ve fikirlerin piyasada oluşmasını sağlayarak kar elde etmesidir. Bir hisseyi manipüle etmek isteyen bir kişi, elinde bulundurabileceği nakit miktarı ile belli oranda alım satımını yapabileceği büyüklükteki bir hisseyi, kendine hedef tesbit ettiği belli bir rakamın altına düştüğünde almaya başlar². Bu alımlar hisse fiyatını satılması hedeflenen fiyata yavaş yavaş yaklaştırırken, aynı zamanda hedeflenen oranda hisselerin elde toplanmasına sebep olur. Hisse belli oranda elde edilince fiyatın düşmesini engellemek için o anki piyasa fiyatının hemen altında pasif alım emirleri girerler ve bu arada kendi aralarında³ piyasa fiyatının hemen üzerinde alış satışlar yaparak fiyatı daha da yükseltici bir etki oluştururlar⁴. Bunlara ek olarak hisse

¹ Şirket yöneticileri, muhasebecileri vb.

² Fiyatın bu rakama düşmesi için önce satış pozisyonu da alabilir.

³ Manipülatif hareketler genellikle beraber hareket eden kişilerin oluşturduğu gruplar tarafından yapılırlar. Bu ayb-ı zamanda suçun ispatlanmasını zorlaştırıcı bir faktördür.

⁴ Hissenin işlem hacmi, fiyat trendinin bir göstergesidir. Artan bir işlem hacmi fiyatın yükseleceğinin bir işareti olarak kabul edilir. Manipülatörler gerek başlangıçta yaptıkları alımlarla gerekse kendi aralarında yapacakları alım satımlarla işlem hacmine istedikleri yönü verebilirler.

fiyatını arttıracak ve satışı kolaylaştıracak yanıltıcı bilgiyi çeşitli iletişim kanallarıyla piyasaya yayarak fiyatı düşürmeden eldeki hisseleri satmaya çalışırlar.

Manipülasyon ve içerden bilgi alarak ticaret yapmaya ek olarak, hisse senetleri piyasasının yeni olması ve yeterli düzeyde denetimin yapılamaması, aracı kurumlarca fiktif satışları ve müşterilerine ait hisselerin izinsiz olarak nakde çevrilebilmesini mümkün kılmıştır. 94 krizinden sonra Takasbank'ta uygulamaya konulan "Müşteri Bazlı Saklama Sistemi" meseleye önemli bir çözüm teşkil etmiştir.

Sermaye piyasalarında hileli faaliyetlerin engellenmesi, yapanların ortaya çıkarılması ve cezalandırılmasını yetkili ve sorumlu en yüksek merci Sermaye Piyasası Kuruludur (SPK). İstanbul Menkul Kıymetler Borsası (İMKB) Gözetleme Bölümü ise İMKB'deki alım satımları gelişmiş bilgisayar modelleri yardımıyla inceler. Küçük suçların İMKB bünyesinde sonuçlandırılmasını sağlayan bölüm, içerden bilgi alma veya manipülasyon şüphesi olan durumları Sermaye Piyasası Kurulu'na bildirir. Piyasayı denetleyici organların ve enstrümanların bugüne kadar ki olan gelişimine baktığımızda, hileli işlemlerin oluşmasını engelleyecek önlemlerin alınabilmesinden çok bu tür olayların arkadan takip edilmiş olduğu anlaşılmaktadır⁵.

Çalışmanın birinci bölümünde adı geçen hileli işlemler örnek davalar yardımıyla açıklanmaktadır. İkinci bölümde ise yatırımcıların aydınlatılmasında önemli rol oynayan enstrümanlar ve kaideler tanıtılmaktadır. Son bölüm ise, Türkiye Sermaye Piyasalarında hileli işlemlerin ortaya çıkarılmasıyla yetkili ve görevli kurumlar ile hileli işlemlerin İMKB'nin açılışından bugüne kadar ki dönemde izlediği seyir, buna karşılık denetleyici kurum ve enstrümanların geçirmiş olduğu gelişmeler; günümüz itibarıyla hisse senedi piyasasındaki hileli işlemlerin boyutu ve daha iyi denetlenen ve güvenilir bir hisse senedi piyasası için planlar ve öneriler içermektedir.

⁵ 1992'ye kadar Sermaye Piyasası Kanunu içerden bilgi alarak ticaret yapmayı ve manipülasyonu bir suç olarak içermemiştir. Eşit bilgilendirmede çok önemli bir faktör olan "Özel Durumların Bildirilmesi" konulu bir tebliğ ancak 1994'te çıkarılmış. sadece gözetleme işiyle ilgilenecek ayrı bir bölümün kurulması ise 1994 ortalarında İMKB bünyesinde gerçekleştirilmiştir.

**ILLEGAL PRACTICES ON STOCK EXCHANGES:
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ABBREVIATIONS

CBCS	: Customer Based Custodian System
CMB	: Capital Markets Board
CML	: Capital Market Law
CPA	: Certified Public Accountant
GAAP	: Generally Accepted Accounting Principles
GAAS	: Generally Accepted Auditing Standards
ISE	: İstanbul Stock Exchange
NASDAQ	: National Association of Securities Dealers Automated Quotation
NYSE	: New York Stock Exchange
SEC	: Securities and Exchange Commission
TL.	: Turkish Lira
US	: United States
USA	: United States of America

INTRODUCTION

Everybody investing in securities aims a high return. There have been many studies carried out for this purpose. While some people are satisfied with the return for a given risk level, some others try to figure out the ways of deriving above average returns. Therefore, portfolio theories¹ explaining risk-return relations and many other statistical models have been developed to enable investors to make rationalist and reasonable investment decisions. For those who don't have time, possibility or the ability to know, understand or implement those theories or methods, trading in securities have been handled by some specialists whose jobs are to know them. Mutual funds, pension funds and many other institutional organizations have been established and investors have always tried to beat the markets.

Along with all these theories and efforts, empirical studies carried out in this field highlighted the fact that those institutional investors and users of the mentioned methods and techniques have not been able to derive above average returns in the long run. So nowadays it is accepted that it is not possible to make prompt and accurate decisions about the future and beat the market by just considering past information. At this point, pointing their views to the future, investors have tried to find out the ways of reaching the information about the future or present time sooner than anybody since it has a direct effect on the stock prices. For example, merger of a company with another is a very important factor that will soon increase the price of the subject stock. Someone who can reach this information before it is announced to the public can purchase many stocks and without taking any risk, can gain very high above average returns. This is like the case in which someone learns the winning numbers in a numerical lottery before they are announced to the public and plays accordingly. In capital markets, this is called insider trading, and it is illegal.

Another unfair way of deriving above average returns in stock markets is manipulation. In this case, with some special activities such as buying or selling in

¹ See for further information, Frank K. Reilly, *Investments*, The Dryden Press International Editions, Orlando, 1992, p. 571.

great amounts or disseminating misleading information, one tries to make other investors have materially false or misleading convictions about the securities. With this artificial conviction, manipulators aim to make other investors purchase, sell or keep some stocks for their own ends.

In this study I will also deal with speculation, the twin brother of manipulation and insider trading. Although it looks much alike the others, it is not illegal. Speculators know the market, take high risks and trade in very large amounts so that they also can affect the price movements in the markets. Sometimes a very thin line like the intention of the trader becomes a separator between them. Therefore this is a factor causing difficulties to both lawmakers and their implementers. In general when we look at big speculators in the history of capital markets, they are those who are also getting some sort of inside information and making some manipulative activities. In a sense it is not false, in my opinion, if we state that some speculators are somewhat like mafia fathers. You always have the feeling that they may be doing some frauds, perhaps they know how to do it, you can not prove.

In the first part of my study, manipulation, insider trading and speculation concepts that had existed in the past and also exist now in all capital markets of the world will be studied in depth with sample cases. After that I will deal with some specific problems of Istanbul Stock Exchange as an emerging market.

In the second part of my study, I will concentrate on the institutions and the instruments that are utilized to regulate, to audit and to prevent such activities.

In the last part, while stating past developments and present structure of regulatory activities, also I will state some plans, arguments and suggestions for a better-regulated stock market system.

PART I

ILLEGAL PRACTICES

1. MANIPULATION

1.1. DEFINITION

In theory, stock prices are determined by supply and demand and reflect real market conditions, and the value of security equals to the present value of future cash flows that will be derived out of it². Therefore expectations and predictions about the possibilities or certainties of future events have direct effects on the supply and demand for the subject security.³

To what extent do investors make estimations and predictions? What factors are considered materially effective and important in making a decision of purchasing or selling a security?

- Rumors about a company that it will soon suffer great losses or go bankrupt decrease the demand and increase the number of sellers, and consequently, lead to a decrease in the price of the subject stock. On the other hand, predictions, expectations, rumors or inside information that a company is merging with another or has made many profitable investments increase the price of the subject stock due to the returns that will be derived in future. So information is an extremely important factor affecting stock prices.
- In addition to information, herding behavior has an important role; that is demand tends to increase for those stocks that are heavily traded. Because, they are considered as liquid assets which means that they can be sold easily with a low cost when necessary. Secondly, increasing trend of trading volume

² See for further information, Frank K. Reilly, *Investments*. The Dryden Press International Editions. Orlando, 1992. p. 229. and Eugene Brigham and Louis C. Gapenski, *Financial Management*, The Dryden Press International Editions. Orlando, 1991, p. 171.

³ The problem is that estimations, predictions and certainties can be artificially affected in a number of ways.

of the subject stock implies and indicates that the price will soon be increasing. As a result of these convictions, some other investors may tend to buy the same stock assuming that the subject stock is somewhat undervalued and that this is why it is increasing.

What is manipulation?

Manipulation is getting unfair returns by deceiving other investors. And in all stock exchanges of the world, it exists and is unlawful.

- Stock prices are determined by free market forces, supply and demand unless there is an intervention.
- The level of supply and demand may be affected artificially while other investors consider it natural. And stock prices may not reflect the market conditions or the real level of supply and demand but reflect what the manipulator wants them to.
- Manipulators make prices rise, fall or remain stable for their own ends.

How:

- They either purchase the subject security in high volumes or have it purchased.
- They either sell the subject security in high volumes or have it sold.
- They may disseminate information in favor or against but in both cases misleading.

Intention:

- Intention is not to make profit through an ordinary transaction.
- Intention is to make other investors purchase or not purchase, sell or keep a particular security or securities.
- Surely, what they want is profit, but their profit comes after this point⁴

⁴ A manipulator trading in high volumes and/or disseminating misleading information can affect supply and demand of a particular security for his or her own ends in the light of the explanations on page 3.

A shorter explanation can be given this way. Any series of transactions would affect the price of the security dealt in. The crucial point is the purpose. If the activity is engaged in for the purpose of inducing the purchase or the sale of such security by others, then it is unlawful.

In other words, the concept of manipulation, which is illegal, and the concept of speculation, which is legal, sometimes come very close to each other and are almost indistinguishable. Because the only difference is the intention of the trader. So it is a difficult task for lawmakers to make an exact definition and for regulatory authorities to prove the bad intent. At this point, the definition of the concept is given this way in many securities regulations books: "The term manipulation is used to refer to trading made with 'bad-intent' when the underlying transactions are indistinguishable from normal trading activity."⁵

Before giving the types and stating situations where a person may have interest in manipulation, it would be good to give an example to clarify the concept.

CASE⁶

One of the basic and widely used methods of manipulation is to try to increase the price of the security dealt in before selling the stocks you already have in your portfolio.

Ivan Boesky was one of the manipulators of Wall Street during the bull market of 1980s. In 1985, he purchased the common stock of Gulf & Western Industries through his companies at the suggestion of Carl Icahn, who is also a manipulator and a partner of Boesky in manipulative actions. Between April and October 1985, Boesky accumulated 3.4 million shares representing 4.9 percent of outstanding G&W shares. The expectation or the prediction was that the stock was undervalued then and would soon have an increase in

⁵D. Ratner and T.L. Hazen, *Securities Regulations, Cases And Materials*, West Publishing Company. St. Paul. 1996, p.446.

⁶ Ratner, *ibid.* p. 438.

price⁷. But it didn't happen that way. Afterwards Boesky aimed to sell the shares back to the company at the best possible price. He got in contact with the directors of the company and informed that he had 4.9 percent of the shares. The price was then about \$ 44. He asked them to buy the shares back at 45 or otherwise he would try a leveraged buy-out. The company declined the offer stating that they could buy the shares back only at the last sale – the price at which the stock traded on the New York Stock Exchange at the time of the last sale. After that, Boesky made a critical phone call with John A. Mulheren, who is a registered broker of the Securities and Exchange Commission before 11.00 a.m. on October 17, 1985. And he told Mulheren on the phone that he would not pay more than 45 for G&W stock and it would be great if it traded at 45. To this Mulheren replied 'I understand.' At 11.00 a.m. the stock was trading at \$ 44,75. From 11.04 a.m. to 11.10 a.m. Mulheren's company purchased 75.000 shares on the open market. Consequently the price was \$ 45 at 11.10 a.m. At 11.17 a.m. Boesky and Icahn sold 6.715.700 shares back to the company at 45. At the end of the day the stock was closed on the NYSE at 43,63 per share. And as a result of the 0.25 dollar increase in price, Boesky and Icahn gained more than \$ 1.500.000 in six minutes.

⁷ At this point this is a case of speculation.

1.2. MAJOR METHODS

1.2.1. WASH SALES

This is the oldest type of manipulation. It is employed in order to change the price in desired direction. This is a fictitious trade and the actual change of the ownership does not take place.

1.2.2. CORNERING

In this case, you make sales and purchases in order to decrease or increase the price of a target security. By doing this, you form an artificial pressure on the price. This way, you both gather a large portion of the target security and force it to the price level advantageous for you.

After gathering the desired portion and the reaching the desired price level, manipulator starts looking for investor or investors to sell the securities on hand. During the sale, he/she tries to take necessary precautions to keep the price stable.

1.2.3. POOL OPERATIONS

Two or more people decide to take common action so as to manipulate the prices. In pools, there is a leading manipulator, other members follow his/her directions. Pool members may be working in different financial institutions and companies.

In pool operations, they employ both cornering and wash sales⁸. By cornering prices, they gather first a target portion of the security, afterwards they arrange wash sales in order to keep the price at a desired level.⁹

⁸ As the securities trading is monitored by computers and regulated extensively, they employ modern examples of wash sales. For example, a member sells the shares on the open market and hands the proceeds of the sale to another member, then he or she purchases the same amount on the open market.

⁹ See for further information, Meral V. Tezcanlı, *İçerden Öğrenenlerin Ticareti ve Manipülasyonlar*, İMKB Yayınları, İstanbul, 1996, pp.127-140.

1.3. SITUATIONS WHERE A PERSON MAY HAVE INTEREST IN MANIPULATION

1.3.1. PURCHASES OR BIDS BY PERSONS INVOLVED IN A PUBLIC OFFERING

Most widely used and basic manipulation technique is trying to increase the price of the security that is being offered to the public by purchasing it for his/her own account or with the help of his partners and relatives and so on; and therefore increasing the demand which would enable him/her to sell the securities at the best possible price. The case of initial public offerings is alike this. Therefore it is unlawful to make purchases for those who are participating the distribution. According to Securities Regulations, person or persons listed below can not make purchases during an initial public offering.

- Underwriter
- Prospective underwriter
- A broker or a dealer
- Anyone who is participating the distribution
- Person on whose behalf the distribution is being made
- Selling stockholders
- Anyone who is acting for any of the above mentioned parties

1.3.1.1. STABILIZATION

During a public offering, if there is not enough demand to keep the same level of price offered in the beginning, the issuer can make purchases to stabilize the price. For example , let's say the initial price is \$ 10, you sell some portion of the stocks at this price, some time later due to lack of demand, the price tends to decrease which is something disadvantageous for the investors who purchased the stock previously. So stabilizing the price during a public offering is considered legal under some circumstances.

CASE 1¹⁰

In 1936, the Flintkote Company applied for the initial public offering of 280.000 shares. The initial price was determined as \$ 47,25. Several days after the IPO was announced, 100.000 shares remained unsold. And the price then on the open market was \$ 46,25. So the company applied the SEC and asked for permission to make purchases in order not to let the price fall any further.¹¹ The SEC decided to allow stabilization provided that the action of stabilization was disclosed to the public. In 1939, the subject was enacted in this direction as the rule 426 of the Securities Act. And the law made it necessary to disclose it in the prospectus.

However there are different opinions about whether or not taking into consideration the intention on purchases. While some argue that trading department should be allowed to continue with its regular purchases, not excessive, for his own portfolio or for his customers during the time the retail department is distributing the securities and that ordinary trading activities should be distinguished from manipulative purchases¹²; the opposite opinion argues that if a person or an institution is carrying out an initial public offering, it is difficult, if not impossible, to give credence to the view that the trading transactions were also conducted , at least in part, for the purpose of increasing the price.

CASE 2¹³

In July 1960, a company named USAMCO was established to operate on automatic vending business by raising \$ 1.000.000 capital. They decided to issue convertible bonds for \$ 700.000 and stocks for \$ 300.000 and offered 290.000 shares of stocks to the public. All of the shares were sold to the

¹⁰ Ratner . op.cit. p. 451.

¹¹ At that time, stabilization was within the prohibitions against manipulation of the rule 10b-6 of the Exchange Act.

¹² 1980s were the years of deregulation. In March 1983, the Securities and Exchange Commission amended the rule 10b-6 in this direction.

¹³ Jennings, Marsh and Coffee, *Securities Regulations*.University Casebook Series: The Foundation Press.Inc., The USA, 1992, p. 596.

customers of Dunbar, Troutman, Drum, Stevens, Kaye and Teweles who are brokers and investment advisors working for the same brokerage house in different branches, and some portion was purchased by them or their partners or relatives or so on.¹⁴

Some other investors also seemed interested in the stock but their offers were declined stating different reasons. On November 14, the price reached up to \$ 3. And the above mentioned brokers continued purchasing the stock generally at increasing prices. Consequently the stock traded at 5 - 5,5 on November 18, at 5,75 - 6,25 on December 15, at 7 - 7,5 on December 30, at 12 - 13 on January 31, 1961, at 14 - 15 on March 3 and at 19 in April. At that time the mentioned brokers were the only market makers of the stock.

USAMCO, which began its operations on September 30 with 1.000.000 capital, was made to look like a bright and prospective company by means of advertisements. The advertisements were misleading and false. The slogan was "The firm that research built." Many newspaper and magazine articles were being published pointing out that the company had profitable investments and would almost derive 1.000.000 profit as of the year end. This information was being disseminated by the brokers although they knew that the business was going bad and the realized net loss as of June 1961 was \$ 608.893. While disseminating this sort of misleading and false information about a company that was about to go bankrupt or already had gone bankrupt, the brokers were trying to persuade their own customers to invest in USAMCO stock. Kaye, one of the brokers, suggested a 13 year old boy who wanted to buy Smith-Corona Stock to purchase USAMCO stock at 18,5 pointing out that favorable developments were imminent regarding USAMCO which he was not then at liberty to disclose. Another example is that they suggested a 70 year old lady to purchase the subject stock who had \$ 1.250 savings and a weekly income of \$ 65 and therefore who desired an risk-free investment. While all these were

¹⁴ Rule 10b-6 of the Exchange Act prohibits to purchase the subject stock for those who are also participating the distribution of a public offering.

happening, the brokers were the only market makers. In April, when the net loss of approximately \$ 600.000 was realized and when the price was around \$ 19, the brokers and their relevant parties acting together with them sold all their shares at prices between 15 and 19. While doing this, they suggested their customers to purchase, and they also declined the bid offers of the investors who had purchased the stock, and who were willing to sell then. At that time, almost all the shares belonged to the brokers or to their customers. After they had finished selling all the shares in their portfolios, sale of the shares of their customers was carried out at prices below \$ 12.

1.3.2. CORPORATE REPURCHASES

Corporate repurchases refer to purchases of the stocks by the issuers on the open market, which are previously issued by them. This sort of purchasing is legal under some circumstances while it may be illegal under the others. The company may aim to keep the prices stable at a level that is suitable for its own ends. Furthermore, since they are the insiders, they know better than any other person whether their stocks are undervalued or overvalued and accordingly they can make purchases and sales with best timing.

CASE¹⁵

Between January and October in 1987, Haas Stock (Haas Securities Corporation) was heavily traded by Capital Share, a registered brokerage house of the SEC. During this time period, trading of Capital Shares on the subject stock amounted to \$ 44 million. The amount it sold to Haas Securities Corporation was \$ 20 million. Most of the transactions were carried out after 3.00 p.m. After the investigation, the SEC concluded that;

¹⁵ Ratner. op.cit. p. 434.

- There was an unwritten guaranteed profit agreement between Capital Shares and Haas Securities Corporation.
- Capital Shares made purchases on behalf of Haas Securities Corporation in order to keep prices at a desired level for them, and to make other investors believe that the stock was actively traded.
- And Haas treated as a buyer of last resort¹⁶.

1.3.3. TAKEOVER BIDS

Takeover refers to trying to purchase the shares of a company from shareholders on the open market and gaining the control of the company at a price determined by the offeror or at the prevailing market price. We often see manipulative effects in this kind of actions.

- In case of a tender offer, incumbent management may try to increase the prevailing market price, which may make the tender offer unsuccessful if they are not willing for a merger.
- And in some cases, the intention of the tender offeror is not to purchase some target portion of the shares and not to gain the control of the firm but to sell them back to the company at a profit. Or as a consequence of his purchases,

Crane that they were not interested in a merger. But Crane continued its purchases, which was a legal right. In 1968 Crane declared its intention to the SEC by filing 14-b statement. At that time the stock was selling at \$ 36. Shortly thereafter, the directors of Air Brake approved a merger with another company, American Standard Inc. To make this approval effective, permission of the majority of the shareholders was required. Standard declared that 2 shares of Air Brake Stock would be changed with one Standard preferred stock after the merger, which was then selling at approximately \$ 100 on the open market. The price soared up to \$ 44 on the New York Stock Exchange. On April 10, Crane announced an offer which was to expire on April 19 at 5.00 p.m. that one share of Air Brake stock would be changed with one subordinated debenture with a par value of \$ 50. The price goes up to \$ 49 right away. However the price on April 19 went down to \$ 45, during that day Standard made purchases of 82.400 shares on the open market at increasing prices up to \$ 60. After that, Crane extended the duration some more times. He accumulated then 32,2 % of Air Brake shares, which amounted to 1.480.623 shares. On May 16, at shareholders meeting, shareholders voted in favor of merger with Standard and tender offer of Crane became unsuccessful. Crane first changed his Air Brake Shares with Standard Preferred Stock, and then sold them on the NYSE. This was the largest sale made in a single transaction.

1.4. MANIPULATION VERSUS SPECULATION

Speculation in dictionary means thinking or talking about a matter without having the necessary facts, or making guesses, and in a business dictionary it refers to trading and dealing in securities whose price is still uncertain, in the hope of a large profit.

In all markets there are some ordinary investors who don't go to the market everyday. They benefit from the overall increase of the market. They usually have another job and they want to have some returns on their savings. They generally prefer risk-free investment alternatives and are satisfied with the average return.

On the other hand, some other investors prefer risk-taking. They make speculation, which is, in some cases, something like gambling. They are generally not satisfied with the average return and try to beat the market. While doing this, they can receive substantial profits as well as suffering great losses. Their business or job is mostly trading on securities. Some of the speculators have a great deal of money or they trade together on the same direction, so this gives them power to affect prices artificially if desired. If the intention of a speculator is to induce others to purchase or to sale a security, then it is no longer a speculation but a manipulation and unlawful.

The problem is that speculation and manipulation are quite alike in appearance and not easy to distinguish. For example, one could make purchases or sales in great amounts and the trades could move the prices in one direction and while doing this, the trader could genuinely believe that the prices would move in that direction. If so, this is not a manipulation case although the trader affects the price. So changing prices is not always manipulation and this makes it difficult to make an objective definition of the concept. The only definition that makes sense is subjective, the intention of the trader. This way or another any transaction can affect the prices. It is unlawful if it is made to induce other investors to purchase or not to purchase, or to keep or to sell any security. In many security regulation books where the concept is explained, the term is defined as profitable trades made with 'bad intent.'

2. INSIDER TRADING

2.1. DEFINITION

XY COMPANY BALANCE SHEET			
Assets		Liabilities	
Current Assets	300.000	Debt	400.000
Fixed Assets	700.000	Equity	600.000
TOTAL	1.000.000	TOTAL	1.000.000

Assume that this is a newly established company that has just gone public and has 100.000 outstanding shares.

So each share is \$ 6 ($600.000/100.000$).

One year later, the realized profit amounts to, let's say, \$ 400.000. This will be added to Equity in the Balance Sheet as retained earnings (Assuming that no dividends will be paid out.). And the company buys some marketable securities and invests in constructing a new plant with the retained earnings. Next year, the balance sheet becomes as in the

XY COMPANY BALANCE SHEET			
Assets		Liabilities	
Current Assets	500.000	Debt	400.000
Fixed Assets	900.000	Equity	1.000.000
TOTAL	1.400.000	TOTAL	1.400.000

second table. So at the end of this year,

the price of the security is expected to be

\$ 10 per share ($1.000.000/100.000$).

(Assuming that the market price

fully reflects the financial records.) This is the real value of the security. Before the announcement of the profit of \$ 400.000, the price may be below (which means that it is undervalued) or above (which means that it is overvalued) \$ 10. If it is below that, it begins increasing with the disclosure of the profit and vice versa. Because before the profit is realized and disclosed to public, many investors and speculators make speculations about future prices and returns, they may have some expectations and some estimations which may prove to be true or not. For example, they may expect a

profit of \$ 600.000, in such a case the price is assumed to go up to \$ 12 per share. This is called speculation and is legal. But these speculations, expectations or estimations may be based on some inside information which makes them something certain rather than a guess, that is those who can reach this information before being disclosed to the public can make purchases or sales whichever is favorable for their own ends. Since ordinary investors don't have this information, insiders can derive high returns or avoid suffering losses. So making any trading transaction based on this information is unlawful before it is fully disclosed to the public.

CASE 1¹⁸

On September 1994, the Board of Directors of Konya Çimento A.Ş. (Konya Cement Industry Inc.) decided for an increase of capital from TL. 6.248 million TL. to 406.120 million TL. The Istanbul Stock Exchange was informed about it, but the decision was not disclosed till the end of the day. At the end of the day it took place in the ISE Bulletin. During that day, the stock traded heavily on the exchange through the intermediation of Işıklar Securities, Koçbank and Akbank. Observations are as follows;

- Işıklar Securities is the only brokerage house with a branch office in Konya.
- The directors of the corporation had family relationships with the investment advisors of Işıklar Securities.
- On September 22, 1994, after the decision of capital increase but before it was disclosed to public; twenty five investors, including three executives of Konya Cement Industry Inc., some investment advisors and investors of Işıklar Securities, made purchases at prices ranging between TL. 285.000 and TL. 290.000. In the following four days most of them sold their shares at prices ranging between TL. 435.000 and TL. 455.000.

¹⁸ *Capital Markets Board Annual Report*. The Capital Markets Board . Ankara. 1996, p. 27.

- The mentioned investors had not made any transactions on the mentioned security prior to September 22, 1994.

The case has a major importance since it is the first insider trading case in the history of Turkish Capital Markets with a decision of conviction.

CASE 2¹⁹

Pacific Stock Exchange was a relatively small stock exchange in the USA. Gary Sampson was a market maker in this small exchange and was trying to make money by writing options. In October 1981, he was writing call options²⁰ for a giant company named Santa Fee International operating on natural resources in California. The stock was trading between \$ 21 and \$ 23 then. The number of options sold on October 1 was 1553, the next day the number almost tripled and became 3993. This much increase in one day seemed rather strange to Sampson and to other option writers. But they thought that investors were sometimes doing strange things. They kept writing options. On October 2, Tuesday, Kuwait Petroleum Company, one of the national petroleum companies of Kuwait, announced a tender offer stating that they would pay \$ 51 for one Santa Fee stock. So the option holders exercised the options which required Sampson and his friends to buy the stock at least at 51 and sell them back to the option holders at something around the previous prices (21-23). The loss incurred by option writers was \$ 6 million. Sampson told his friend that the option buyers must have known the merger before it was announced to the public. So this was an insider trading case. They informed the SEC of the situation. Additionally the Enforcement Department had also noticed the abnormal trading transactions of Santa Fee Options before being informed. The department searched the records of October 1 and 2 and tried to find out those who purchased the options. Then they faced a

¹⁹ David A. Vise and Coll Steve. *Sokaktaki Kartal*, translated by Nil Ayhan, Sermaye Piyasası Kurulu, Ankara, 1997, p. 41.

²⁰ Writing call option means that you sell an option to someone, which in return makes you buy the subject stock at the price specified on the option if the owner of the option wants to exercise it. See for further information, Reilly, op.cit, p. 47.

very unpredictable situation that most of the options were purchased through the intermediation of a large bank, Credit Suisse, in Switzerland. So it was not possible to learn the names due to the banking regulations in that country. After that, the SEC decided to sue the unknown persons and Credit Suisse. This was a very new understanding. Afterwards the head of the SEC, John Shad, and the head of Enforcement Department, John Fedders, went to Switzerland for some negotiations. Consequently, for the first time, a Swiss bank declared names of its customers. The options were purchased by some directors, lawyers and accountants in Kuwait and America. Later an agreement was made between governments pointing out that the SEC would be able to learn the names of the investors who broke the securities acts in the USA through intermediation of Swiss Banks provided that some investigations would also be carried out under the surveillance of Switzerland Government.

2.2 MATERIALITY

After stating that inside information can not be used for trading on related securities, let's state the extent of inside information.

The authoritative definition given by the US Supreme Court in 1976 is that, a fact must be disclosed to the public if a reasonable investor would consider it important in making an investment decision or if there is a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the total mix of the information made available²¹. And this kind of information is called material. So the extent is materiality, and a statement is misleading if there is a misstatement or an omission of a material fact.

Although the definition given seems to be satisfactory, in real life and cases, many different questions may arise about the concept of materiality. So we will try to explore them in the following section.

²¹ Ratner , op.cit, p.155.

2.2.1. QUALITATIVE INFORMATION

Profit has a direct effect on stock prices and this is a sort of inside information. And any insider who knows the amount of profit or loss before it is disclosed to the public can not make purchases of the shares of the subject company. In addition to this sort of material information, there may be many other material facts to be disclosed in reported statements and prospectuses. So;

- There can not be *any misstatement that* would be considered important by a reasonable investor.
- There can not be *any omission that* would be considered important by a reasonable investor.

In other words, what is required is not only that all disclosed information is true but also *all* material facts are disclosed.

CASE²²

Louis V. Glickman was a large-scale real estate developer, operator and investor with a good reputation in this field. From 1956 to 1960, he set up many different companies in order to do real estate business. In these companies, he had the majority of the shares. The most important and the largest of the companies was the Glickman Corporation of Nevada, one of his wholly owned corporations, and it was known as Venada Corporation. In May 1960, he formed most of the publicly owned corporations into one entity that had previously been under his control. He was then the president of the formation, and afterwards became the first chairman of the board of the directors.

The prospectus of the formation said Glickman spent \$ 211.000 for registration and organization costs, and the amount would be paid back out of the proceeds of the public offering without interest.

²² Ratner. *ibid.* p. 159.

On October 12, 1990, the registration became effective. Two days later, Glickman began transferring funds secretly. In two months, the total amount of transfers amounted to \$ 296.329. One year later, in October 1961, the amount of transfers was \$ 2.372.511.

Alleged Deficiencies:

- Glickman had a very good reputation in real estate business. This was an important factor for investors. The 1960 prospectus failed to disclose the intention of Glickman for the funds obtained through public offering. The funds were utilized for the benefit of Venada Corporation.
- The prospectus failed to disclose Glickman's strained financial position and his urgent need of cash, and his pledges of his control stock. On this ground, his substantial fund withdrawals were unlawful.
- The prospectus failed to disclose the integrity of his management with Venada, his wholly owned corporation.

2.2.2. NON-ECONOMIC INFORMATION

In this section, disclosure of material information that is unethical or unlawful to engage in will be discussed. Something that the company has engaged in may be somewhat unethical or unlawful, and yet it may well affect the prospects of the company, and therefore is to be disclosed and in many circumstances they are not, or they can not be due to other legislation. In such a situation there exists a material information that are known only by insiders and that are only for the use of insiders.

2.2.2.1. BRIBERY AND OTHER UNLAWFUL PRACTICE

This understanding was first employed in 1970s when Stanley Sporkin was the head of the Enforcement Department of the SEC. The argument is that what will happen, how it will be disclosed, or whether it will be disclosed or not when a company engages in illegal activities. Because this sort of actions may result in many

advantageous situations for the firms and surely a reasonable investor would consider it important in making an investment decision.

For example, a firm may bribe an official, a deputy or a minister for a profitable adjudication; this may increase the profit of the company and therefore may lead to an increase in the growth rate of the firm or in the amount of dividends paid out. Then the question is this, will this be disclosed? If yes, how?

2.2.2.2. ENVIRONMENTAL REQUIREMENTS AND EQUAL EMPLOYMENT PRACTICES

This is also another factor in which some investors may be interested. Environmental disclosure is a subject, especially in the USA, increasing in importance. It is also argued that this sort of social disclosure is used more in voting rather than in making investment decisions.

2.2.2.3. TAX EVASION

Due to tax evasion and some other factors, especially in Turkey, it may not be possible to say that the figures such as profit, sales, and inventory on hand on the financial statements are representing the true situation. This is an unexplored field in our country that will perhaps be dealt with in future. From this point of view, reduction of inflation to a reasonable level and reliability of financial statements requires a complete study by academicians and practitioners.

CASE²³

Stanley Sporkin, the head of the Enforcement Department of the SEC in 1970s, may be assumed as the founder of this understanding. He was the first to discuss this kind of disclosure requirements.

For Sporkin, it was not important whether something is legal, it was important for him whether something is true or not. In 1970s, the SEC gained an

²³ *Vise, op.cit.* p. 9.

international reputation. It was investigating the US firms' bribery and monetary contributions for political ends abroad and overseas. And these were not related with the law that the SEC was to enforce. The related laws were prepared after the 1929 crisis and aimed to provide a fair market condition without fraudulent activities. In 1970s, the SEC yawned the laws to satisfy the need to follow such practices.

In 1974, Stanley Sporkin became the head of the Enforcement Department. And the campaign to disclose the corruption that the US firms engaged in started after this point. Once Sporkin was watching Watergate trails on a local TV station. The interest for the trails was decreasing then. But all the witnesses were not listened. And among the witnesses, there were the directors of some giant corporations such as Northrop Company, American Airlines and Gulf Oil Corporation who made secret payments to the CREEP²⁴ of Nixon in 1974. Sporkin thought that those directors had broken the securities laws. As a well-educated accountant, he was wondering how these hidden payments were shown on the financial statements of the corporations. After the investigation, it was understood that the payments were not recorded as payments to the CREEP. Indeed, it was not expected to be so since such an activity was unlawful. *Were the companies to disclose this sort of activities in the reports they filed to the SEC?*

Sporkin concluded that yes, they had to disclose as bribes were enabling them to earn more profit. Some multinational companies argued that the amounts paid as bribes were too small to disclose, and therefore was not material. To this, the SEC argued that what they earned as a consequence of bribery was not small. They were making millions of dollars. Eventually, the SEC declared that any company which did not disclose this sort of activities would be sued by the SEC.

²⁴ Committee to Re-Elect the President

In mid 1970s, the SEC investigated many cases of this sort, and the newspapers were all writing about Sporkin and the investigation activities. Once, the SEC was investigating a bribery case of a company named United Brands that was said to bribe the Honduras Government to reduce the tariffs imposed on banana imports. Before the investigation started, an executive officer of the company, Elie Black, committed a suicide, and also the investigation caused the Honduras President to resign in a month time.

2.2.3. READABILITY

Companies disclose material facts about themselves through reported financial statements and prospectuses. Although companies are required to prepare clearly understandable prospectuses and reports, it is difficult for an average investor to be able to understand the disclosed information. There are two main difficulties:

- Many of the companies going public have some advanced technology. Generally an average investor does not have that specific knowledge to enable him/her to understand whether the company is a good one or not. Take a new broadcasting company; say the prospectus reads that it has 4 up-link and 10 down-link systems, and 45 cameras. First of all, we do not know what an up-link system is. We also do not know the required number of cameras, whether 45 are enough or not. How many cameras do other companies in the sector have? So understanding the disclosed information may require some specific expertise about that business.
- Another difficulty is that understanding the disclosed facts requires knowing accounting. If we do not know where to look at, financial statements may be quite misleading for us. For example, a company with a high profit is not always that good and prospective, there are many other factors to consider in the evaluation of the performance.

So fully effective disclosure requires the reporting of complicated business facts, which may have little meaning to an average investor. As a result of this, most

investors receive the filtered information by the professionals such as brokers, investment advisors and bank managers.

Then another question arises here. For whom should the disclosure be made? While some argue that the disclosure should be directed to the experts, believing that an average investor can not understand and even does not read the reported statements, others argue that the reports and the prospectuses must be prepared for both the average investors and the knowledgeable students of finance. Separate reports should be disclosed for both parties, otherwise you run the risk of saying some points that are to be left unsaid and not saying some other points that are to be disclosed.

2.2.4. UNCERTAIN EVENTS

As stated before, future events have a direct effect on stock prices. And the timing of disclosure for this sort of information is of utmost importance. But the certainty of the information is important as well, that is disclosure of an uncertain event may also be misleading just as it would be misleading if not disclosed when it is certain. For example, you may disclose that an oil company has found a new ore close to the surface. And after that, you may not be able to find anything while the price might have risen. So the administrations must disclose those facts when it is likely to take place, and must neither disclose nor deny when it is unlikely, and when it is a bit of both or in the midst, they have to issue a 'no comment' statement.

Agreement in principle is the approach that is to be utilized in preliminary merger discussions. This states that the merger should be disclosed when the price and the structure of the transaction are agreed upon. There are three main benefits of this approach;

- It preserves the confidentiality of the discussions,
- It prevents misleading the investors if they then decide not to merge,
- It provides an exact measure for disclosure of mergers.

CASE²⁵

Basic Inc. was a company manufacturing chemical refractors for steel industry. In 1976, Combustion Engineering Inc., which was also operating in the same sector, expressed some interest in merger with Basic. From September 1976 to December 1978, many talks and telephone calls were carried out between the directors and the representatives of the mentioned firms. During this time, there were rumors about the merger, the stock was heavily trading, and the price was fluctuating. On December 18, 1978, Basic asked the NYSE to suspend the trading of its securities stating that a merger with another company was approaching. The next day, it declared its approval of the tender offer price of \$ 46 per share.

From 1976 to 1978, the company made three public statements and denied that there were continuing negotiations for the merger.

The court concluded that Basic Inc. violated securities laws because it disclosed that no negotiations of merger were underway, and that the company did not know any reason for the stock's heavy trading, and denied their existence. *They could have omitted some facts because they were not certain, but what they declared contained a misrepresentation.* So if things are not certain, companies can omit some facts in order not to be misleading, but keeping in mind that all of what they disclose must be true.

2.2.5. ESTIMATES OF VALUE

There are two different opinions about the subject.

- Issuers must show the original cost or book value of their assets in reported statements. Otherwise, companies can make predictions, which do not reflect the

²⁵ Ratner, op.cit. p. 190.

present situation and might be misleading for investors. In this approach, estimations have been prohibited for many years.

- Today another approach is being considered, that is, original cost is a historical data and therefore would not show the exact value of the company. And adequate, reliable and proper estimations might be beneficial and necessary.

2.2.6. PROJECTIONS

Companies, especially large ones, make predictions for future. For example, they try to estimate future sales, revenues and other cash flows. This is important because, based on these assumptions, they may decide either to borrow or to lend in order to maximize their profits. They may disclose these estimations in their reported statements, and surely they are of importance to the investors since those who prepare the statements know the prospects of the company, and results and implications of the complex accounting records. This may be considered that complex figures in the statements along with many other inside information, which the management of the company knows very well, are being evaluated and interpreted by the management of the company. *But what if the management fails to make a correct prediction or even if the management makes the misleading prediction deliberately.*

There are some guides to comply with in disclosure of predictions;

2.2.6.1. RETENTION OF GOOD FAITH REQUIREMENT

This requires the management of the issuer to prove that the projection was prepared with a reasonable basis and was disclosed in good faith. There is burden of proof for the issuer.

2.2.6.2. DISCLOSURE OF ASSUMPTIONS

The management must disclose the assumption on which the prediction is based. These assumptions are material because they make the predictions meaningful and reliable for investors. Based on these assumptions, projections can better be evaluated and comprehended by professionals and ordinary investors.

2.2.6.3. DUTY TO CORRECT

After making projections, the management must disclose it if realized that a projection was false or misleading from the outset, or it later became false or misleading due to some unexpected events that were not considered or anticipated previously.

2.3. PERSONS SUBJECT TO LIABILITY

Anybody, who uses a material information before being disclosed to the public to trade on securities, either to make profit or to avoid loss, is an insider trader.

The Article 47 of the CML defines insiders. The article includes potential insiders, presidents, board members, staff of the CMB, employees of stock exchanges and publicly owned companies. According to this regulation.²⁶

- A-
- i. The president and board members,
 - ii. Managers,
 - iii. Internal auditors,
 - iv. Staff of;
 - a. Companies which offered their securities to the public,
 - b. Companies which have more than 100 shareholders,
 - c. Capital market institutions,
 - d. Institutions maintaining relationships with the above institutions and companies, and
 - e. People who have direct and/or indirect relationships with the people declared in A- (i), (ii), (iii), (iv), and (c), (d).
- B-
- a. Chairman and the board members of the CMB.
 - b. Chairman, the board members and the staff of the stock exchanges,
 - c. People who have direct and/or indirect relationship with the people declared in B-(a), (b), are described as potential insiders. But those people can trade in securities markets by disclosing the inside information they have possessed.²⁷

²⁶ Tezcanlı, op.cit, p. 16.

²⁷ See for further information Tezcanlı, ibid, pp. 165-185, *Sermaye Piyasası ve Borsa Temel Bilgiler Kılavuzu*, İMKB Yayınları, İstanbul, 1997, pp. 29-30, and for the original, the article 47 of the CML.

3. MAJOR ILLEGAL PRACTICES OF BROKERAGE FIRMS

3.1. CHURNING

Churning refers to excessive trading by brokers in order to generate high commission income. Churning is an illegal practice prohibited by law regardless of whether the account's profits or its principal is misappropriated.²⁸

3.2. BOILING ROOMS

A boiler room is usually a temporary operation established to sell a specific security. Without adequate basis for recommending the security or without informing the prospective buyer of the possible adverse effects and risks, they make phone calls with prospective buyers whose names are obtained from a "sucker list."²⁹

3.3. UNAUTHORIZED USE OF CLIENT ASSETS AND FICTITIOUS TRADES

Turkish Capital Markets experienced these kind of illegal practices widely prior to 1994 crisis. Due to the lack of inspection and regulation, many brokerage firms sold the same security to more than one investor or sold client securities without authorization, or they sold non-existent Treasury bills. The species of fraud is discussed in detail in the last part of the study.

²⁸ See for further information, Jennings, *op.cit.*, pp. 630-632.

²⁹ See for further information, Jennings, *ibid.*, pp. 620-624.

PART II

SECURITIES REGULATIONS

1. REGISTRATION

1.1. UNDERWRITING

Registration is a long and detailed process. Firms need to prepare adequate reports and prospectuses for full disclosure. Moreover firms need some help in distribution of the securities to the public. While preparing reports and prospectuses they need the help and the approval of Certified Public Accountants (CPAs) and in order to sell the stocks they need the help of brokerage houses whose job is trading on securities on the market. To this end, they make underwriting agreements¹ depending upon the size and the reputation of the company, the number and the type of the security to be offered. There may be different terms in the agreements. Basic underwriting methods are as follows:

1.1.1. STRICT OR OLD FASHIONED UNDERWRITING

The method is known as traditional English System of distribution. Nowadays, it is not widely utilized. In an underwriting agreement, generally firms sell the securities to the underwriters, and then the underwriters resale them to the public. But in old fashioned underwriting, firms do not sell them to underwriters or elsewhere. Firms make an agreement with underwriters and the underwriters announce the public offering. Those, who desire to purchase the security, contact with the underwriters and get listed. When there are enough buyers listed, the underwriter announces that the list is closed. From that time on, the firm delivers the securities directly to the buyers.

Underwriters also ensure that the firm will receive the amount of funds it requires, that is underwriting agreement also covers an insurance agreement which specifies that underwriter agrees to purchase the shares that can not be sold to the

¹ Underwriting refers to taking responsibility for possible failure.

public. For unknown and small firms, failure is more likely to occur. Due to this high possibility, underwriters may prefer to charge high fees or premiums for small size and unknown firms, and low or relatively less for those with good reputation.

We name the method as old fashioned since it was a widely utilized technique in the past. Today, it is utilized in offerings made to existing shareholders by means of warrant and options.

1.1.2. FIRM-COMMITMENT UNDERWRITING

In this kind of agreements, underwriters buy the securities for resale instead of ensuring a specified number of shares to be sold. We can say that the way the shares are distributed is different, but the purpose is the same. Both of them assures the issuer of a specified amount of money.

In firm-commitment underwriting, issuers sell the newly issued shares to a group of securities firms all of which shares the risk of distribution, and one of them is the principal underwriter. Before the registration statement becomes effective, securities can not be sold to the public, even to the dealers who are not underwriters. So prior to the effectiveness of the registration statement, issuers and underwriters may change their minds and may not engage in the distribution.

Leading or managing underwriter organizes an underwriting syndicate². In the syndicate, securities firms that are participating the distribution as underwriters and the portions that they are going to purchase are specified. The managing underwriter is authorized broadly on the agreement. He can stabilize the price by making purchases and can increase the portions of participating underwriters for the allotment of the securities bought for stabilization. Some underwriters do not join the distribution, they just share the risk of distribution, that is, they accept to buy a specified amount of shares after the public offering, and in return they benefit from the profit out of the spread. Spread includes management fee for the managing underwriter, underwriting commission for the participating underwriters, and profit on sales for those who actually sold the shares to the public.

² Agreement among underwriters that states the terms of distribution.

1.1.3. BEST EFFORTS UNDERWRITING

For small size, new and unknown firms, it is more likely that a higher portion of the public offering may remain unsold. Due to this risk, securities firms do not prefer to underwrite the offering; they merely try to do their bests in order to sell the shares. This is also a factor decreasing the cost of offerings for issuers, but there is no guarantee that all the shares will be sold³. In other words, the service rendered by securities firms is not underwriting that takes responsibility for a possible failure; this is just a sort of merchandising.

On the other hand, very large scale and prominent firms also prefer this sort of underwriting agreements in order to avoid high distribution costs. The supporting idea is that their shares can be sold without any underwriting commitment as they are prominent and there is a high demand for their stocks.

1.2. REGISTRATION PROCESS

1.2.1. REGISTRATION STATEMENT

Registration Statement consists of two parts. First part is called prospectus and is prepared for ordinary investors who are not specialized and do not know the complicated approaches of accounting. This part is to be given every investor. Second part gives more supplemental and detailed information. This part is not to be given to every investor, but may be obtained upon request. And generally sophisticated analysts and those who render financial services prefer to do so.

A prospectus generally contains following points⁴;

- description of the company's business
- product and services of the company
- marketing and distribution

³ Some agreements may assure that, for example, 50 % of the shares would be sold.

⁴ Ratner, op.cit, p. 82.

- competition
- key customers
- government regulation (including environmental issues)
- employees
- technology
- risk factors
- management's discussion and analysis of financial condition
- results of operations
- material transactions with insiders
- use of proceeds
- the details of underwriting
- the plan for distributing the securities
- capitalization
- description of securities being registered
- identification of officers and directors
- pending legal proceedings
- options to purchase securities
- principal owners of securities

There is a different system in the USA for disclosure of adverse facts, that is, in Turkey if the regulatory authority (The Capital Markets Board) feels that this is somewhat a speculative and a risky investment with bad prospects, issuance of underlying security may be prohibited⁵. Whereas in the USA, the SEC can not prohibit issuance of any security if full disclosure about adverse facts is made. By doing this, the SEC can make the offering unattractive and make the management of the company inform investors of possible dangers, but can not prohibit or prevent the public offering.

⁵ By many professionals, this is considered a good precaution for a young stock market while being criticized by some others.

Adverse factors⁶ may contain following points;

- lack of business history
- adverse business experience
- operating losses
- dependence upon particular customers, suppliers, and key personnel
- certain types of transactions with insiders
- a low tangible net worth per share compared to the offering price
- potential dilution that may result from the exercise of convertible securities, options, and warrants
- a small investment by the promoters compared with the public investment

To this end, the SEC often requires those mentioned adverse factors to be on the cover page of prospectuses in bold face form. Moreover, some other points may also be required to be on the cover page with cross-references.

1.2.2. PREPARING REGISTRATION STATEMENT

Preparation of the registration statement is a combined operation, and close cooperation is required among those who are preparing the statement. The following parties all have an important role in preparation of the registration statement⁷;

- representatives of the management of registering company
- the underwriters
- certified public accountants
- counsel for company
- counsel for underwriters
- engineers and appraisers (occasionally)

⁶ Ratner, op.cit. p. 84.

⁷ K. F. Skoushen, *An Introduction to SEC*, South Western Publishing Company, Ohio, 1976, p. 38 .

Counsels collect information both orally and in writing from many sources. This is important because based on their own recollections everyone can somewhat overestimate or underestimate some figures, so all information must be verified by using different sources for the same information and insisting on back-up documents.

2. AUDITING

2.1. ECONOMICS OF AUDITING

Audited financial statements are utilized by numerous investors. In order to emphasize such a need for auditing, assume, Company A is issuing bonds, that is, it will borrow some cash from investors promising to pay the principal amount plus some interest on the amount borrowed at a specified date. And in such a case there are four possible factors explained below that may affect the rate of the interest to be paid.

2.1.1. RISK-FREE INTEREST RATE

Investing in government bonds and treasury bills has very little default risk⁸. This is also referred to having no risk. And in practice, governments are the biggest firms and they have the lowest relative default risk on their borrowings compared with other large or small size firms. And the default risk is a primary determinant of the interest rate. That is, the higher the risk, the higher the interest rate. As a result of this, all business units that seek funds from surplus units must pay a somewhat higher interest rate than the government. In other words, governments are expected to determine the lowest level of interest to be paid on borrowings and this level of interest rate is called risk-free interest rate.

⁸ This is not a practical factor in Turkey since the government is paying a higher interest rate on borrowings than banks, financial institutions, and other firms although lending the government is considered risk-free.

2.1.2. BUSINESS RISK

There is always a possibility that the borrower will not be able to pay back the borrowed funds. This may be caused by several reasons such as wrong management decisions, going bankrupt, recession, and etc. This risk is inherent in the nature of borrowing-lending business and can not be fully eliminated.

2.1.3. FINANCIAL RISK

This risk refers to financial position. That is, the default risk is higher if the firm's assets are financed by borrowing in high percentages. The more debts you have the more difficult you pay.

2.1.4. INFORMATION RISK

This risk means that the information you have about the going operations (business risk) and the financial position of the companies (financial risk) is an important factor in making investment decisions. So financial reports are the most important factors in reducing the information risk and therefore must reflect the true situation of the companies.

CPAs have nothing to do with the first three factors. Their duty is to try to eliminate the information risk ensuring that the reported statements are reflecting the true situation from all aspects. If this risk is eliminated, borrowers, lenders, and the overall economy benefit from that. That is, if lender knows the firm to which they are lending, they will be more willing to lend; in other words, they will not increase the rate of interest due to lack of information about the company. As a result of this, borrowers will be able to find funds at lower costs which will make them eligible to produce and sell cheaper products as they could use a lower cost of capital as a production factor. The consequence of this would be the increase in the productivity of the overall economy, which eventually would increase the wealth of the nation. So independent auditors can play a crucial role in eliminating the information risk and help establish a better financial system that efficiently transfers funds from surplus units to deficit units.

2.1.4.1. CAUSES OF INFORMATION RISK

2.1.4.1.1. REMOTENESS OF INFORMATION

It is not possible for investors to have firsthand information about the companies in whose stocks they are investing. So they must rely upon the information provided by other parties. And this sort of provided information might deliberately or unintentionally include some misstatements or material omissions.

2.1.4.1.2. BIAS AND MOTIVES OF PROVIDER

Those who prepare and publish material information to the public may be biased either in favor or against. The reason for this may even be an honest optimism or pessimism. But in either case the statement is misleading.

2.1.4.1.3. VOLUMINOUS DATA

Large companies may have improper records. This means that although the GAAPs are fully applied, the statements may not be reflecting the true situation. For example, if there is not a proper internal audit system, many errors in recording may remain undiscovered, and when they come together, the amount may be material.

2.1.4.1.4. COMPLEX EXCHANGE TRANSACTIONS

In 20th century, there have been many developments, and many new instruments in business life have been introduced. Consequently, recording transactions properly has become more difficult due to this complexity. Preparing consolidated financial statements of large organizations with subsidiaries in many different industries and different countries could be an example for this.

2.1.4.2. REDUCING INFORMATION RISK

2.1.4.2.1. VERIFICATION OF INFORMATION BY INVESTORS

One way of reducing information risk is verification of information by investors themselves. But this is impractical and uneconomical for most of the investors and is not utilized in practice.

2.1.4.2.2. SHARING INFORMATION RISK WITH MANAGEMENT

Publicly held firms are required to disclose all material events to the public. This kind of information includes those such as changes of top executive officers, bankruptcy of a supplier when it is difficult to obtain the raw material from other sources, merger with another company, and strike of employees.

This kind of information is to be disclosed to the public as soon as they take place as they have a direct effect on stock prices. And some information is to be disclosed regularly in regular reports such as plans for future operations of the firm. Disclosure of all material information is the responsibility of the management of the firm.

2.1.4.2.3. PUBLISHING AUDITED FINANCIAL STATEMENTS

Firms publish regular audited financial statements in order to reduce information risk. Here independent auditors are responsible for performing the audit of financial statements according to the GAAPs. Investors then may sue the independent auditors in cases of suffering losses due to improper audits. Management of the firms may also be held responsible for inaccurate figures on the statements. As a result of this, management can also sue independent auditor for allowing such a deficiency. On the other hand, this does not mean that independent auditors are responsible for the correctness of the figures such as profit, earnings per share, etc. Their responsibility is to make sure that the statements are prepared in accordance with the GAAPs.

2.2. CERTIFIED PUBLIC ACCOUNTANTS

Certified Public Accountants perform auditing activities on the financial statements of the companies whose shares are publicly traded. CPAs are also called as Independent Auditors. There are some regulations for becoming a CPA and retaining the license:

- Education: The primary requirement for eligibility is being graduates of faculties at which they have taken a specified number of accounting courses.
- Uniform CPA Examination: They have to pass CPA examination that is administered at specified dates.
- Experience: They must have worked in a CPA firm before they apply for the title.

2.3. GENERALLY ACCEPTED AUDITING STANDARDS

Generally Accepted Auditing Standards (GAAS) are guidelines for auditors while fulfilling their duties. They have been developed by American Institute of Certified Public Accountants (AICPA)⁹. Since then, they virtually remained the same. These standards are considered as minimum standards rather than maximum standards or ideals.

Although CPAs are to comply with the standards, there are no specific measures. Some argue that the standards should provide clearly defined measures for gathering evidence. On the other hand, some others argue that if strict measurements are made, auditors can not use their personal judgments and professional expertise. In addition to that, there may be some cases in which a standard is impractical or impossible to apply, and in some other cases, applying the standard does not make a material difference in amount while causing a huge cost. In such a case if the standard is not applied, it is auditor's responsibility to justify that following the standard was not necessary.

⁹ Alvin A. Arens and James K. Loebbecke, *Auditing An Integrated Approach*, Prentice Hall International Editions, New jersey, 1991, p. 16.

2.3.1. GENERAL STANDARDS

2.3.1.1. ADEQUATE TECHNICAL TRAINING AND PROFICIENCY

Person or persons performing an audit should have adequate technical training and proficiency. This includes having a formal education of accounting and auditing, working experience of audit business, and having some technical information of the industries in which their client companies are operating. If the independent auditor does not have adequate information, he or she should suggest another auditor who is qualified for the subject sector or industry or must decline engaging in the audit of the firm.

2.3.1.2. INDEPENDENCE IN MENTAL ATTITUDE

Auditors must be able to perform their duties independently without any force, influence or anything of this sort that will impair objectivity of the auditor. This is an important principle in performance of audits by CPAs and will be discussed in detail in the ethics of auditing section.

2.3.1.3. DUE PROFESSIONAL CARE

This means that auditors are responsible for performing audits diligently and carefully. That is it is their duty to avoid bad intent, bad faith and negligence.

2.3.2. STANDARDS OF FIELD WORK

2.3.2.1. ADEQUATE PLANNING AND SUPERVISION

Some of the work in a performance of an audit is carried out by assistants who are not very well experienced. So the supervision of the assistants and having an adequate plan are important factors in performing an audit successfully.

2.3.2.2. UNDERSTANDING THE INTERNAL CONTROL STRUCTURE

An auditor should understand very well the internal control structure of his/her client in order to be able to prepare a good audit plan. Because a poor internal control structure will make it difficult to obtain reliable information.

2.3.2.3. SUFFICIENT COMPETENT EVIDENCE

Auditors must be able to find out satisfactory amount of evidence in order to support their opinions about the financial statements of the company. To this end, auditor should carry out inspection, inquiries, observation, and confirmation with healthy skepticism.

2.3.3. STANDARDS OF REPORTING

- a. Auditors must assure that financial statements under examination are prepared in accordance with the GAAPs.
- b. Auditors must note if any of the accounting principle is not applied in the current period, which was applied in previous periods. This refers to a change in the methods utilized such as changing inventory valuation method from first-in-first-out (FIFO) to Last-in-last-out (LIFO).
- c. Auditors prepare a report of overall opinion on financial statements taken as a whole, including the disclosure of information. So he or she should state if disclosed information does not rest on a reasonable adequate basis.
- d. Sometimes auditors can not state an overall opinion; in this case the reasons for this should be clearly stated.

2.4. PROFESSIONAL ETHICS IN AUDITING

2.4.1. ETHICS

The term refers to moral principles and values that are necessary for healthy societies. It is also essential that independent auditors have these values although

many of them are not backed by law. Ethical values may be summarized as follows;¹⁰

- **Honesty:** Be truthful, straightforward; do not cheat, steal, lie or deceive.
- **Integrity:** Be principled, honorable; do not be two faced.
- **Promise keeping:** Be worthy of trust, fulfill commitments; do not search for excuses and justifications for breaking commitments.
- **Loyalty and fidelity:** Do not use or disclose confidential information. Make professional independent judgments by avoiding influence of unreasonable factors.
- **Fairness:** Be open-minded and willing to admit an error.
- **Caring for others**
- **Respect for others**
- **Responsible citizenship:** Obey just laws, avoid unnecessary secrecy or concealment of information. Make sure that others have all required information in order to be able to make intelligent choices and exercise their rights.
- **Pursuit of Excellence:** Perform all of your duties to the best of your ability. Be diligent and reliable.
- **Accountability:** Accept responsibility for decisions. Take whatever actions are necessary to correct or prevent inappropriate conduct of others.

2.4.2. INDEPENDENCE

Independence of CPAs is extremely important in preparation of reported financial statements. As all investors rely upon the statements, which is the most important way of eliminating information risk, this is the most critical characteristic

¹⁰ Arens, *ibid.*, p. 68.

of independent auditors. Reducing the information risk is two fold; in order to be able to reduce the information risk, it is also essential that investors believe the audit is performed independently as well as publishing audit reports that reflects the true situation.

Since independent auditors are in such an important position, there are some restrictions imposed on them.

2.4.2.1. FINANCIAL INTEREST

CPAs can not have any stock or other direct investment in the companies whose financial records are being examined by them. But this is not an easy principle to apply in practice. For example, an unknown friend of independent auditor may have substantial amount of shares of a company whose records are being examined. So the independent auditor may have some interest in reported statements published in favor of the company. Therefore this kind of indirect ownership is also prohibited, but it is something very difficult for regulatory authorities to discover and prove the conspiracy. Another example would be that while a CPA is examining the records of the Company AB, CPA himself or with the name of a friend of him may have invested in a mutual fund that holds a substantial amount of shares of the company AB in its portfolio.

Another argument is that whether a CPA branch can examine the records of a company if some other staff in another branch in another city has some interest in the company.

2.4.2.2. OTHER FINANCIAL INTEREST ISSUES

1. Former Practitioners:

CPA firms can not examine the financial statements of a firm if they employ someone who is a former partner, shareholder (in high volumes that enables him/her to be an insider) or personnel of the subject firm.

2. Normal Lending Procedures

CPA firms can not engage in the preparation of the financial statements if they borrow or borrowed from a firm subject to an audit. But there are exceptions for this, for example, a CPA firm can buy bonds of its client company on the open market that are not specifically issued for the auditing firm. Here the assumption is that the rate of interest or the amount of borrowing is not affected by a possible unwritten agreement between the auditor and its client, and therefore it does not influence the report to be prepared by the independent auditor.

3. Financial Interest of Next Kin

An independent auditor's children, brother, sister, spouse, mother, father and etc also can not have financial interest, investment, business relationship or be directly working for a client company.

4. Director, Officer, Management or Employee of a Company

Independent auditors can not be a member of the board of directors or officers of the client company.

5. Litigation Between CPA firm and Client

If there is a litigation between an CPA firm and its client , preparation of an objective report is questionable.

6. Bookkeeping Services and Audits for the Same Client

CPA firms can not perform independent audits of those firms to which they also provide bookkeeping services although this bring additional costs to firms to work with different accounting firms for their affairs related with accounting.

7. Payment of Audit Fees by Management

It is also possible that the independence of an independent auditor is likely to be affected by the amount of payment of audit fees. With a high amount of payment, an auditor may be biased in favor or vice versa.

Another argument about this is that auditing services could be rendered by the public sector. Obviously, this would not solve the problem and not provide a complete atmosphere of independence since bribery or some other corruption may come into use.

2.4.3. INTEGRITY AND OBJECTIVITY

While carrying out an audit of financial records, an independent auditor must maintain integrity and objectivity and must be impartial. Also the auditors must not have any sort of interest that would lead him/her to prepare reports containing material omissions or misrepresentations deliberately. Additionally, objectivity is questionable in cases, for example, where an independent auditor is checking the figures on financial statements such as profit and sales and at the same time he or she is preparing tax returns for the same company.

2.4.4. CONFIDENTIALITY

During or after the performance of an independent audit, a CPA can not disclose confidential information to the public or to any party to whom the management of the company does not allow. But in some cases, there are exceptions for the concept of confidentiality;

a. **Obligations Related to Technical Standards**

After the publication of reports, an auditor may discover that the published reports have a material omission or a misrepresentation. Even if this is a confidential information for the client company, the auditor must disclose it since his/her responsibility of disclosure is more important than that of confidentiality.

b. **Subpoenas and Summons¹¹**

In case of a subpoena or an investigation carried out by regulatory authorities, CPAs are required to disclose all the information they possess.

c. **Peer Review**

It is a normal practice that a CPA firm may conduct a peer review of quality control. In such a case, a CPA firm can share the information with another CPA firm.

d. **Ethical Issues**

If regulatory authorities feel that an audit is performed poorly, another CPA firm or a supreme board of CPA firms may examine the working papers after the audit.

Another point to be considered is that audit fees can not be determined according to the outcomes of audits. So the fee must be determined beforehand before the audit begins.

3. REPORTING

Publicly owned firms are required to disclose their financial statements such as balance sheet, income summary, and statement of cash flows and other material information such as changes of auditing firms or persons and changes of the executive officers of the firm. These statements are also required to be audited by Certified Public Accounting Firms. Thus, published statements are accompanied by an independent audit report that states the statements are prepared in compliance with the Generally Accepted Accounting Principles (GAAPs).

¹¹ Terms refer to being ordered to attend a court of law.

3.1. GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

The purpose of the securities regulations is to help provide investors with reliable information to make investment decisions. So companies are required to prepare detailed annual reports. To this end, CPAs utilize some established principles, GAAP, in order to make fair representation. Otherwise, unaudited financial statements with different principles in preparation would be quite misleading. Even after utilizing the principles, accountants are facing some cases to which no principle can be fully applied. In those cases, accountants are to employ traditional assumptions of accounting.

3.1.1. BUSINESS ENTITY

This assumption means that the business is a separate unit from its owners or founders. And the owner may have many other businesses, or a parent company may have many different subsidiaries. And the performance of each business or subsidiary should be evaluated separately. For example, a person may have a grocery store with many other related or unrelated valuable assets which enables him/her to support the business financially in case of a recession, and this does not mean that the business is making profit. So in order to evaluate the success of the store, it should be considered as a separate entity.

3.1.2. GOING CONCERN

This concept assumes that the business will remain for an indefinite time period, in other words we assume that the business will not go bankrupt or be liquidated. Surely there is always such a possibility that firms may go bankrupt, but we deliberately ignore it unless it is certain.

Many accounting practices rest on this assumption such as prepaid and accrued expenses and revenues, depreciation accounts. And also firms may have long-term liabilities for 20 or 30 years which would have to be paid right away in case of a liquidation and some intangible assets that have a value as long as the firm continues its operations.

In a case which a firm is threatened with bankruptcy or liquidation, the going concern assumption is dropped. Because the investors then would be interested in the liquidation value which would be obtained after selling all valuable assets and settling all liabilities and receivables. Then, the figures prepared under the GAAP would not be meaningful. So if this is the case, it must be clearly disclosed that the financial statements are prepared considering that the business will be liquidated.

If the assumption were not dropped, the financial figures would be misleading. For example, intangible assets have no liquidation value, but the balance sheet may have substantial amounts for them. Dropping the assumption also makes all assets and liabilities current, that is they are to be turned into cash within a short time period. You are forced to pay all your long-term debts right away and may have difficulty in collecting receivables. And you also get less money if you are to sell everything you have immediately. All these factors increase the difference between the liquidation value and the value calculated under going concern assumption.

3.1.3. TIME PERIOD

Firms issue their reports regularly, this requires them to select an accounting period. Many businesses choose the calendar year as an accounting period and begin recording transactions on January 1 and end the accounting period on December 31. And some other firms choose another twelve month accounting period ending at the end of another month rather than December. This type of period is known as a fiscal year. Moreover some other businesses may try to choose a more suitable accounting period for their unique characteristics such as those operating seasonally.

Any investment normally has longer duration than above mentioned accounting periods. Consequently, firms are confronted with uncertainty. Because there are many uncompleted transactions and commitments whose outcomes can easily be influenced and changed under different circumstances. In such a case what accountants are doing is to make the assumption that things will go the way they did in the past. For example, we sell many commodities on credit. We record some portion of it as an allowance for doubtful accounts, this is an estimation based on past experiences and we don't know exactly whether they will be collected or be

written off. And in the meantime, we record and post the earnings (out of sales on credit) to the income statement as if they were fully collected, or we may have substantial amounts of inventory on hand. We also assume that they will be sold at a specified price. And it is again possible that they can not be sold or can be sold but not at a price we desired. So, we accept some uncertainty in order to have a timely reporting.

3.1.4. MONETARY UNIT

In order to bring financial statements together, a specific measure is required. Without such a measure, usage of such terms as five cars, two buildings would not be meaningful to the investors. So money is used as a measure of value. So statements and figures can be compared with each other.

Money has different names in different countries. For example it is the Turkish Lira in Turkey, the Mark in Germany, the Dollars in the USA. And the point is that they are not equal to each other. So a statement prepared in terms of Turkish Liras can not be directly compared with another statement where figures are represented in terms of another currency. So they have to be changed into the same currency before a comparison.

The biggest problem of using money as a measure of value is inflation. That is, the same amount of Turkish Liras can not buy the same amount of commodities one year later. Furthermore, this is a more significant problem for our country since our economy has been suffering double or triple digit inflation for years. Therefore, in countries where the effects of the inflation can not be ignored, figures on financial statement are adjusted according to inflation rates.

This does not bring a complete solution to the problem since increases in prices are not solely caused by inflation. The increase may also include some quality changes and technological advancements.

3.1.5. HISTORICAL COST

There are five different measurements that are applied while preparing the financial statements. These are;

- Historical Cost
- Current Cost
- Current Market Value
- Net Realizable Value
- Present Value

Historical cost is utilized in practice as a measurement if it is not obvious that the historical cost is not recoverable.

3.1.6. CONSERVATISM

Accountant may face many different situations in which there are different possibilities with reasonable supports. Conservatism principle requires accountants to choose the possibility with the least favorable effect on net income. But accountants can not use arbitrarily low figures in order to recognize a possible future loss if it does not have a reasonable support.

3.1.7. REALIZATION

Realization of revenues is a problem of accounting. The problem is how to determine the timing of realization objectively. In different situations, it may be suitable to recognize the revenues at different times. The general conclusion is that revenue should be recognized when¹²;

- the earning is virtually complete, and
- the exchange value is objectively determined.

So in practice, revenue is recognized at the point of sale. But it is not always possible to recognize the profit at this point. For example, construction business is a

¹² C.H.Gibson, *Financial Statement Analyses*, South Western Publishing Company, Ohio, 1992. p. 18.

continuous process where the point of sale approach can not be applied. So in this sort of cases, there are other methods of recognizing the revenues;

a. End of Production

If you know the price and if there is a ready market, you can recognize the profit at the end of production process. Because it is likely that the product will be sold at the market price. For example, olives are harvested in winter but they are not retailed right away. Waiting for summer is required for them to be tasteful. In such a case, revenue should be recognized in winter before they are sold in summer.

b. Receipt of Cash

This method should be utilized when the collection of money is doubtful.

c. During Production

In construction business, revenue is recognized as operations are progressing. Because it is a long process and it is not fair to wait for the proper completion of construction in order to recognize the revenue, so the revenues for the finished portions are recognized right away.

d. Cost Recovery

In highly speculative businesses, you are even not sure that you will be able to get back your initial investment. So in this sort of unpredictable businesses such as investing in a venture search for gold, you recognize the portion of the revenue that exceeds the initial cost.

3.1.8. MATCHING

This assumption refers to matching related costs and revenues with each other. The timing of cost recognition is important as well as the timing of revenue recognition. There are some methods such as First-in-First-out, Weighted Average for matching costs with revenues. And the expenses like utility expenses, research and development expenditures that can not be charged to a specific department,

process, or a product are allocated to related revenues by using specific policies conducted by cost accountants.

3.1.9. CONSISTENCY

This requires the firms to publish their reports on a timely manner for the same periods regularly, so that the statements are comparable. To this end, it is also important that the firm is utilizing the same accounting method in all periods, that is, for example the firm should use the same inventory valuation model. On the other hand, in some cases changing business environment makes it necessary to change the methods. Although they can not be changed frequently, such changes, if they occur, must be disclosed to the public emphasizing its possible effects on financial statements.

3.1.10. FULL DISCLOSURE

Accountants are required to disclose all material information that are important for investment decisions. To this end, the duty is not only to prepare the financial statements, but also to give some additional information by using footnotes cross-references, supporting schedules, etc. This is a difficult principle for accountants to apply since it requires personal judgment.

In preparation of the statements, their duty is not to disclose all detailed, complex and sophisticated financial information that may be misleading for investors. Therefore, a reasonable summary of all material information reflecting them in fair importance must be provided.

3.1.11. MATERIALITY

Only material information is to be disclosed. The duty of accountant is to decide whether a reasonable investor would consider it important in making an investment decision. This is a difficult decision, and they are sometimes sued by those who claim that they have suffered losses due to a misstatement or an omission of a material fact.

3.1.12. INDUSTRY PRACTICES

Some industries have so different features that customary accounting principles can not be fully applied. These are mostly due to government regulations. For example, railroad, insurance and utility industries are highly regulated and they have to record some other sort of transactions that only exist in those industries due to government regulations. Normally other industries and firms do not have them and therefore have a different form of statements. Although accountants try to eliminate the differences, uniqueness of different industries does not allow a full elimination.

3.1.13. TRANSACTION APPROACH

Accounting only records the operations and the events that are related to financial position. Although there are many other factors, material for investors, financial statements do not reflect them. For example, employees may have gone on a strike or the company may be about to merge with another company.

Such factors have a material impact on stock prices, but they are not reflected in financial statements and this is not the responsibility of accountants.

3.1.14. PRESENT VALUE CONSIDERATIONS

Firms have monetary items. They are mainly cash, marketable securities, receivables and payables. And receivables, payable or bonds with long maturity are usually recorded at their present values. That is, receiving \$1000 is not the same with receiving the same amount five years later. The simplest reason is inflation. So monetary items other than current ones¹³ can have material differences between the present value of future cash flows and the nominal value of them. Therefore, if there is a material difference between the values, the figures are calculated under this assumption.

¹³ The term refers to monetary items that can be collected or be converted into cash within one accounting period.

15. ACCRUAL BASIS

The assumption states that revenues and expenses are recognized under the principles of realization and matching. This is against the assumption of cash basis which states that revenues and expenses are recognized when the cash is paid or collected.



PART III
REGULATORY ACTIVITIES:
PLANS & SUGGESTIONS FOR FUTURE

1. REGULATORY INSTITUTIONS IN TURKEY

1.1. THE CAPITAL MARKETS BOARD (CMB)

The CMB is the regulatory and supervisory authority in Turkish Capital Markets. The board was established in 1981 with the appointment of seven members and a chairman. It held its first meeting in February 1982. The CMB is a public entity with the highest level of decision-making authority for capital markets in Turkey.

The main office of the board is in Ankara and it has a bureau in Akmerkez, Istanbul. The Department of Enforcement carries out its operations in Istanbul bureau.

The board has two main bodies: The Decision-Making Organ and the Organization Unit.

1.1.1. THE DECISION MAKING ORGAN

The body consists of seven members and issues all binding decisions. The chairman is the head of the body. Three of the members including the chairman are appointed by the State Ministry in charge of economic affairs. The other four members are appointed by the Ministry of Justice, the Ministry of Industry and Trade, the Central Bank and the Bank Association.

1.1.2. THE ORGANIZATION UNIT

The Chairman is also the head of the Organization Unit that consists of eight departments organized under Executive Vice-Presidents. While all binding decisions are issued by the Decision-Making Organ, all projects are prepared by the specialists within the Organization Unit.

Newly graduated students, mostly from prominent schools of Turkey, are invited to a competitive entrance examination. Those who can pass the exam become assistant specialists. Then, they attend an on-the-job training and courses both in Turkey and abroad. Three years later they take another exam so as to be specialists.

1.1.2.1. DEPARTMENTS

a. The Department of Enforcement

The department supervises the registered corporations, brokerage firms, and other financial institutions. The department is principally responsible for prevention of fraudulent activities in capital markets. *Namely prevention of market manipulations and insider trading violations falls into the responsibility of this department.*

b. The Department of Corporate Finance

The department deals with the examination of the prospectuses and other required reports at initial public offerings. In other words, it is responsible for full disclosure in primary market operations.

c. The Department of Institutional Investors

d. The Department of Intermediary Activities

e. The Research Department

f. The Department of Legal Consultancy

g. The Department of Data Processing and Statistics

h. The Department of Administrative and Financial Affairs¹

¹ See for further information the web site of the Capital Markets Board of Turkey. (www.spk.gov.tr). *Sermaye Piyasası ve Borsa Temel Bilgiler Kılavuzu*, op.cit. pp. 30-31. and *Capital Markets Board Annual Report*, op.cit. pp. 25-27.

1.2. TAKASBANK

The ISE Settlement and Custody Bank Inc. is the central securities depository in Turkey. The bank initially began its operations as a department within the ISE in 1988. In 1991, it became a company, the ISE settlement and Custody Company, and received its current status as a bank at the end of 1995. The bank is in Mecidiyeköy, Istanbul.

The management consists of a Chairman, a Vice-President and 11 Board Members. The Board of Directors includes members of the ISE Executive Council and representatives of the CMB and the brokerage firms.

The bank has a paid-in-capital of \$ 5.1 million as end of 1997. It is owned by the ISE and the brokerage firms. The stake of the ISE in capital is 21,85 %; the stake of each brokerage firm can not exceed 5 %.²

1.3. THE ISE SURVEILLANCE DEPARTMENT

As the location of the CMB as a regulatory authority is in Ankara, monitoring the securities trading has been carried out by the ISE. Initially there was not a separate department for surveillance function within the ISE. A separate department was set up in June 1994. The department handles a very important function in preventing manipulations and insider trading. It is responsible for examining the abnormal price and volume movements by considering the past performance of the securities. Although the department employs advanced tracking models, the need for a system that automatically detects such abnormalities is evident.

Depending on the nature of the case, the ISE Executive Council may impose penalties, and if irregular transactions constitute a criminal offense for manipulation or insider trading, then the management of the ISE notifies the CMB of the circumstances.

² See for further information the web site of the Istanbul Stock Exchange (www.imkb.gov.tr).

2. GENERAL OVERVIEW

Turkish Stock Market is a young and emerging market. It is in a relatively good position compared with other emerging markets in the world that are now suffering from crisis. The market is also extremely liquid. Despite many problems such as high inflation and political instability, capital markets are promising and giving good signs for future. On the other hand, the market lacks the required depth, and there are some market makers and speculators who are also engaging in market manipulations and insider trading violations.

Approximately 50 % of the securities listed on the ISE are hold by foreign investors. And foreign investors seem less interested in manipulations based on inside information as many of them are institutional investors that naturally prefer long-term investments. This assumption is also proved by the average trading volume of foreign investors that although they keep half of the shares, their average trading volume constitutes approximately 10 % of the total daily trading volume on the ISE.

On the other hand, Turkish investors are holding the other half of the securities on the ISE, but their trading volume goes up to 90 % of the total trading volume. This makes it evident that many Turkish investors are not in fact investing in securities, they are merely playing on the market.

It is argued that there are some 10 big players on the market determining the prices. They are said to have sufficient cash ranging from \$ 50 million to \$150 million, and they carry out half of the daily transaction on the ISE. They are cornering the prices, and small investors are generally getting the train of increasing prices as the last passenger. Major applications of manipulation and insider trading are as follows³;

Generally, big players prefer to play with those shares that lack depth so that controlling the share and its price becomes easier. Initially they try to choose undervalued shares. They start buying⁴ and go on until they obtain a target portion of

³ Based on the interviews.

⁴ In general, they form a group and take common action.

the shares. While doing this, they take actions to increase the overall demand⁵. To this end, they disseminate information that the stock, for example, would double or triple its price; they sometimes state that the target price would be ten times higher⁶.

When they gathered the target portion, they take necessary precautions in order to prevent a possible fall in the price before they empty their portfolio. To this end, they arrange modern examples of wash sales⁷, this increases liquidity of the share⁸, and they also give passive buy orders just below the prevailing market price. This prevents any possible decline⁹ on the one hand, and persuades other investors who have the same stock that there are many buyers and few sellers on the other. As this is encouraging, investors do not feel that the stock is overvalued or will soon suffer a decline or remain steady for a long time. Even they may choose to buy some more shares since the number of the buy orders that seems somewhat higher than that of the sell orders is considered to prove an increasing trend for the price.

When they decide to sell, their objective is to be able to sell all their shares before the price begins falling. Among all other true information, you may have misleading information about the stock through a TV, a newspaper, or a magazine. Or your broker, whom you trust very much¹⁰, may recommend you the share.

Another way of selling the shares is that, they go abroad and get in touch with foreign institutional investors. They ask the manager to buy all the shares they have

⁵ Trying to increase the overall demand may be applied for two reasons. First, in order to increase the price to the target level; second, in order to empty their portfolios.

⁶ This misleading and artificial information may come to you through a TV, a newspaper, a magazine, or your broker or investment advisor among those that reflect the true situation.

⁷ In order not to be identified by the regulatory authorities, the group members do not make direct transactions between each other. Instead of this, for example, they sell on the market and hand the proceeds to another group member and he/she purchases the stock on the open market.

⁸ A decline in the transaction volume is considered as a sign that the price will soon suffer a decline, so high transaction volume artificially indicates that the price does not have a downward trend.

⁹ But there is a danger at this point for the manipulators. That is, the issuer may issue some additional shares that the manipulating group can not afford to buy, and consequently the price may start going down. To eliminate the risk, it is a normal practice that the manipulators go to the issuer firm and persuades it, this way or another, not to offer any new shares until they empty their portfolio. (They shake hands!)

¹⁰ I think this is a healthy skepticism. And most of the time it happens this way (This allegation is surely not for all the brokers). You have a broker, he/she always recommends you advantageous trades, you appreciate his/her work and trust him (We may also take a TV program, a magazine article, a prominent journalist and so on.). One day you get recommendation of such a manipulated share, you do not hesitate, afterwards you are told, "Wait! This stock will be good!")

by offering some hidden payment to be made to the manager in return. Since the institutional investors usually hold the shares for a long time or do not make sales shortly after purchasing, the price does not fall or remains steady for a long time.

Another way applied in practice is that sometimes the manipulators fall into the need of urgent cash before they become able to sell the shares. This time, they try to find someone else who could possibly buy the shares temporarily. They guarantee that the shares will be bought back, or they will sell them together on the open market. But having someone to carry the shares is a sign of obstruction that may result in bankruptcies.

While cornering prices, they either use an upward or a downward pressure. As well as increasing the prices by substantial purchases, they also make sales in order to buy the shares when they hit the rock bottom.

In the case of insider trading, it is argued that potential insiders such as corporate managers and officers, and staff of intermediary institutions are trading indirectly based on hidden agreements. It is even argued that some politicians may also be benefiting from the fluctuations on the ISE. Some speeches, for example, lead the general price level, a few days later we hear another declaration, "I did not mean that."

3. DEVELOPMENT OF REGULATIONS

Prior to 1980s, Turkey suffered from banker crisis. Investors lost some \$ 3.2 billion. And in the wake of 1980 financial crisis, it proved necessary to establish a board responsible for regulating, controlling, developing and inspecting the securities sector. Consequently, the CMB was formed in 1981, and a chairman and seven members were appointed to the board. The board held its first meeting in February 1982. In December 1985, the ISE was opened, and the first trading occurred in January 1986. Since then, the market experienced a fast development.

Initially there were 40 companies publicly traded and illegal practices were wide spread. Unfortunately, the board chased up after incidents rather than preempting them. An inspection carried out on 24 brokerage firms at the end of 1987 produced some remarkable results¹¹. Some of those are as follows;

- There were no client orders routed to the brokerage firms.
- A number of brokerage firms had not even kept accounts.
- Some brokerage firms mingled their own portfolios with client accounts.
- Innumerable fictitious sales and purchases were detected during the investigations.
- One of the banks even refused to provide the inspectors with information.

As a result, the ISE licenses of six brokerage firms were canceled. The other members faced prosecution by Public Prosecutors and the Ministry of Finance. Based on the investigations, it was also understood that some illegal practices were committed on a systematic and continuous basis.

Until the reforms of 1992, the board even was not allowed to hand over the cases to the courts directly. Initial permission of the ministry was required for this. Yet the courts are slow in Turkey; additionally they were new to the securities regulations, and when the permission from ministry was added to these shortcomings, obtaining one's rights through the Turkish Judicial system remained theoretical. Rather than

¹¹ Abdurrahman Yıldırım, *Fortunes Made Fortunes Lost The Saga of the Istanbul Stock Exchange*, translated by Lucy Wood. Intermedia. İstanbul, 1996, p. 194.

battling with the courts to win their rights, investors tended to give up altogether. This made it further difficult to prevent fraudulent activities as the prevailing market view was that the CMB inspection or investor complaints would not result in any kind of dissuading penalty. In addition to the atmosphere that encouraged illegal practices, the regulations even did not cover the concepts of manipulation and insider trading until 1992. Along with this, there was not a system or a department to perform the surveillance function on a systematic and continuous basis so as to detect such deficiencies. The early 1990s lacked also adequate supervision. The third chairman of the board was under medical control for two years and went to the USA many times for medical reasons. This caused the board staff to lose their concentration.

In 1990-91, the number of brokerage firms soared outnumbering the listed companies. Many received the license by political means; they first contacted with the government to have the operating license, then the CMB acted accordingly. This way, many, which lacked adequate knowledge, expertise and capital, got into the brokerage business. As the competition grew, they inclined more in risky operations. The main point was that they engaged in fictitious trades and unauthorized use of client assets. This went on till the 1994 crisis. Only then, the restructuring of the settlement and custody services seemed to solve the problem.

In 1987, the CMB introduced the system of independent auditing in order to have some of its inspection functions fulfilled. However, companies had no concept of disclosure and in some cases never disclosed their statements on time. With effect from mid-1995, it became obligatory to publish balance sheets and income statements in detail and accompany them with an independent audit report¹². This made a significant contribution to improving levels of disclosure. On the other hand, the underground economy in Turkey is estimated to be around 50 %, which means that many transactions are not reflected in accounting records. So inflation and general economic conditions remain to be an impediment for full transparency through disclosure of financial statements.

¹² Yıldırım, *ibid.*, p. 226.

After covering insider trading and manipulations in the CML in 1992, a Special Situations Communiqué was issued in 1994 so that the companies were required to inform the CMB and the ISE of the material information through the fastest means of communication. In mid-1994, a separate department responsible for performing surveillance function was set up within the ISE¹³. The department tries to detect any abnormal price and volume movements and notifies the CMB of the circumstances¹⁴. Today, the CMB is considering setting up a surveillance department within its own organization. Nevertheless, the need is evident for a computerized tracking model that automatically notifies of the abnormal transactions.

As of the end of 1995, the CMB identified seven cases of manipulation and five cases of insider trading and handed them over to the courts¹⁵. But out of twelve, two insider trading cases have been resolved¹⁶.

4. OBSTACLES TO EFFECTIVE INSPECTION

The CMB had some friction and disputes with the ISE. On the one side the CMB, empowered by law as the top administrative body of capital markets, on the other the ISE, empowered by being the only stock exchange in Turkey could not succeed to establish a productive dialogue with each other. As a result of this many necessary changes on regulations were not made at the opportune time and remained on paper.

The location of the CMB in Ankara has formed an obstacle for effective inspection. The surveillance function was performed by the ISE, and computerization of the CMB, a key factor in performance of surveillance, began in 1995.

The CMB has two main bodies: one the Decision-Making Organ, the other the Organization Unit. The chairman is the head of both of the bodies. All binding and

¹³ Until then, the function was among the duties of another department within the ISE.

¹⁴ As required by Decree Law No:91 and the provisions of the CML.

¹⁵ Yıldırım, op.cit. p. 174.

¹⁶ *Borsa Uyuşmazlıkları, Uygulama, Örnek Kararlar ve Mevzuat*. İstanbul Mankul Kıymetler Borsası, Hukuk İşleri Müdürlüğü, İstanbul, 1997, p. 608.

final decisions are issued by the Decision Making Organ, most of the members of which are appointed by politicians. Conversely, the personnel of the Organizational Unit are recruited through a competitive entrance examination from the graduates of prominent universities in Turkey. And it represents the technical strength of the board and prepares all the projects, but the Decision-Making Organ has often been unsuccessful to give the last word on the decisions. Also there sometimes appeared lack of coordination between the bodies. This further strained the board's ability to make timely and prompt decisions.

Prior to the 1994 crisis, the third chairman of the board had medical problems for two years. And the early 1990s were the years of fallback for the board. The professional staff worked hard not to lose their credibility. Recruitment, training and overseas education were also abandoned, and a warning in a report presented to the Decision Making Organ in the early 1993 seems to prove that the board even was not able to follow up the inspection files during the period. "Unless the risks are reduced and safety mechanism put in place, the system will be at great risk. If the necessary measures are not taken, there is a strong probability that the risk will grow out of control and shake the foundations of the system."¹⁷

Some restrictive actions taken by the board in order to prevent manipulations and insider trading were not supported by the ISE and the brokerage firms¹⁸. The conflicts also eroded the public image of the board. Changes of the chairmen brought different policies and lacked, to some extent, adequate level of consistent supervision and inspection.

¹⁷ Yıldırım, op.cit. p. 175.

¹⁸ The CMB required intermediary institutions to disclose the names of their customers, but some US brokerage firms did not comply with. Then the CMB prohibited transactions through the intermediation of those firms. But it could stand the pressure of the market for two days and suspended the prohibition.

5. DEVELOPMENT OF SETTLEMENT AND CUSTODY SERVICES

When the ISE initially began operating, there was not a special department, an institution or a bank providing settlement and custody services. A special room was provided in the building of the ISE where purchasers and sellers could come together so as to carry out physical delivery of shares versus payment. In 1988, a separate department responsible for settlement and custody was set up within the ISE. But the service rendered did not change much. In the mean time, the department was not providing custody service. It was merely a place where the physical exchange was taking place. Either the shareholders or the brokerage firm on behalf of them used to keep the securities in their own vaults. But default of some investors to bring the money forced the department to provide custody service from then on for those that were not taken from the department. This was how it started rendering custody services. The department continued its operations until 1991 with the support of İşbank. In 1991, the department became a separate company, the ISE Settlement and Custody Company. This time it was being supported by Vakıfbank.

That some brokerage firms went bankrupt in 1994 made it evident that the system of settlement and custody services was to be revised. In February 1995, a new system called “Customer Based Custodian System (CBCS)” was introduced. Until that time, brokerage firms were allowed to provide custody service for their customers. In other words, they were allowed to keep the securities physically in their own vaults.¹⁹ And the Settlement and Custody Company used to take the brokerage firms as customers and was not able to know which share belonged to which individual investor. This made it possible for brokerage firms to carry out fictitious transaction and unauthorized use of client assets. Illegal practices such as the sale of the same security or non-existent Treasury Bills to many investors did not cause a problem until the 1994 crisis. With the collapses, the system suffered some \$ 160 million.

¹⁹ Individual investors do not have direct access to trading on securities on the ISE. Any investor, either a Turkish citizen or a foreigner, has to use the intermediation service of a brokerage firm authorized by the CMB. In the USA, investors have direct access to securities trading and this is something criticized by foreign investors at the moment.

To solve the problem, the CMB made it obligatory for the ISE members²⁰ to be a member of the CBCS after February 1995. With the new system, Takasbank gave an account identification number along with a password to all customers of the brokerage firms. These accounts were recorded under the custody accounts of the brokerage firms as sub-custody accounts. This does not solve the problem entirely as the brokerage firms were still authorized for trading on client securities. The use of duplicated entries could still make unauthorized use of client assets possible unless there is a direct access between Takasbank and the investors. So, an interactive voice response system was introduced to make it possible for investors to be able to receive information on their account balances 365 days and 24 hours by simply dialing "ALO TAKAS" lines and using the passwords and account numbers allocated to them²¹. Also the CMB prohibited the brokerage firms to provide custody services for their customers²².

At the end of 1995, the company became an investment bank, the ISE Settlement and Custody Bank Inc.(Takasbank). The bank began operating in January 1996.

A new feature has recently been added to the CBCS. As the system requires to make frequent phone calls in order to be sure that the brokerage firm has not made any unauthorized transaction on the balance of the accounts, the system now makes it possible to freeze the accounts by investors. In other words, investors can make their accounts remain unchanged for a certain period of time by telephoning Takasbank.

As explained above, many precautions have been taken in order to prevent unauthorized and fictitious trading on securities by brokerage firms. The CBCS is the heart of the system. Nevertheless, mutual fund investors are not provided with the system as they are given participation certificates. In other words, Takasbank does not give sub-custody accounts for the owners of the certificates as they can be sold

²⁰ The brokerage firms and some banks.

²¹ The service is available in Turkish and in English.

²² The shareholders themselves can keep their securities in their own vaults as the ownership right is preserved by law.

on the open market freely without a need to inform the mutual fund or Takasbank. At this point, so as to prevent reoccurrence of the abuses of former periods, the CMB checks the accounting records of the Mutual Funds everyday and compares them with the balances represented in the records of Takasbank. Although this seems to solve the problem, with the use of double-bookkeeping there is still a possibility that invested funds in mutual funds can be used for other purposes without being detected by the regular audits of the regulatory authorities.²³

Another new feature has also recently been added to the CBCS in order to prevent market manipulations and insider trading violations. For this purpose, Takasbank now requires brokerage firms to disclose the names of their customers. This will increase the transparency of transactions and be a stepping stone to prevent the use of fictitious names.²⁴ To this end, Takasbank is also planning the use of a special investor identification card. With this, it is aimed to prevent the use of different names by the same person.

With these developments, we can state that the market is much better regulated compared with the former periods. Also effectiveness of dematerialization of capital market instruments and carrying out all transactions on the computers of Takasbank from one account to another, whose holders are known, will definitely make great contributions to transparency.

²³ Assume, a mutual fund forms a portfolio and issues 2000 participation certificates. But it records, say, only 1500 of them, and also maintains another recording only for their customers covering the entire issue. The missing 500 certificates can not be detected because the records of the mutual fund checked everyday by the CMB does not cover the missing certificates as well and proves to be the same with those in the records of Takasbank. Although this is a dangerous game, the process can be maintained for years without being detected by regular audits.

²⁴ In the first place, the Swiss Banks are an obstacle for this as they do not accept to disclose the names of their customers unless the verdict is final. Also some giant US brokerage firms do not comply with the rule. (Some time ago the CMB prohibited those to provide intermediation service on the ISE. it could stand the pressure of the market only for two days.) Beyond this, we also hear the rumors that some Turkish investors are coming to the ISE through the intermediation of foreign brokerage houses in order not to be followed up by the CMB.

6. FACTORS THAT ENCOURAGED MANIPULATION

The market was new and did not have required depth. So it was easy to affect the prices. Individual investors were also new to the securities investing and susceptible to be deceived. Short-term investments were favored by the trading rooms, general economic conditions and inflation, and the trading turnover on the market was high. All these factors along with the view that any complaint or inspection would not result in a significant penalty were encouraging to manipulate the market.

That the ISE experienced two major booms from 1986 to 1990 encouraged many adventure seekers to have brokerage firm licenses. Many of them got the license to be an ISE member through political means. After this, the CMB approved permissions initially taken from the political parties. That the CMB limited the number of brokerage firms also prevented those firms with serious approach from getting into the business. The people most enthusiastic about owning brokerage houses were attracted by the profitability of operating as an intermediary on the ISE and were keen to get onto the ISE trading floor and speculate for themselves, or form a group in a bid to manipulate prices²⁵.

Capital inadequacy and lack of experience were other problems for brokerage firms. So they tried to figure out the ways of deriving substantial returns by means of limited capital.

After the intermediary boom in 1990-91, small investors more or less withdrew from the market. While there were 1.000.000 investors in 1990-91, the number went down to 250.000 as of the end of 1995²⁶. The market came to the point where virtually most of existing turnover was attributable to the managers, directors and brokers of ISE members. That it, as a result, decreased the commission revenues sharply made earning money through illegal means more widespread.

²⁵ Yıldırım, op.cit. p. 182.

²⁶ The number is around 500.000 today.

7. PROBLEMS WITH BROKERAGE FIRMS²⁷

In various inspections carried out by the CMB, two main kinds of illegal practice employed by some brokerage firms were identified²⁸;

1. Unauthorized use of client assets and fictitious trades
2. Manipulations and insider trading violations

7.1. UNAUTHORIZED USE OF CLIENT ASSETS AND FICTITIOUS TRADES

Until the 1994 crisis, the brokerage firms were allowed to provide custody service for their customers, but some abused their authority to provide this service. The practice of the service was this way;

As an individual investor you do not have direct access to the ISE, you have to use intermediation service of the ISE members. When you purchased a security through your brokerage firm, you had the right to keep it in your own vault, or the brokerage firm used to keep it either in its own custody or place them into the vaults of Takasbank. This way, the customer of the Takasbank was the brokerage firm and in its records appeared that, for example, ABC Brokerage Firm deposited a certain amount of securities. Neither the customers of the brokerage firm nor Takasbank itself did know which shares belonged to which investor. And some brokerage firms employed double accounting entries; one for investors and one for Takasbank. So this made it possible that some shares appeared in records but did not exist in reality. They collected cash, for example, for 1000 shares of XYZ stock but only bought 500. And the rest of the cash collected was utilized commonly for following purposes:

- They engaged in illegal money lending at high interest. To some extent, they provided unauthorized one-sided banking service. And the revenues were shown as commission income.

²⁷ Allegations are surely not made for all the brokerage firms in Turkey.

²⁸ Yıldırım, op.cit, p. 185.

- They used the securities as collateral when they borrowed.
- They used the funds for manipulation and speculation.

Inadequacy of the system to detect the illegal practices and the use of duplicated entry system also enabled the brokerage firms to;

- carry out fictitious portfolio management. This way, they acquired funds and used them for their own ends. As they were buying on collective basis rather than on client basis, they were also able to record high sales and low purchases into their own portfolios.
- carry out fictitious treasury bill sales. They sold treasury bills to their customers that existed only in accounting records. And when the bills were due, they paid the required interest along with the principal.
- carry out fictitious repo transactions, which were not backed of collateral²⁹.

7.2. MANIPULATIONS AND INSIDER TRADING VIOLATIONS

In addition to the manipulation techniques commonly employed on the ISE, brokerage firms engaged in following activities in micro level;

- They used portfolio management and investment advising as tools for manipulation.
- They used duplicated entry system and used some other records to cover up questionable transactions.
- They used fictitious client names, even those inscribed on tombstones.

²⁹ Today, the repo and reverse repo transactions are carried out on the Repo/Reverse Repo Market on the ISE, opened in February 1993, and the securities backing as collateral are kept in Takasbank.

8. HIGH TURNOVER AND VOLATILITY ON THE MARKET

The market has experienced three major booms, in 1987, 1989 and 1993. And just after the peaks the index experienced sharp declines. Many reasons such as geographical crisis, political and economical affairs were considered to account for³⁰. And high GNP growth rates and relatively low interest rates were considered to account for the sharp increases. Especially in the early years of its establishment, the ISE was among either the best performing stock exchanges or the worst performing ones³¹.

- In 1987, the first in the world with a dollar based return of 261.1 %.
- In 1988, the worst performing stock exchange in the world with a total fall of 61.1 %.
- In 1989, the first in the world with a dollar based return of 502.4 %.
- In 1991, the third worst performing stock exchange in the world with a total fall of 41.8 %.
- In 1992, the second worst performing stock exchange in the world with a fall of 52.8 %.
- In 1993, the second best performing stock exchange in the world after Poland with an increase of 234.3 %.
- In 1994, the second worst performing stock exchange in the world with a fall of 40.2 %.

As well as being a highly volatile market, the ISE has been a highly liquid market with a considerably high trading turnover. In 1995, stocks on the market, on average, changed hands 7.5 times³².

³⁰ See for further information about the reasons of the crises. Yıldırım, op.cit. pp. 36-37.

³¹ *Emerging Stock Markets Factbook*, International Finance Corporation. Washington D.C., 1995. cited in Yıldırım, ibid. p. 38.

³² Yıldırım, ibid. p. 50.

Who is winning, who is losing?

Firstly, the brokerage firms, as they receive commission on every transaction, a liquid market has meant very much to them in this respect, even if none of them engaged in market manipulations and insider trading.

Secondly, foreign investors, they were mostly institutional investors. They began trading on the ISE in 1989 with a good timing. Today, they hold half of the securities. But on average, their daily trading approximately constitutes 10 percent of that of the total volume. This was even lower before. So it can be concluded that they are not the main reason for the volatility. Moreover, they enjoyed the liquidity instead of falling manipulator traps. They sometimes increased their share in trading volume up to 35-40 percentages with very good timings. More specifically, they invested heavily prior to 1989 and 1993 booms when the index hit the bottom and emptied their portfolios after reaching peaks. This way they seemed to know what they are doing. They derived substantial amounts of returns in those years as the ISE was among the best performing stock markets of the world.

In this sense, the foreign investors seemed less interested in manipulations³³. However, one may argue that everywhere in the world exist manipulators. So there also have to be some manipulators among those foreign investors. To some extent this is true, but they need a strong local partner, as effectiveness of manipulating business requires to know the market environment very well and to have a continuous flow of inside information.

Thirdly, manipulators, the percentage of the trading turnover of the local investors is approximately 90 % although they have, on average, half of the shares. While some part of the volatility is attributable to the commission generating efforts of the brokerage firms, which once outnumbered the firms on the ISE, manipulative activities also played an important role.

In its tenth year, the ISE became Europe's eighth largest stock exchange in terms of transaction volume³⁴, but not in terms of total outstanding capital of listed

³³ Those Turkish citizens who are investing through foreign brokerage firms are beyond discussion.

³⁴ Yıldırım. op.cit. p. 16.

companies. And a yearly turnover of 182.2 % gave the ISE the third place in the world. The first was NASDAQ with a 236 % turnover and the second was Taiwan with 202.2 %. When we consider that approximately 25 % of the shares of the companies listed on the ISE are publicly owned, the turnover ratio of the ISE exceeds that of NASDAQ and Taiwanese Stock Exchanges since the percentage of publicly owned shares is higher on those exchanges. So this assumption gives the ISE the first place in the world in terms of liquidity. And also when we consider that local investors, who have 50 % of the shares, carry out 90 % of the transactions, we have a brighter picture of the transaction speed among the local investors.

Those small investors who are not going to the market everyday are also benefiting from the overall increase of the index, but the overall outlook implies that small investors who prefer short term are losing or deriving relatively low returns.

9. DEMATERIALIZATION OF CAPITAL MARKET INSTRUMENTS

As of today securities are posted from one account to another in Takasbank. While this is being done, the securities that appear in accounts physically are kept in the vaults of Takasbank. And it is prohibited for brokerage firms to provide custody service for their clients, but the investors have the legal right to keep their securities in their own safes.

With the implementation of the dematerialization, again the securities will be posted from one account to another. But the securities will not exist in reality and therefore will not be kept under custody. Firms issuing securities will issue a paper instead that reads, for example, 1.000.000 shares of XYZ Company stock with a face value of \$ 1.000.000. Putting this into use means individual investors as well will not be able to keep their own shares physically in their own vaults. Here, the CMB is planning a trick. It wants to control and monitor the market with no leakage. To this end, it also now requires financial intermediaries to disclose the names of their customers; in addition to this, having all transactions carried out from one account to another in accounting records will contribute to the effectiveness of surveillance. But as the ownership right is preserved by law, Takasbank has been to allow withdrawals; and as it does not seem possible to change the law in opposite direction, the CMB desires the legislation of dematerialization of capital market instruments. This way, withdrawals by individual investors automatically will be impracticable and unattainable, as the shares of stocks will not exist in reality.

So surveillance and the monitoring the market will be performed on a much more effective basis, as all the transactions will be carried out on the computer within the same system. Also it will be easier to detect the illegal practices, provided that the use of fictitious names is prevented.

The Interactive Voice Response System and the use of sub-custody accounts for each investor make unauthorized use of client assets and fictitious trades almost impossible, as investors have direct access to learn their account balances; provided that investors check their balances and the brokerage firms do not dare to take such a risk and to use duplicated entries. On the other hand, the clients of mutual funds are

not provided with the service, and it is still possible to deceive both sides, the investors and the regulators, with the use of duplicated entries. The reason that they are not given sub-custody accounts by Takasbank is that they take participation certificates issued by the mutual fund. These certificates can also be traded on the ISE. So sub-custody accounts for these certificates seems impracticable. But the problem remains unsolved as the unauthorized use of client assets and fictitious traded is still possible by means of duplicated entries.

To solve this problem, assigning sub-custody accounts to participation certificates instead of investors is required³⁵. So as to be able to do this, Takasbank should issue a special label to be attached onto the participation certificates that contains an account number along with a password. It is essential that the label be issued by Takasbank as mutual funds may give the same number more than one certificate. This way, certificate holders can learn the number of certificates issued by mutual funds and amount of securities represented by the certificates.

On the other hand, if put into use, dematerialization of certificates can solve the problem at the outset. As everything will be on the records of Takasbank, double sale of one certificate by means of duplicated entries will not be possible.

Along with the dematerialization, an advanced form of network to connect the computers of the CMB, the ISE, Takasbank and the ISE members to each other is required. After this point, an automatic stock watch tracking system should be employed so as to detect abnormal price and volume movements.

Today such a system is employed by the surveillance department of NASDAQ. The department is capable of monitoring on average 150.000 transactions and 40.000 price movements a day. The system takes into consideration the historical data and automatically notifies the authorized officers of the suspected transactions³⁶.

³⁵ For the time being, assigning sub-custody accounts for investors works this way. Investors have an account number. after dialing ALO-TAKAS lines, they learn their balances with the use a password so that others can not get access to their accounts.

³⁶ Tezcanlı, op.cit, p. 187.

10. TURKISH JUDICIAL SYSTEM

There are two main problems;

- The view that litigation would not result in any penalty,
- Even if it does, litigation is a lengthy process in Turkey,³⁷ and moreover the judicial system is new to the area.

The situation, from the point of investors, is discouraging to go to the courts; and from the point of illegal practitioners, is encouraging to engage in fraudulent activities. Following example is a good one to summarize the problem:

19 top officers of Turkish Development Bank (Türkiye Kalkınma Bankası) were under prosecution. It was alleged that they had learned the information of the capital increase of Uşak Ceramics Inc. (Uşak Seramik Şirketi), a subsidiary of Turkish Development Bank, before it was disclosed to the public. During the trial, the judge got difficulty in understanding the crime and asked following questions: “What is wrong with your buying the shares?”, “What is the problem here? Why can they not buy while ordinary persons can buy them?”

To solve the problem, it is argued to establish Specialty Courts³⁸ (İhtisas Mahkemeleri) where the cases will be handled by the judicial staff specialized on securities regulations. In addition to the Specialty Courts, a new capital market law is required. The present structure of the laws is one of the main reasons of the length of the litigation process. Other related laws such as Turkish Commercial Code are also applicable to the securities trading violations. This is causing a complexity. So the new law must be in such a broader form that articles of other related laws will be invalidated. If these are accomplished, we will hopefully have a judicial system of securities trading that discourages the illegal practitioners and encourages the investors to follow their rights³⁹.

³⁷ “There is no courts specialized in Capital Markets in Turkey” laments Hülya Kamehli, acting the head of CMB’s legal department. “Small cases can take three years to come to court.”

³⁸ Although argued, it will not come into use with the new Capital Market Law, which is currently at the parliament now.

³⁹ In this respect, special emphasis should be given to investor grievances.

Additionally, whenever you impose a new sanction, new ways are found to break them. Therefore, the new law should also provide the CMB with the capability to yawn regulations in desired direction⁴⁰.

Self-regulation is also another important factor that will contribute the effectiveness of the regulations. From this point of view, the establishment of a Supreme Board of Brokerage Firms would be essential. The board can bring effective measures to the internal control system of brokerage firms. It is also argued that foundation of an investor protection fund will also have a decreasing effect on manipulative activities. Another thing is rewarding and encouraging, this way or another, the informers of manipulations and insider trading.

Finally, one of the main reasons for the easy handling of manipulations is the lack of depth of the ISE. So encouraging actions should be taken in order to attract more investors and more firms to the market. In addition to this, the reliability of financial statements is questionable as unrecorded economy is estimated to be around 50 %. Also the high inflation rate the economy has been suffering is another factor that makes it difficult to interpret and compare the figures on financial statements.

⁴⁰ Due to the complexity in this field, effectiveness of a communiqué of the CMB for the dematerialization of the capital market instruments was halted by the Supreme Court. Danıştay. Now dematerialization is waiting for the new Capital Market Law.

CONCLUSION

Turkish Stock Market is a young and emerging market. It is in a relatively good position compared with the other emerging markets in the world that are now suffering some crisis. The market is also extremely liquid. Despite many problems such as high inflation and political instability, capital markets are promising and giving good signs for future. On the other hand, the market lacks the required depth and there are some market makers and speculators who are also engaging in market manipulations and insider trading violations.

Approximately 50 % of the securities listed on the ISE are hold by foreign investors. And foreign investors seem less interested in manipulations based on inside information as many of them are institutional investors that naturally prefer long-term investments. This assumption is also proved by the average trading volume of foreign investors that although they keep half of the shares, their average trading volume constitutes approximately 10 % of the total trading volume on the ISE.

On the other hand, Turkish investors are holding the other half of the securities on the ISE, but their daily trading goes up to 90 % of the total trading volume. This makes it evident that many Turkish investors are not in fact investing in securities, they are merely playing on the market. It is also argued that there are some 10 big players on the market determining the prices. They are said to have sufficient cash ranging from \$ 50 million to \$150 million and they carry out half of the daily transaction on the ISE. They are cornering the prices and small investors are generally getting the train of increasing prices as the last passenger.

In its tenth year, the ISE became Europe's eighth largest stock exchange in terms of transaction volume⁴¹, but not in terms of total outstanding capital of listed companies. And a yearly turnover of 182.2 % gave the ISE the third place in the world. The first was NASDAQ with a 236 % turnover and the second was Taiwan with 202.2 %. When we consider that approximately 25 % of the shares of the companies listed on the ISE are publicly owned, the turnover ratio of the ISE exceeds that of NASDAQ and Taiwanese Stock Exchanges since the percentage of publicly

⁴¹ Yıldırım, op.cit. p. 16.

owned shares is higher on those exchanges. So this assumption gives the ISE the first place in the world in terms of liquidity. And also when we consider that local investors, who have 50 % of the shares, carry out 90 % of the transactions, we have a brighter picture of the transaction speed among the local investors.

When we look at the development of regulations, we are confronted with the fact that regulatory authorities chased after incidents rather than preempt them. Until the reforms of 1992, the board even was not allowed to hand over the cases to the courts directly. Initial permission of the ministry was required for this. Yet the courts were slow, and were new to the securities regulations, and when the permission from ministry was added to these shortcomings, obtaining one's rights through the Turkish Judicial system remained theoretical. Rather than battling with the courts to win their rights, investors tended to give up all together. This made it further difficult to prevent fraudulent activities, as the prevailing market view was that the CMB inspection or investor complaints would not result in any kind of dissuading penalty. In addition to the atmosphere that encouraged illegal practices, the CML even did not cover the concepts of manipulation and insider trading until 1992. And a Special Situations Communiqué was issued in 1994. In mid-1994, a separate department responsible for performing surveillance function was set up⁴². Today, the CMB is considering setting up a surveillance department within its own organization.

The brokerage firms, which once outnumbered the listed companies, also caused some problems. Many received the license by political means, which lacked adequate knowledge, expertise and capital. As the competition grew, they inclined more in risky operations. The main point was that they engaged in fictitious trades and unauthorized use of client assets. This went on till the 1994 crisis. Only then, the restructuring of the settlement and custody services seemed to solve the problem. While there were 1.000.000 investors in 1990-91, the number went down to 250.000 as of the end of 1995⁴³. The market then came to the point where virtually most of existing turnover was attributable to the managers, directors and brokers of ISE members. That it decreased the commission revenues sharply made earning money through illegal means more widespread.

⁴² Until then, the function was among the duties of another department within the ISE.

There were obstacles to effective inspection. The CMB had some friction and disputes with the ISE. On the one side the CMB, empowered by law as the top administrative body of capital markets, on the other the ISE, empowered by being the only stock exchange in Turkey, could not succeed to establish a productive dialogue with each other. As a result of this, many necessary changes on regulations were not made at the opportune time and remained on paper. Also there sometimes appeared lack of coordination between the bodies of the CMB. This further strained the board's ability to make timely and prompt decisions.

The location of the CMB in Ankara has formed another obstacle. The surveillance function was performed by the ISE, and computerization of the CMB, a key factor in performance of surveillance, was begun in 1995.

On the other hand, developments and plans for future are promising. With the implementation of the dematerialization, the surveillance function and the monitoring the market will be performed on a much more effective basis, as all the transactions will be carried out on the computer within the same system. Also it will be easier to detect the illegal practices, provided that the use of fictitious names⁴⁴ is prevented. Even then, the following points will remain as factors encouraging manipulations and insider trading;

- Lack of depth; it is easy to lead the prices.
- Lack of institutional investors; the trading turnover is high, in other words majority of investors prefers short-term investments.
- Slow and non-specialized judicial system; the system is good on paper, but, to be discouraging requires prompt penalties. The view that the complaints of investors or the investigations of regulatory authorities would not result in a dissuading penalty must change.
- Herding behavior; investors do not know securities investing well, many are following the general trend of the market and mostly what their brokerage firms and media of financial news recommend.

⁴⁴ In various inspections carried out by the CMB. it was understood that some brokerage firms used fictitious client names. even those inscribed on tombstones.

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