FINANCIAL MARKET INTEGRATION IN THE EU AND PROBABLE EFFECTS ON TURKISH STOCK MARKET

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ABSTRACT

FINANCIAL MARKET INTEGRATION IN THE EU AND PROBABLE EFFECTS ON TURKISH STOCK MARKET

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The aim of this thesis is to analyze the probable effects of integration with European stock markets on stock market in Turkey as an acceding country. The required changes in Turkey's legal framework and economic effects on Turkish stock market have been examined by reference to the current legal framework of the EU and the measures that can be defined as reform within the dynamic integration process of the EU. It is determined that adopting the legal framework of the EU will have numerous effects on all the parties involved in the stock market, namely; stock exchange, financial intermediaries, firms and investors, leading to a pro-competitive environment, the end result of which is likely to be an increase in the share of the stock market in the national economy and a positive growth effect for the economy as a whole.

Keywords: Financial market, stock market, integration, FSAP, EU.

ÖZ

AVRUPA BİRLİĞİNDE FİNANSAL PİYASALARIN ENTEGRASYONU VE TÜRK HİSSE SENEDİ PİYASASINA OLASI ETKİLERİ

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Bu tezin amacı AB üyeliğine aday konumda olan Türkiye'nin Avrupa hisse senedi piyasalarına entegrasyonunun Türk hisse senedi piyasasına olası etkilerini araştırmaktır. AB'de mevcut yasal çerçeve ve dinamik entegrasyon sürecinde reform olarak adlandırılabilecek önlemler dikkate alınarak Türk hisse senedi piyasasına ilişkin yasal çerçevede yapılması gereken değişiklikler ve ekonomik etkileri araştırılmıştır. AB mevzuatına uyumun hisse senetleri piyasasındaki tüm taraflara; borsaya, aracı kuruluşlara, şirketlere ve yatırımcılara sayısız etkileri olacağı tespit edilmiştir. AB mevzuatına uyumun rekabeti teşvik edici etkiler yaratması beklenmekte olup bunun sonucunda nihai beklenti hisse senedi piyasasının ekonomideki payının artması ve ekonominin bütünü için pozitif büyüme etkisi yaratılmasıdır.

Anahtar Kelimeler: Finansal piyasa, hisse senedi piyasası, entegrasyon, FHAP, Avrupa Birliği.

to my parents,

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TABLE OF CONTENTS

PLAGIARISM iii
ABSTRACT iv
ÖZ v
DEDICATION vi
ACKNOWLEDGMENTS vii
TABLE OF CONTENTS viii
LIST OF TABLES x
LIST OF FIGURES xi
LIST OF ABBREVIATIONS xii
CHAPTER 1
1. INTRODUCTION 1
2. FINANCIAL MARKET INTEGRATION IN THE EU AND SINGLE MARKET IN FINANCIAL SERVICES 8
2.1. Global Environment as the Background of Financial Integration 8
2.2. Effects of Financial Market Integration 13
2.2.1. Financial Markets 13
2.2.2. Role of Financial Markets 16
2.2.3. Expectations from the Integration of Financial Markets in the EU 17
2.3. Formation of Single Market in Financial Services in the EU 19
2.3.1. Single European Market 19
2.3.2. Formation of a High Tech Stock Exchange 21
2.3.3. Economic and Monetary Union 21
2.3.4. Financial Services Action Plan (FSAP) 24
2.3.5. Lisbon Strategy 24
2.3.6. Lamfalussy Process 25
2.4. Implications of Stock Market Integration in the EU 26

3. REGULATION SUPERVISION AND THE LEVEL OF INTEGRATION IN EUROPEAN STOCK MARKETS 27
3.1. Securities Market Regulation and Supervision in the EU 27
3.2. MIFID and the Potential Effects 34
3.3. Level of Integration in the EU Stock Markets 40
4. FUTURE OF STOCK MARKET INTEGRATION IN THE EU 50
4.1. Post – FSAP Agenda 50
4.2. Challenges of Integration in Stock Markets 54
5. PROSPECTIVE INTEGRATION OF TURKISH STOCK MARKET WITH THE EU STOCK MARKETS 59
5.1. Comparison of Turkish Stock Markets with the EU Member States' Stock Markets 59
5.2. Turkish Stock Market and Adoption of the Acquis 79
5.2.1. Probable Effects on Legal Framework 81
5.2.2. Probable Economic Effects on the Stock Market 84
6. CONCLUSION 94
BIBLIOGRAPHY 107
APPENDICES 114
APPENDIX-1 EC Treaty Articles 56, 57, 58, 59, 60 114
APPENDIX-2 EC Treaty Articles 43, 49 117
APPENDIX-3 Stock Market Regulations to be Enacted According to the Program for Allignment with the Acquis 118
APPENDIX-4 Acquisitions in the Brokerage Industry 133
APPENDIX-5 The Objectives and Major Components of the Twinning Project 134

LIST OF TABLES

TABLES

Table 3.1 FSAP Components 31
Table 3.2 -Supervisors of Banking, Securities and Insurance in EU Member States,US and Japan 39
Table-5.1 Number of Active Brokerage Firms (2001-2007) 62
Table-5.2 Residents' Investment Breakdown 2005-2007 (Million USD) 63
Table-5.3 Non-Resident's Investment Breakdown 2005-2007(Million USD) 63
Table-5.4 Breakdown of Equity Portfolios by Investor Categories 65
(2001-2007)(Million USD) 65
Table-5.5 Number of Listed Companies (2006-2007) 67
Table-5.6 Market Capitalization of WFE Members (2006-2007) (USD millions) .. 69
Table-5.7 Market Capitalization: ISE and European Stock Exchanges (Dec.31, 2007) (Million Eur) 71
Table-5.8 Stock Market Indexes of WFE Members (2006-2007) 73
Table-5.9 Stock Market's Significance in the National Economy of WFE Members, 2006 75
Table-5.10 Share Traded Values and Turnover Velocity in the European Stock Exchanges and ISE (USD millions) 77

LIST OF FIGURES

FIGURES

Figure 2.1 The financial system 14
Figure 3.1- Proportion of Variance In Local Equity Returns Explained by Euro Area and US Shocks 45
Figure 3.2-The Degree of Cross-Border Holdings of Equity Issued by Euro Area Residents 47
Figure 5.1. Outstanding Shares, Government Bonds and Treasury Bills (1997-2007) (000 TRY) 64

LIST OF ABBREVIATIONS

ABBREVIATIONS	
ACMIIT-Turkey	The Association of Capital Market Intermediary Institutions of Turkey
CAPM	Capital Asset Pricing Model
CEECs	Central and Eastern European Countries
CESR	Committee of European Securities Regulators
CMB	Capital Market Board
CML	Capital Market Law No. 2499
CRA	Central Registry Agency Inc.
ECB	European Central Bank
ECJ	European Court of Justice
EEA	European Economic Area
EEC	European Economic Community
EMI	European Monetary Institute
EMU	Economic and Monetary Union
ERM	Exchange Rate Mechanism
ERT	European Round Table of Industrialists
ESC	European Securities Committee
ESCB	European System of Central Banks
EU	European Union
FESE	The Federation of European Securities Exchanges
FDI	Foreign Direct Investment
FSAP	Financial Services Action Plan
FX	Foreign Exchange
GDP	Gross Domestic Product
IPO	Initial Public Offering
ISE	Istanbul Stock Exchange
IOSCO	International Organization of Securities Commissions
M&A	Mergers and Acquisitions

MIFID	Markets in Financial Instruments Directive
NASDAQ	National Association of Securities Dealers Automated Quotations
OECD	Organization for Economic Cooperation and Development
OMC	Open Method of Co-ordination
OTC	Over the Counter Market
RIA	Regulatory Impact Assessment
SEA	Single European Act
SEC	US Securities and Exchange Commission
SEM	Single European Market
SMP	Single Market Program
TNC	Transnational Corporation
TRY	New Turkish Lira
TurkDex	Turkish Derivatives Exchange Inc.
UCITS	Undertakings for Collective Investment in Transferable Securities
WFE	World Federation of Exchanges
WTO	World Trade Organization

CHAPTER 1

INTRODUCTION

Financial markets and institutions form the financial structure which is an important part of the modern economy. Financial structure which brings together borrowers and lenders fosters economic efficiency and enables better allocation of resources. The expected result is a higher stock of capital for the economy and a better standard of living for the citizens.

Financial markets are traditionally segmented into capital markets for long-term securities and money markets for short-term securities. Money market instruments include short-term, liquid, marketable, low-risk debt securities whereas capital markets include longer term and riskier securities. Securities in the capital market are more diverse so the capital market can be divided into four segments: longer term fixed income markets, the derivative markets for options, derivative markets for futures and the stock markets.

Financial assets and the markets in which they are traded play a crucial role for the economy. Therefore governments give importance to the formation of properly functioning financial markets for both domestic borrowers and lenders and for the international ones. Especially with the advances in communication technology and dismantling of regulatory constraints, there is a tendency towards the formation of a worldwide financial market and the countries are competing with each other to attract investors and to become major financial centers. Capital markets in general and stock markets in particular are at the center of the above mentioned developments.A properly functioning stock market is a requirement for the existence of a developed financial system.

As far as the Turkish stock market is concerned, development of the stock market is of primary importance for promoting industrial growth and capital accumulation. Accordingly the legal framework of the stock market in Turkey has been formed taking into account the systems of the developed financial markets, especially the US system. The main aim has been to have a market which provides a level playing field for the parties involved in the system, both domestic and international. In other words, the objective has been to harmonize with the international regulations in order to improve the investment climate. With the start of accession negotiations with the EU, the adoption of the EU *acquis* related with stock market regulations became a requirement. Turkish regulations regarding the capital markets in general and stock market in particular have begun to be revised according to a predetermined calendar in the National Program. It is very important to assess the probable effects of adopting the *acquis* and the integration with a pan-European stock market on Turkish stock market legal framework and functioning of the stock market. At present there is no uniform study covering all the related aspects of this process, while it is very crucial to determine the effects of the stock market integration with the EU.

Because the legal framework related with stock markets in the EU is within the context of regulations concerning financial market as a whole, to study stock market integration in the EU requires the understanding of the financial market integration in the EU.

The Treaty of Rome (1957) focuses on free movement of goods, services, labor and in capital in order to form a common market. Establishment of a common market would be accompanied by the harmonization of economic policies of the member states (Hitiris, 2003:63). Initial focus was on the formation of customs union which was achieved in 1968. Within this context, the free movement of capital was required to the extent necessary to ensure the proper functioning of the common market. Treaty of Rome includes no specific aim of financial market integration in general and stock market integration in particular. However free

movement of services which as a major pillar of the Treaty serves as a basis of the financial integration process.

The unfavorable economic climate of the 1970s was also unfavorable for the realization of economic integration. Due to the recession following the oil price shocks of 1973 and 1978 and high rates of inflation and unemployment, member states focused on their domestic economic problems instead of economic integration (Hitiris, 2003:63). However, during the phase of the economic recovery in the 1980s European integration was reactivated. Commission's White Paper "Completing the Internal Market" was published in 1985. The White Paper set the objectives of completion of liberalization of capital movements, the unification of national markets for financial services and the establishment of a common regulatory structure for financial institutions. Following the Commission's White Paper of 1985, Single European Act (SEA)(1986) which accelerated the integration process positively especially with the introduction of qualified majority voting was enacted.

The Single Market Program (SMP) which foresaw the completion of the single market by 1992 brought into the agenda, the concepts of "minimum harmonization" and "mutual recognition" of regulations. These two concepts formed the basis on which a single market in financial services was found. The integration of financial markets has been a policy priority for the European Union (EU) especially since the late 1990s. Lisbon Strategy (2000) sets the goal of making Europe the "most dynamic, knowledge–based economy in the world by 2010". The integration of financial markets has been expected to create the dynamics to modernize the European economy in reaching this goal.

There are some major initiatives driven by the EU besides the SMP that serves the formation of an integrated European financial market, of which stock market is an inseparable part (Bieling, 2003a:209). Economic and Monetary Union (EMU), Financial Services Action Plan (FSAP), Lisbon Strategy and Lamfalussy

Process deserve to be mentioned in analyzing the formation of an integrated financial market.

It should also be stated that behind the process of financial integration in the EU there also exists a broader background – global financial market integration. The financial markets have been globalizing since the late 1970s and developments in Europe are not independent of this tendency. In literature main reasons for the internationalization of financial markets are given as technological development and the rise of neoliberalism (Koskenkyla, 2004:16).

European stock markets have been integrating over time and there are some indicators which are used to assess the degree of integration of these markets. Studies show that after EMU, stock prices are influenced heavily by euro area developments. Some studies also show that correlation of price movements of equities of similar industries listed on different national stock markets has increased. Investors also make cross-border investments and there is also a tendency towards consolidation of the equity trading business in Europe (Muller, 2004:147-148). Integration also can be inferred from cooperation among stock exchanges as well as mergers among stock exchanges.

In the Euro zone wholesale financial markets where the securities are sold between broker-dealers to institutional investors show the highest level of integration whereas retail financial services where individual customers are served is fragmented. Remaining obstacles affecting the integration process can be described as the differences in legal, administrative, accounting, tax and consumer protection systems, language, business culture and habits (Muller, 2004:151).

The Commission's White Paper on Financial Services Policy 2005-2010 presents financial services policy priorities which include serious implications for the stock markets as well. To understand the future developments in financial

integration and thus in stock market integration it is necessary to study the regulatory and supervisory reforms of the EU related with financial markets.

EU is also experiencing a widening in its integration. So adaptation of new member states to the process of financial integration is of primary importance for both the success of the SMP and for the success of enlargement rounds. Integration of stock market is an inseparable part of the process. Turkey, as a candidate country to the EU membership, is also in a position to adopt the EU *Acquis*. Turkey will adopt the EU system and in case of full membership, Turkish stock market will be a part of the single stock market in the EU. So the process of stock market integration in the EU will directly affect legal framework of financial services in Turkey.

In this context Turkey has to harmonize existing rules and regulations with the *Acquis* in order to adopt the EU system. Actually in the EU level, there are also debates on further reforms in regulatory and supervisory frameworks in order to reach the goal of single market for financial services. Turkey will adopt the existing system and also the following developments, since *Acquis* is a *moving target*.

The main aim of this thesis is to investigate the probable effects of Turkey's full membership to the EU on the Turkish stock market. The subject is analyzed from both legal and economic aspects. The effects of adopting the EU system on the legal framework of the Turkish stock market is examined by determining the steps taken and steps which need to be taken for the adoption of the *Acquis*. However it should be stated that details of the regulations related with the adoption of the *Acquis* is beyond the scope of this thesis both because of the extent of the related regulations and because the aim is not to discuss the details of the legislation but to give a general understanding to assess the impacts. It should also be stated that, regulations regarding the stock markets have beeen reshaped recently in the EU. Therefore, the experiences of EU-15 or newly acceding countries can not be used to assess the economic implications regarding the integration with a pan-European stock market. New entrants to the EU membership, namely CEECs, also cannot be

used for the comparison since these have the background of command economies different from the Turkish system. Accordingly the economic effects of adopting these new set of rules are assessed taking into account economic theory, the Commission's expectations, the rationale behind the changes in regulations and also some tendencies evident even with the start of the accession negotiations.

In literature it can be seen that stock market integration is a major part of the process of financial market integration so in most of the cases it is not possible to separate the developments regarding the financial market integration from the developments related with stock market integration. The achievements for the realization of a single market in financial services also serve for the integration of stock markets, vice versa. So, in order to analyze the probable effects adopting the EU *acquis* on stock markets, it is necessary to study the stock market integration in the EU which constitutes a main part of the financial integration process. Accordingly, Chapter 2 provides information on financial integration process in the EU. Within this context, background of financial integration, i.e. the environment that fostered the idea of a single market in financial services is explored. The expectations from the financial market integration with the emphasis on stock market dimension are investigated. The analysis of the EU initiatives for the formation of single market in financial services is the last section of the chapter.

In order to comment on implications regarding the integration of Turkish stock markets with the EU, regulatory framework of the stock market in the EU and the achievements regarding the formation of a single market in financial services has to be evaluated. So, in the third chapter, the regulation and supervision in securities markets in the EU is focused on. In the last part of the chapter the existing level of integration of stock markets is examined in light of the studies conducted on this issue.

In the fourth chapter, focus is on the future of stock market integration. Since Turkey is in the process of harmonizing the legal framework with the EU, probable

developments that may revise the system are also important for Turkish stock market. The agenda of the EU regarding the European stock markets are directly related with the accession negotiations in Turkey since the *acquis* is a moving target. Accordingly, post- FSAP agenda with a special reference to stock markets and challenges of integration is explored in the chapter.

In the fifth chapter, in light of the information and the analysis given in the previous chapters, the probable effects of adopting the EU *acquis* on Turkish stock market are analyzed. First of all a comparison of the EU stock markets with Turkish stock market in terms of the market data is made. Next, probable effects of adopting the EU system are discussed on two subsections: effects on legal framework of stock market in Turkey and economic effects on the stock market.

The sixth chapter is the conclusion which represents the overall results of the study.

CHAPTER 2

FINANCIAL MARKET INTEGRATION IN THE EU AND SINGLE MARKET IN FINANCIAL SERVICES

Financial market integration is an integral part of a broader process of economic and political integration in the EU and stock market integration is a major part of the process. In most of the cases it is not possible to separate the developments regarding the financial market integration from the developments related with stock market integration. The initiatives for the realization of a single market in financial services also serve for the integration of stock markets, vice versa. Accordingly, to give the general framework related with the stock market integration financial market integration should be studied. Therefore the aims of this chapter, which would form the basis for the analysis regarding the stock market integration, are to describe the global environment as the background of financial integration, to clarify expectations from the realization of a single market in financial services, and to explain major steps in the formation of single market in financial services.

2.1. Global Environment as the Background of Financial Integration

The development of the European socio-economic order can be subdivided into two periods.

The first period was the Keynesian period which marks the era of 1945 to late 1970s, during which the general European regulatory framework primarily aimed to support national socioeconomic models and their development by providing an economic environment which is advantageous for growth and

employment. The second one is the post-Fordist era beginning in the late 1970s which can be characterized by the employment of neoliberal policies.

In the first period there was a fairly broad consensus in the public that national governments bore exclusive responsibility for the national mode of socioeconomic modernization (Bieling,2003a: 205). In this era where global capitalism was characterized by inward-looking Fordist forms of accumulation, the rules associated with Bretton Woods System gave governments enough autonomy to promote stability and prosperity domestically without endangering the international monetary and trade relations (Soederberg, 2001:3). The old European economy was thus characterized by a limited opening-up of the national economies, an opening which did not weaken either the national Fordist paths of development or the welfare states but indirectly secured and stabilized them through the growth effects achieved without the need for any supranational welfare objectives (Bieling, 2003b:2).

In terms of the European integration process, from 1952 but especially 1957 onwards, the EU had two main priorities; to provide security and to support the reconstruction of Western Europe. Economically, the main goal was the establishment of a customs union, i.e. the removal of tariff barriers between the EU members and the establishment of a common external tariff. This was accomplished by the end of the 1960s. European free trade was successfully combined with the national right to intervene in the economy in order to maintain order and social peace (Bieler, 2003:5). Thus, it was in accordance with the compromise of embedded liberalism'[1] which marks the era of 1945-1970 according to Ruggie (Ruggie, 1982:392).

There is a change in this tendency in the second period which coincides with a time when national regulatory models all over Europe found themselves in crisis especially due to the oil price increases of 1973/1974, cost push inflation, overstrained budgets, unfavorable demographic conditions etc (Bieling, 2003b:1).

[1] Embedded liberalism defines a system where economic liberalization was embedded in social environment.

According to Bieling, European financial market integration is the outcome of a whole series of initiatives. To demonstrate, three structural developments can be mentioned (Bieling, 2003a:208).

First of all, throughout the 1970s and early 1980s there was a period of “Euro-pessimism”. The pessimism was mainly the result of the sudden end of the post-war Fordist growth tendency and the slowdown of the integration process. There was a general belief that Keynesian policies would not provide solutions to the weakness of European economy and also are not enough to compete with US and Japan. According to this understanding stagflation of the European economy was the result of the institutional rigidities which are mainly created by excessive government intervention, too powerful trade unions, and overburdened welfare state (Apeldoorn, 200: 74). Loss of competitiveness was, in addition to above mentioned factors, the result of the fragmentation of the European market, insufficient economies of scale and technology gap vis-à-vis US and Japan.

From the 1970s onwards there was an accelerated liberalization of financial regulation in USA and the UK. Indeed, the ability of other governments to control financial markets were impaired, so in order to prevent outflow of funds, many countries followed this attitude and the result was easing of regulation within domestic finance industries. This new arrangement can be defined as a shift from *embedded liberalism* to *embedded financial orthodoxy*[2] (Cerny, 2004:12). Since the investors look for more liberal -lower- regulatory standards, easing of regulation was also a way of attracting international investors. In a way this is a “competitive re-regulation” of national financial markets (Cerny, 2004:14).In that
sense states were competing to attract foreign direct investment (FDI) or portfolio investment by creating favorable environments for the investors.

[2] A shift away from Keynesian macroeconomic demand management to a more structural approach to fiscal and monetary policy (Cerny, 2004:12).

Secondly, from the early 1980s onwards there was an expansion of financial sphere through public debt and the issuing of public-sector bonds, increasing securitization of cross border transactions, privatization of formerly publicly owned enterprises, growing market capitalization of transnational corporations (TNCs), and a strong rise in FDI, mostly via M&As.

Thirdly, there emerged a group of new actors in the financial field—institutional investors (insurance companies, investment and pension funds), investment banks and rating agencies who changed the conventional role of big banks.This period also witnessed major changes such as technological and organizational changes in the production process, liberalization of trade under GATT and WTO, the break-down of the Bretton Woods system, beginning of currency floating, liberalization of financial markets, the explosion of FDI, and the emergence of powerful TNCs in manufacturing, services and financial sectors.

During the process of European integration in the era of 1965 to 1985, from de Gaulle's empty chair crisis to the initiation of the Internal Market, only limited progress can be observed. With the perception of failure in integration process, also as a response to the worldwide economic recession in the 1970s, European integration was reactivated in the mid 1980s around the SMP (Bieler, 2003: 5).

European big business has a major role in this revitalization. First we see the European Round Table of Industrialists (ERT) which is founded in 1983 and consisting of 45 chief executive officers (CEOs) and chairmen managing leading European TNCs initiating the SMP. ERT included two groups- *globalists* (favoring neo-liberal policies) and *Europeanist* (favoring neo-mercantilist-protective regionalist- policies). In the 1980s the strategic orientation was towards protective regionalism however from 1988 onwards globalists became the dominant group within the ERT (Apeldoorn, 2001:80). Thus European response to the crisis of 1970s was *protective* whereas in the 1990s the tendency returned to neo-liberalism.

The financial integration in the EU is not independent from the general process of internationalization and globalization which gained momentum with the dominance of neoliberalism in the late 1980s. Especially with the advances in communication technology and dismantling of regulatory constraints, there is a tendency towards the formation of a worldwide financial market and the countries are competing with each other to attract investors and to become major financial centers (Konskenkyla, 2004, 20-21). This is an era when deregulation is the dominant ideology. International organizations played a major role in promoting free trade. Organization for Economic Cooperation and Development (OECD) published two recommendations on free movement of capital and this development has affected international flow of funds positively. The World Trade Organization (WTO) also contributed to the development of international trade in financial services (Konskenkyla, 2004, 21).

In this post-Fordist era, the emergence of the competition state[3] can be seen. Indeed, the new era defined especially by the Lisbon strategy (2000) is totally compatible with Jessop's definition of *Schumpeterian competition state* with its concern in technological change, innovation, enterprise and new techniques of governance (Jessop, 2002:96). Especially from 1980s onwards the process of European integration is oriented towards the objective of *improved global competitiveness.* Neoliberal strategies of adjustment were employed and the concepts of *competitive deregulation* and competitive *austerity* gained importance (Bieling and Steinhilber, 2000:39).

As the discussion above shows financial market integration which stems from both political and economic reasons is the product of a neo-liberal consensus with the main actors of European governments, Commission and TNCs. Behind the

[3] "A state that aims to secure economic growth within its borders and/or to secure competitive advantages for capital based in its borders, even where they operate abroad, by promoting the economic and extra-economic conditions that are vital for success in competition with economic actors and spaces located in other states." (Jessop, 2002:96).

process of financial market integration in Europe a broader picture of global financial integration can be observed.

2.2. Effects of Financial Market Integration

2.2.1. Financial Markets

Financial markets and institutions form the financial structure which is an important part of the modern economy. The Figure 2.1 shows the main actors and working of the financial system in the broadest sense. The households, the business sector, the governments and the foreigners are the clients of the financial system. In general, households invest their excess funds whereas the business sector and the governments are the fund raisers. However the opposite is also possible, i.e. the households may also be borrowers and the firms may need to invest their excess funds in the financial assets. Indeed in every economy all the above mentioned categories can be both fund raisers and lenders.

Surplus economic units meet with deficit economic units in financial markets. As Figure 2.1 illustrates borrowers either transact directly with lenders in a financial market or work through intermediaries. In the first system borrowers and lenders of the funds meet in the primary markets. Primary market is the one that channels the funds directly to the end-users, i.e. from savers to investors through the numerous types of securities such as stocks, bonds, notes, mortgage loans and money market instruments, i.e. newly issued stocks are created and distributed in the primary market. However once securities are created investors may not want to hold the related securities indefinitely. There is a need of a market for the exchange of existing securities. Existence of a broad and deep secondary market where the liquidity is provided by the trade of existing securities is also an essential part of the system. The main samples of secondary markets are organized stock exchanges.

As Figure 2.1 shows, in the second system financial markets such as banks, investment companies, insurance firms bring borrowers and lenders together. Financial intermediaries sell their own liabilities to raise funds that are used to purchase liabilities of fund raisers. To give an example, a bank raises funds by borrowing (taking deposits) and lends the funds to the borrowers. In that case borrowers and lenders do not contact each other directly; bank is the intermediary. Another example can be given from the mutual funds which pool the money of small investors and manage the collected funds taking the advantage of economies of scale in terms of cost of transactions and offer portfolio diversification which is not feasible for small amounts of individual portfolios.

The market-based system where there is no intermediary such as bank between borrowers and lenders is also defined as disintermediated system. The other system where intermediaries exist between borrowers and lenders is named as bank-based. It can be said that the financial systems are market-based in US and UK in contrast to the bank based systems of continental Europe.

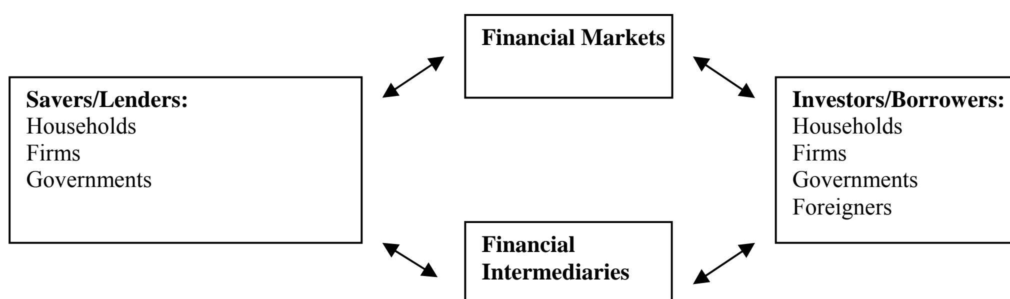

Figure 2.1 The financial system
Source: Santomero, Babbel, 1997:5.

Financial markets are traditionally segmented into capital markets, for long-term securities, and the money markets, for short-term securities. Money market instruments include short-term, liquid, marketable, low-risk debt securities whereas

capital markets include longer term and riskier securities. Securities in the capital market are more diverse so the capital market can be divided into four segments: longer term fixed-income markets, the derivative markets for options and futures and the stock markets which is the subject matter of this thesis.

The fixed-income capital market is composed of longer-term borrowing instruments other than those traded in the money markets. Examples of the securities involved are Treasury notes and bonds, municipal bonds, mortgage securities and corporate bonds.

Derivatives market for options and futures is a major development in financial sphere in recent years. These instruments provide payoffs that depend on the values of other assets such as commodity prices, bond and stock prices or market index values. That is why the instruments are called *derivatives.* Their values are derived from the value of the underlying assets. Options give the right holder *the right to buy* (call option) or *the right to sell* (put option) an asset at a predetermined price on or before a specified date. The futures contract requires the delivery of the asset (or the cash equivalent) at a specified maturity date for a predetermined price, i.e. it involves an obligation to buy or sell an asset.

Stock market is another segment of the capital markets. Common stocks, also called equities, which are traded in these markets, represent ownership of shares in a corporation. The two major characteristics of stock as an investment are residual claim and limited liability. Residual claim means that in case of a liquididation of firm's assets stockholders are the last in line to receive payment. Limited liability means that in case of a failure of the company, for example in banktruptcy, the liability of stock owners is limited to the amount of their investment in shares, i.e. they do not have personal liability in firm's obligations. As mentioned above, stocks are created and marketed through initial public offerings (IPO) in the primary markets and already issued stocks are traded in secondary markets such as organized

stock markets, the over-the-counter market and some other trading systems depending on the regulatory framework of the related country.

2.2.2. Role of Financial Markets

Financial assets and the markets in which they are traded play a crucial role for the economy. Accordingly, governments give importance to the formation of smooth functioning financial markets for both domestic borrowers and lenders and for the international ones. In the broadest sense, financial markets enable savers to increase their future consumption through the yield of financial assets that they invest their surplus funds. A developed financial market enables the accumulation of resources which are used to finance investments and enables efficient allocation of resources. The existence of funds enables business firms to invest in plant and equipment which would increase productivity. In other words funds obtained from financial markets enable firms to exploit profitable opportunities (Santomero, Babbel, 1997:8). An efficient financial system is expected to direct the scarce resources to the best possible investment alternatives (Grahl, 2005:1005). In fact, allocation of capital in the economy and canalization of savings to the productive investments can be achieved by the financial markets and institutions (Reszat, 2005:155). By dispersing the funds to different investment alternatives, the market also creates the ground for the dispersion of risk. For the economy as a whole overall effect is an increase in standard of living; greater capital intensity, greater output and greater consumption (Santomero, Babbel, 1997:8).

In addition to these direct effects, financial sector also has indirect effects on economic growth. A wide range of business such as accounting, marketing, management consulting, legal services is related to the financial sector; financial sector creates demand and employment in these industries (Reszat, 2005:155). It can also be said that developed financial markets bring discipline to the corporate sector

especially with the use of the corporate governance principles which constitute a main item in the agenda of current financial developments.

2.2.3. Expectations from the Integration of Financial Markets in the EU

The main aim of the EU is to create an integrated area where goods, services, capital and labour move freely. As mentioned above, the integration of financial markets has been a *policy priority* for the EU especially since the late 1990s in accordance with the Lisbon Strategy. According to the Commission integration of financial markets has been expected to create the dynamics to modernize the European economy and integration of stock markets is a major part of the process of financial integration in the EU.

Financial integration is expected to create both macroeconomic and microeconomic effects. In terms of the macroeconomic effects, it can be said that through the capital flows within an integrated market, countries can regulate their consumption by borrowing during recessions and lending in favorable climates (Freixas, Hartmann, Mayer, 2004:478). Lower transaction costs and improved market liquidity results in an improved allocation of funds (City of London:7). Free flow of capital in an integrated market obliges governments to apply disciplined macroeconomic policies, specifically sound macroeconomic policies which create a favorable environment for the investors. Integration is expected to broaden and deepen financial markets and improve the efficiency and functioning of the financial systems (Freixas, Hartmann, Mayer, 2004:478). Specifically the expectation is that there would be an increase in the flow of funds in the financially less developed countries which in turn would lead to an increase the share of financial sector relative to GDP in these countries (Gianetti, Guiso, Jappelli, Padula, Pagano, 2002:12).

In terms of the microeconomic effects, a developed single market in financial services would provide consumers a wide range of financial products which can be traded all over Europe. An integrated financial market would include a vast array of investment alternatives compared to a national market. In addition, it enables risk diversification and an increase in the expected return of the portfolios of the investors.

An integrated financial market would enable the firms to raise equity across Europe with lower cost. Firms which would have access to a vast array of sources of funds would find an opportunity to strengthen their capital. Having access to the capital with lower cost, firms would find an opportunity to direct these funds to investment; this in turn would boost the rate of innovation, increase productivity of labor and capital, and affect economic growth and employment positively. It is predicted that financial integration in Europe would reduce the equity cost of capital by 40 basis points and increase GDP by 1.1% in the long term (London Economics, 2002:v). Opportunities for the borrowers also increase and the cost of funds decreases due to availability of a broader range of lenders (Freixas, Hartmann, Mayer, 2004:478).

It is also expected that financial integration will increase FDI flows - also in the form of mergers and acquisitions (M&A) which enables firms to reach economies of scale. The integration process would also result in competition among the providers of financial services, the end result of which is a decrease in their profit margins leading to a decrease in the cost of capital for firms and an increase in net gains from investments for investors.

Increase in the efficiency of financial intermediaries and markets of financially less developed countries is also a probable result of financial integration (Gianetti, Guiso, Jappelli, Padula, Pagano, 2002:12) The main rationale behind this development is the increased competition with cheaper and more sophisticated foreign financial intermediaries (Gianetti, Guiso, Jappelli, Padula, Pagano, 2002:13)

The other reason for this potential for development is the improvements in national regulation. During the integration process, there is a need for the convergence of regulatory standards. In practice the regulatory standards of financially less developed countries needs to be improved which also results in local financial development for these countries (Gianetti, Guiso, Jappelli, Padula, Pagano, 2002:13).

2.3. Formation of Single Market in Financial Services in the EU

The process of an integrated European financial market can be tought of as the result of six major initiatives driven by the EU (Bieling, 2003, 209): Single European Market (SEM), formation of a high tech stock exchange, EMU, FSAP, Lisbon Strategy and Lamfalussy Process.

2.3.1. Single European Market

The general principles related to the formation of a common market for financial services were already present in the Treaty of Rome which foresees free movement of services and capital. However in the process of European Integration Single Market for financial services has always been delayed (Santangelo, 1997: 2-3). It can be said that a major step towards financial market liberalization was the SMP (for free movement of goods, services, capital and people). SMP was born as a solution to the problems of weak growth, high unemployment, and relative weakness in competing with Japan and USA and with the aim of improving the competitiveness in economic and regulatory terms. With SMP the concepts of deregulation, flexibilization and privatization were brought into European agenda. During this period, President of the Commission was Jacques Delors, whose single market strategy can be summarized as the relationship between completing the internal market, decision-making reform and further monetary initiative (Dinan, 1999:109-110).

SMP represents the primacy of economic issues in the process of European integration. It was backed by a broad coalition of national and supranational actors. Delors created strong discursive and ideological ties between transnational big business, the Commission, and national governments (Bieling and Steinhilber, 2000:42).

It came about as a result of the European policy-makers' concerns about European companies' uncompetitiveness *vis a vis* US and Japan especially in the high technology sectors (Starie, 1999:48). Accordingly, SMP was intended to increase competitiveness by stimulating "economies of scale" and by raising productivity which would lead to higher investment and increased competitiveness, stronger economic growth, lower inflation and increased employment. The steps taken to this end were mainly the abolition of all non-tariff trade barriers, the introduction of qualitative majority decisions, and the comprehensive application of the principle of mutual recognition of national regulatory standards. The plan was to complete the internal market by the end of 1992.

SMP and the drive and energy displayed by the Commission for the realization of the Program, restored the image of the EU as a vital and modern entity and paved the way for the successful launch of the single European currency (Dinan, 1999: 377). In accordance with the Commission's recommendations the Treaty of Rome was amended and SEA came into force on July 1, 1987. It can be argued that with SMP financial liberalisation gained momentum but in terms of formation of the integrated financial markets there was still a lot to do.

2.3.2. Formation of a High Tech Stock Exchange

The second initiative was the formation of a single European market for trading in equities in high technology startups in Brussels similar to US NASDAQ[4]. However due to conservative attitudes of European banks and governments the aim could not be realized and national "new markets" only linked with each other electronically (Bieling, 2003a:210).

2.3.3. Economic and Monetary Union

EMU was mainly designed to be a solution to the instability of the EMS and dominance of Germany and Bundesbank with the major aims of completing the Single Market, decreasing transaction costs, realizing common control of a restrictive monetary policy, acquiring a better position in the global currency competition.

SMP and EMU are major initiatives that formed the background of financial market integration, and helped for the transformation of national economies. The Commission, most central bankers and national governments regarded the incompatibility of fixed exchange rates and free capital movements as a serious problem and in order to overcome it, they pushed for EMU as a necessity for the completion of the 1992 programme (Bieling, 2001:101). EMU with the coordination of macroeconomic policies and the endorsement of "binding rules for budgetary policies" is of paramount for the completion of the single market (Hitiris, 2003: EMU 144).

The Treaty of Maastricht which was signed in 1991 laid out the plan for achieving EMU. It foresaw a three-stage process. The first stage (1990-1993)

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[4] NASDAQ (National Association of Securities Dealers Automated Quotations) is an electronic, screen- based equity securities trading market which aggregates bid and offer quotes from different dealers for particular issues and presents them to the investors so that a qualified investor can also execute a trade by computer without the aid of a broker (Santomero, Babbel, 1997;428-429).

required all community currencies to join the Exchange Rate Mechanism (ERM). Full liberalization of capital movements and improvement of economic policy coordination were major aims of this phase (Hitiris, 2003:145). The second phase of EMU (1994-1998) began with the establishment of the European Monetary Institute (EMI) in 1994. EMI realized the preparation for the introduction of the single currency. ECB began its work in June 1998 and the third phase of EMU began at the start of 1999 with the introduction of the euro.

Under EMU monetary policy is administered by the European System of Central Banks (ESCB). The sole target of the ECB and its interest rate policy, as spelled out in the Treaty of Maastricht, is the maintenance of price stability and low inflation which is assumed to promote financial market integration and capital mobility. Before joining the single currency, member states are supposed to achieve a 'high degree of sustainable economic convergence' (Maastricht Convergence Criteria). Convergence criteria, which are required to participate in EMU are: price stability, low interest rates, public debt lower than 60 percent of GDP, budget deficit lower than 3 percent of the GDP and stable currency. Participating Member States have also committed themselves to support the common monetary policy by maintaining balanced fiscal accounts over the medium term (the Stability and Growth Pact) and by the enforcement of rules for fiscal probity (the Excessive Deficits Procedure). Therefore being a member of EMU requires a common monetary policy and also convergence of fiscal policies.

EMU member countries, in order to meet the criteria, had to implement tough austerity budgets in the run-up to EMU. UK, Sweden and Denmark are not EMU members. Nevertheless, the second stage of EMU commencing in 1994 obliged them too to draw up convergence programmes. Within EMU, continuation of neo-liberal budget policies is ensured through the Stability and Growth Pact which requires member states to avoid excessive deficits. The participating state's budget deficit should not exceed 3%of GDP and debt should not be higher than 60% of GDP and violations will be subject to penalties.(Bieler, 2003: 6).

Sustainable budget deficit is of primary importance for investors to minimize the risk of default. Through the use of single currency and strict fiscal discipline a stable investment climate is expected to be provided for investors (Bieler, 2003: 6). In addition, central bank of the applicant country should be independent. The given criteria help to prevent currency fluctuations and also direct governments to use orthodox market policies which will promote government credibility "in the eyes of financial market players" (Gill, 1998:1).

For both FDI and for portfolio investments investors require *sound money,* low inflation and stable currency. Thus, these central bankers should be free from the pressures of the governments, i.e. they should be independent. So in relation to the institutional setup of the ECB, 'new constitutionalism'[5] can be seen which 'seeks to separate economic policies from broad political accountability in order to make governments more responsive to the discipline of market forces' (Bieler, 2003: 6). The ECB has to report to the European Council and the European Parliament, but neither states nor supranational institutions are in a position to force any kind of policy upon the ECB. Accordingly EMU operates within the context of "new constitiutionalism" which aims to provide a sustainable stable environment for investors of both global currency and capital markets (Gill, 1998: 1)

EMU defined a uniform framework for monetary and financial policy to act as a catalyst in the integration of financial markets. The initiatives following EMU such as FSAP and Lamfalussy Process define the concrete measures and required legal framework.

[5] New constitutionalism can be defined as a governance framework that empowers market forces to reshape economic and social development worldwide

2.3.4. Financial Services Action Plan (FSAP)

The Financial Services Policy Group, made up of EcoFin (Economic and Finance Ministers Council) ministers and representatives of the ECB, under the chairmanship of the Commission, was given the task of identifying priorities for action. A major policy concern at that time was the slow progress in moving towards a single market in financial services, particularly in comparison to the goods market. In October 1998, the Commission published a Communication setting out a Framework for Action on Financial Services, followed by the FSAP itself in May 1999. FSAP, which is the road map for the formation of the single financial market, proposes to update EU financial regulation. Measures related to the stock market integration are a major part of the action plan. FSAP comprises 42 measures designed to harmonise the member states' rules on securities, banking, insurance, mortgages, pensions and all other forms of financial transaction. The first objective of FSAP is to establish a common legal framework for integrated securities and derivatives markets through abolishment of barriers to investment. The second objective was to achieve open and secure retail markets. The third and fourth strategic objectives include prudential rules and supervision that will contribute to the stability of Europe's financial sector (Stirbu, 2004:9). Successful completion of the FSAP provides a solid legislative foundation for more fully integrated European financial markets (Muller, 2004:141). The details of FSAP related to stock market in the EU will be mentioned in Chapter 3.1.

2.3.5. Lisbon Strategy

In Lisbon, in March 2000 the European Council set the goal of making Europe the "most dynamic, knowledge –based economy in the world by 2010". Internal Market Commissioner Frits Bolkestein states that[6] 'financial integration is a building-block of single market". The idea is that financial integration influences growth directly and indirectly (through easier access to market-based finance or to a

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[6] Bolkestein, F. SPEECH/02/99, 07.03.2002, Geneva, downloaded from http:/europa/eu

more integrated European financial market) to the extent that it facilitates technology accumulation and technological integration which translates into higher productivity growth (Padoan and Mariani, 2006: 77-78). Lisbon Strategy also makes clear how the functioning of the new European economy- i.e. of EMU and the financial markets- will affect, via the "Open Method of Co-ordination" (OMC), the reform processes in different fields of policy (Bieling, 2003b: 10-11).

2.3.6. Lamfalussy Process

The most recent initiative in support of an integrated European financial market has been the report of the Lamfalussy group. On July 17, 2000, EcoFin set up the Committee of Wise Man, chaired by Alexandre Lamfalussy, former president of the EMI, to study on European securities markets, financial integration in the EU and implementation of the FSAP. In its Final Report, the Committee identified shortcomings in the regulatory system as the major problem in integrating the EU financial market (Stirbu, 2004: 10).

The main suggestions to overcome the difficulties were to legislate more on the basis of regulations than directives—the latter still have to be transposed into national law—and to set up two new regulatory and advisory committees: a European Securities Committee (ESC) composed of national representatives at the rank of secretaries of state and a Committee of European Securities Regulators (CESR) composed of delegates from national regulators and supervisory authorities. They are now the main agents in the regulatory decision-making process, with the role of the Council and the EU Parliament reduced to the definition of framework and implementation principles. Bieling argues that this represents a further element of a new European constitutionalism, insulating political decision making from public and democratic control (Bieling, 2003:213). However, it can be said that taking into account these criticisms, Lamfalussy process requires that Parliament should be informed in every step of preparation of the regulations. The details of the

Lamfalussy Process related to stock market in the EU will be mentioned in Chapter 3.1.

2.4. Implications of Stock Market Integration in the EU

As mentioned in the previous sections increased integration in financial markets is the result of a whole serious of initiatives. SMP was a major step with its emphasis on financial liberalization for the formation of an integrated stock market.

EMU and the introduction of the euro were paramount for the integration of stock markets as well. Existence of a single currency makes cross border investment easier because of the elimination of the curreny risk. Also coordination of macroeconomic policies Europe-wide makes it easier to give cross-border investment decisions, investors need only to analyze the sector and firm specific factors in their analysis of the stock markets. FSAP, as will be mentioned in the Chapter 3, brings major measures for the integration of stock markets most of which are directly related with stock markets. Lamfalussy Process which aims to solve the problems of regulatory systems that hinders integration of financial markets, sets up two committees ESC and CESR which are the major actors in the formation of regulations for the formation of a pan-European stock market.

As a final remark it should be stated that the above given process which supports the single stock market can also be defined as a business driven process where a neo-liberal tendency and supply-side agenda is evident. This is a transition from simple trade liberalization to the integration of capital markets (Bieling, 2001:106). Indeed creating a *European Union* is more than an economic process. In the way towards the new European economy, beginning with the SEM there is a shift towards neoliberal policies consisting mainly of liberalization of capital flows, monetary policy committed to maintenance of low inflation and austerity (Siegel, 2003: 17). This is a strategic program that is global in nature and not confined to finance capital (Young, 2000: 79).).

CHAPTER 3

REGULATION SUPERVISION AND THE LEVEL OF INTEGRATION IN EUROPEAN STOCK MARKETS

This chapter aims to provide information about the securities market regulation and supervision in the EU and to explore the level of integration of stock markets in the EU by examining the studies at this topic.

3.1. Securities Market Regulation and Supervision in the EU

In general terms, it can be said that regulation is related to the formation of the rules whereas supervision deals with the enforcement of such rules either ex ante in the form of control or ex post in the form of sanctions (Kammel, 2006:1-2).

Financial market regulation stems from the need to correct market imperfections and unfair distribution of resources so it can be seen as a case of public control over the economy (Kammel, 2006:2). The main objectives of financial market regulation are (i) the realization of macroeconomic and microeconomic stability, (ii) improvement of investor protection especially via increased transparency (iii) protection and promotion of competition in the financial intermediation sector (Kammel, 2006:3).

Regulation of banks, investment firms, insurance companies, pension funds is regarded as "prudential" regulation. "Market" regulation which is also regarded as the "conduct of business regulation" is related with the regulation of securities markets. To be specific, market regulation is mainly based on disclosure. In this case, the major aim is to inform investors so that investment decisions can be given in a transparent environment where the investors have access to all the necessary information. In fact *The Magna Carta* of the capital market law is the equal treatment of the market participants (Kalss, 2002:120-121). Regulatory formations depend also on the types of financial systems. A market based system gives

importance to the control of market information, accounting standards and market integrity whereas in a bank-based system priority is given to the supervision of the banking sector (Lannoo, 1999:6).

Securities markets constitute an integral part of the single market in the EU. As it is mentioned above, the objective of securities regulation is to correct market failures. To be more specific, the International Organization of Securities Commissions (IOSCO) defines three objectives of securities regulation: i) the protection of investors; ii) ensuring that markets are fair, efficient and transparent; iii) the reduction of systemic risk. However, in case of the EU the main objective of securities regulation is to abolish regulatory barriers and to promote integration. Convergence of financial regulation of the member states is a policy objective of the EU. Therefore, regulation of the securities market, which is basically based on the objective of market integration, not only represents an important part of the single market regulation but it also supports its objectives and functioning (Asgeirsson, 2004:50).

The internal market which is the economic basis of the EU requires the abolition of barriers to the free movement of goods, persons, services and capital among member states. Free movement of capital is an essential condition for the proper functioning of the Single Market enabling better allocation of resources within the EU, facilitating trade across borders, favoring workers mobility, and making it easier for businesses to raise funs for their operations. Free movement of capital is also an essential condition for the cross-border activities of financial services companies. The effectiveness of EU initiatives in the financial services sector can only be realized if capital movements within the EU are not subject to restrictions. Treaty provisions are primary legislation in the EU and the relevant Treaty provisions regarding free movement of capital can be found in Articles 56

EC Treaty[7] to 60 EC Treaty (formerly Articles 73b to 73h of the EC Treaty) (Annex-1) . Particularly Article 56 EC requires that “all restrictions on the movement of capital between Member States shall be prohibited”.

Similarly the freedom of establishment (Article 43 of the EC Treaty) and the freedom to provide cross border services (Article 49 of the EC Treaty) are two fundamental freedoms which are required for the functioning of the EU Internal Market in general and integration of financial services in particular (Annex-2). The freedom of establishment enables an economic entity (legal or real) to carry on economic activity in one or more Member States. The principle of freedom to provide services enables economic entities to provide services on a temporary basis in another Member State without having to be established. According to the European Court of Justice (ECJ), who has a major role in the formation of the single market, Articles 43 and 49 have direct effect, binding, can be relied upon before national courts.

In brief, the above given articles of the Treaty form the basis for the removal of the impediments which would harm the convergence of the financial markets in general and stock markets in particular. Aside from the Treaty provisions there also exists secondary securities regulation that aims to form a liquid stock market accessible for issuers within the whole Community (Asgeirsson, 2004:51). The regulatory approach of the late 1970s and early 1980s was the use of detailed harmonized rules, i.e. maximum harmonization. Following this period the approach used was converted to mutual recognition with the key concepts of “single passport” and “home country supervision”.

Mutual recognition creates an environment where products or services that have been lawfully produced and marketed in one member state are to be granted free access throughout the internal market. Authorization given by one Member

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[7] Consolidated version of the Treaty on European Union and Treaty Establishing the European Community.

State gives the related party a “single passport” which should be recognized by all the other states. In principle the system is based on “single passport” used by the individual firms whose responsibility is to comply with the home country rules. For example, if an issuer meets the offering requirements of one member state, it can offer its securities in all member states due to the approval of conduct in the first member state. Also this system enables financial service providers open a branch or operate across national borders with the responsibility of control and supervision of its activities on home Member State (Mogg, 2002;68). Member states can still impose non-discriminatory regulation to guarantee market stability and investor protection. The established case-law of the ECJ accepts that restrictions can be accepted by reasons of general interest such as the protection of investors and market stability. However restrictions should not go beyond what is strictly necessary (Mogg, 2002:67). The regulatory measure had to be non-discriminatory and justifiable.

1985 White Paper “Completing the Internal Market”, 1986 SEA and the SMP all recognized the importance of securities regulation for the formation of the single market, they based their models on mutual recognition and minimum harmonization (Asgeirsson, 2004:5). However, at the end of 1990s the fragmentation in securities markets was still a problem. So 1998 Cardiff European Council addressed the problem and the Commission issued a Communication titled “Financial Services: Building a Framework for Action”. The Communication indicated some reform areas for the realization of single securities market (COM, 1998:625). To summarize, the reform areas were;

(1) a revision of the legislative process which can respond to market needs,
(2) modernization of wholesale financial markets,
(3) completion of the single market for retail financial products,
(4) review of supervisory mechanisms and regulatory cooperation,

(5) measures such as integration of infrastructures, effective application of competition and state aid rules, tax harmonization.

The above mentioned objectives were formed into a programme by the Commission "Implementing the Financial Services Action Plan" adopted in May 1999. FSAP was an ambitious program which included over 42 measures for establishing a unified set of rules for investors and consumers under a strict timetable. The aim was to complete the legislative framework for the internal market in financial services and the 2000 Lisbon European Council set the target date for the completion of the FSAP. The FSAP compenents are summarized in Table 3.1:

Table 3.1 FSAP Components

Objective	Main Subject Areas
1.Single wholesale market	EU-wide capital raising Common legal framework for integrated securities and derivatives markets Uniform financial statements for listed companies Containing a systemic risk in securites settlement Cross-border corporate restructuring Single market for investors
2.Open and secure retail markets	Distance selling of financial services Financial service providers' duty of information towards purchasers Cross-border payments E-commerce policy for financial services
3.Prudential rules and supervision	Reorganization and winding-up of insurance undertakings and banks Disclosure of financial instruments Supervision of financial conglomerates
4.Wider conditions for an optimal single financial market	Harmonization of tax regulations Creation of an efficient and transparent legal system of corporate governance

Source: (Reszat, 2005;190).

FSAP which can be devided into four broad categories as shown in the Table 3.1 has been intended to be implemented in 2005, with most of the measures

completed in advance. With the FSAP the problems which creates barriers for the establishment of a pan-European financial market was put forward. To bring the FSAP into life, a reform was also needed which would ensure consistent implementation and convergence of the structures and responsibilities of regulatory and supervisory authorities in the securities markets (Mogg, 2002:71).

In 2000 the Council set up a Committee of Wise Man to assess regulatory mechanism used in the securites market. The Committee headed by the Lord Alexandre Lamfalussy delivered its report (Lamfalussy Report) in 2001. The report's main criticism was about the regulatory system's inefficiency to respond timely and effectively to the market developments. (Asgeirsson, 2004:54). The report not only proposed changes in the area of legal framework but also in the areas of the rule-making and implementing process and the enforcement of rules (Kalss, 2002:118). So a regulatory reform was suggested. In their report Committee of Wise Man proposed establishment of two new intergovernmental committees: European Securities Committee (ESC) and the Committee of European Securities Regulators (CESR).[8] The Lamfalussy Approach, which has been in force since February 2002, is a four-level regulatory approach which shapes the securities markets and stock markets. The levels can be described as follows:

Level One: Level one legislation consists of legislative acts; framework directives and regulations.[9] These are adopted by the European Parliament and the Council under the co-decision procedure on a proposal by the Commission. This attitude has practical implications in that co-legislators agree on the basic framework, basic policy options. By not dealing with technical details in this level the whole process is accelerated.

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[8] CESR began operations in on July 7, 2001.

[9] Both directives and regulations take precedence over member state laws but a regulation has direct effect whereas directives need to be transposed into national law.

Level Two: In level two, the technical details of the level one framework legislation is prepared. The Commission drafts implementing rules by consulting to the CESR. CESR gives its advice by consulting to market participants, investors and security issuers. The Commission also takes the views of the national governments. To this end there exists a regulatory committee, the ESC consisting of the representatives of Member States' finance ministers. The ECS votes for the proposals of the Commission and CESR has the responsibility of development and implementation of regulations given to the ESC. The European Parliament is kept informed about the work of the ESC.

Level Three: Level One and Level Two legislation forms binding Community Law. In level three CESR aims to improve consistency of the implementation and convergence of supervisory practices. Guidelines and recommendations are prepared.

Level Four: The European Commission is seen as the "guardian of the treaty". Within the framework of level-four, it enforces the Community Law and initiates infringement procedures for the Member States which fail to comply with the Community Law. Therefore Level four is related with the enforcement of EC law by the Commission.

It can be said that after these developments, centralization of rulemaking and supervisory coordination has been achieved to a great extent (Wymeersch, 2005:1). Regulatory convergence has been improved, but there are still some limitations that deserve to be mentioned.

In some cases EU directives adopt minimum standards and member states may impose additional rules which results in the diversification of the rules. Also directives need to be transposed by the Member States in order to be applied. Thus, different timetables for transposition of the directives into national legislation may cause divergence of rules between the member states.

Following the Lamfalussy process, there is also a tendency of detailed formation of directives which takes the system to the maximum harmonization. Also following the Lamfalussy Report national regulators cooperate closely with the EU committees having a chance to influence the EU law making units.

It is also argued that the principle of mutual recognition causes regulatory competition since it allows the issuer to move to the member state that has the most favorable regulations and then use this “passport” for the issues in rest of the member states. So convergence of rules and enforcement across the member states is also necessary.

Within this context EU financial regulatory and supervisory scheme has changed substantially in the last decade. New directives have been enacted regarding the securities markets in general and stock markets in particular. The Prospectus Directive and the Market Abuse Directive are only some examples of these directives. However MIFID, the EU Markets in Financial Instruments Directive (2004/39/EC) is the most important measure in the FSAP (Casey, Lanoo, 2006:1).

3.2. MIFID and the Potential Effects

The origins of the MIFID go back to the EU Lisbon Summit 2000. It is a directive which aims to provide greater harmonization of regulatory processes for liberalizing and fostering competition in Europe’s capital markets and to enable firms to provide cross-border services in the EEA with greater freedom (Judge, D, 2006, 2).

MIFID which can be described as a reform in financial sector in general and stock markets in particular is the result of a bargaining between the EU Member States (Quaglia, 2008:22). The two competing belief systems involved in the

negotiations have been the Anglo Saxon approach and the Continental approach. [10] There are great economic interests in financial services so it is not surprising that both parties try to influence the policy process. However the efforts for the completion of the single market in financial services were the success of the Northern coalition, i.e. Anglo Saxon approach. The regulations are tried to be formed taking into account interests of all the parties involved, however a market-making, competition-friendly approach is dominant in the general framework.

The directive with the implementation deadline of November 2007, has replaced the 1993 Investment Services Directive and aims to create a single market in financial services across EU-27and 3 European Economic Area (EEA) member states. MIFID has also indirect effects for US and other third country firms doing business with EU customers but not directly subject to EU regulation.

The directive distinguishes between "investment services and activities"[11] (core services) and "ancillary services"[12] (non-core services). So all the firms performing investment services and activities are subject to MIFID for both their investment and ancillary services. Firms performing only ancillary services are outside the scope of MIFID. MIFID covers almost all tradable financial products with the exception of certain foreign exchange trades. In simple terms it requires the Member States to harmonise the rules governing investment services and the pursuit of investment activities. With this aim in mind, the Member States set up a "single passport" system enabling investment firms to operate through the EU.

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[10] Anglo Saxon approach is characterized by the market-making, principles-based, competition friendly regulation adopted especially by the UK, Ireland, the Netherlands and the Nordic countries. Continental approach is market-shaping, rules-based and heavily regulated and adopted especially by France, Italy and the other Mediterranean countries. Belgium and Germany determine their positions according to the content of the legislation negotiated (Quaglia, 2008:19-21).

[11] Examples can be given as reception and transmission of orders, execution of orders on behalf of clients, dealing on own account, underwriting (buying financial instruments with a view to selling)

[12] Examples of ancillary services are safekeeping and administration of financial instruments, providing credit and loans to clients, advice to undertakings, foreign exchange services connected with provision of services, investment research and financial analysis, recommendations.

MIFID is intended to have substantial pro-competition effects in all EU financial markets, however the greatest impact is expected in stock markets with significant structural changes. Reception and transmission of orders, execution of orders on behalf of clients, dealing on own account, portfolio management, underwriting, investment advice and placing of financial instruments are all within the scope of the MIFID. In terms of the investments, any of the investments in transferable securities, investment funds, money market instruments, financial futures, interest rate, currency and equity swaps, commodity derivatives, and options on the above given investments are within the scope of the MIFID.

MIFID brings a major change in the trade of stocks, it abolishes concentration rule, i.e. national authorities can no longer require firms to realize their orders only in stock exchanges. With the implementation of the MIFID there will be three types of execution venue:

(1) Regulated markets- principally the exchanges,
(2) "Multilateral Trading Facilities" (MTFs), electronic execution platforms currently known as Alternative Trading Systems,
(3) Systematic Internalisers[13] (a new concept introduced by MIFID).

Accordingly, the same stock will be traded in many different venues and not just at different prices but at different trading costs. Firms with a legal obligation to find the best possible price for their clients will have to look across a number of venues. Therefore, big pan-European firms that can afford to make the necessary investments which the new system requires would be in an advantageous position.

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[13] Large firms can execute client orders in shares on own account rather than on an exchange. If this activity is realized regularly on a systematic basis in liquid shares these firms are named as "systematic internalizers".

To eliminate the risks which come from the abolition of concentration rule MIFID establishes new rules for pre-trade and post-trade transparency, together with transaction reporting rules. Outsourcers providing MIFID-supported services will become experts in the new regulatory envitonment and will gain business from financial services firms.

MIFID requires the best exeqution of the orders. Firms will evaluate factors such as cost, speed, the likelihood of execution and settlement and price, will form an execution policy and apply also with the concent of the client. It also sets out requirements for internal audit, compliance functions and the management of risks, safeguarding client assets and managing conflicts of interest.

Another major development which the Directive brings is that it defines three classes of clients: retail[14], professional[15] and eligible counterparty[16], for which there will be different levels of protection and costs. Also investment firms are required to judge suitability of an asset or product looking at the financial capacity and asset allocation of the customer.

Emphasis on home state supervision will be prevailing. Brokerage firms, banks and stock exchanges will offer cross-border services on the basis of their home-country authorization. Firms covered by MIFID will be authorized and regulated in their home state. MIFID passport will enable any entity incorporated and regulated in one jurisdiction to provide services within MIFID's scope from its "home state" across EU without being regulatory oversight by host state regulators. As far as the branches opened in host states they will be subject to host state

[14] A client who is not professional.

[15] A client which possesses the experience, knowledge and expertise to make its own investment decisions and properly assess the risks to which it is exposed (such as credit institutions, pension funds, collective investment schemes, large undertakings etc)

[16] A sub-category of professional clients, which represents the most sophisticated class of investors and therefore receives the least protection under MIFID.

regulations but permission to open branches will be automatic, host state may not impose additional requirements.

Some comments can be made about the probable benefits of MIFID on European stock markets. There are some first-round, i.e. direct benefits to the European stock markets which are attributable to MIFID. Improved regulation is expected to cause improved functioning of the markets. MIFID simplifies the passporting regime which would lead to increased cross-border competition and greater stock market integration. Abolition of concentration rules might enhance competition between exchanges, MTFs and internalizers. Best execution principle leads to reduced prices for investors. Additionally, requirements for firms to disclose their execution policies might impose discipline on cost which would also be favorable in terms of investors (FSA, 2006:13-14). Therefore an overall increase in efficiency and competitiveness is evident from the above given benefits with an emhasis on greater integration of stock markets in the EU. There are also some second-round, i.e. indirect benefits. Markets may become deeper and more liquid, combined with greater competition and reduced transaction costs cost of capital may decrease. The reduction in the cost of capital may cause an increase in investment and a rise in GDP across the EU (FSA, 2006:18).

As stated above legal framework which is of paramount importance for the success of the stock market integration has been revised to a great extent within the last decade. Regulation is related to the formation of the rules whereas supervision deals with the enforcement of such rules either ex ante in the form of control or ex post in the form of sanctions (Kammel, 2006:1-2). So supervision is also of paramount importance for the success of this integration programme.

Different from the US system where there exists single legal authorithy, the US Securities and Exchange Commission (SEC), each member state has its own legal authorithy in the EU. The structure of financial supervision was based on the functional divisions in the financial services sector in the EU. In general, banks,

insurance companies and securities markets had their own distinct supervisory authorities. Table 3.2 shows the supervisors of banking, securities and insurance in Europe, and also in Japan and USA for comparison.

Table 3.2 -Supervisors of Banking, Securities and Insurance in EU Member States, US and Japan

	Banking	Securities Markets	Insurance
B	BS	BS	I
DK	FSA	FSA	FSA
DE	FSA	FSA	FSA
EL	CB	S	I
E	CB	S	I
F	B/CB	S	I
I	CB	S	I
IRL	CB	CB	G
L	BS	BS	I
NL	CB	S	I
AU	FSA	FSA	FSA
P	CB	S	I
SF	BS	BS	I
SW	FSA	FSA	FSA
UK	FSA	FSA	FSA
CH	BS	BS	I
CZ	CB	SI	SI
H	FSA	FSA	FSA
N	FSA	FSA	FSA
PL	CB	S	I
SLOE	CB	S	G
USA	B/CB	S	I
J	FSA	FSA	FSA

Source: (Lannoo, 2002:3)

Notes: CB=central bank, BS=banking and securities supervisor, FSA=single financial supervisory authorithy, B=specialized banking supervisor, S=specialized securities supervisor, I=specialized insurance supervisor, SI=specialized securities and insurance supervisor, G=government department.

B=Belgium, DK=Denmark, DE=Germany, EL=Greece, E=Spain, F=France, I=Italy, IRL=Ireland, L=Luxembourg, NL=Netherlands, AU=Austria, P=Portugal, SF=Suami Finland, SW=Sweeden, UK=United Kingdom, CH=Switzerland, CZ=Czech Republic, H=Hungary, N=Norway, PL=Poland, SLOE=Slovenia, USA=United States, J=Japan.

The Table-3.2 shows that there is no uniform system regarding the authorities related with banking, securities market and insurance. The countries have different attitudes towards the organization of financial supervision. From the 23 countries given in the table eight have a system where there exists a single financial supervisor dealing with all the related parties, namely; banking, securities market and insurance. Also in terms of the major financial centers there is no uniform system. UK has a system where there exists a single financial authorithy whereas US has a system where banks, insurance companies and securities markets had their own distinct supervisory authorities.

In terms of the integration of securities markets in the EU there exists arguments in favor of a single supervisory European authorithy taking into account especially the SEC of the US. However the general idea is that systems continue to differ in the securities markets of the member states, there are various exchanges and markets, so market supervision can best be carried out by the authorithies which are close to the markets (Lannoo, 1999, 23). It is generally accepted that, for the moment there is no need to the formation of a single legal supervisory authorithy in the EU.

3.3. Level of Integration in the EU Stock Markets

The drive for the realization of integrated stock markets in the EU comes from the belief that financial markets in Europe are small and fragmented (Freixas, Hartman and Mayer, 2004:476). Europe used to have fragmented capital markets where financial institutions served only the local investors and there has been little flow of cross-border financial services. Continental European financial system has been bank-oriented accompanied by smaller market systems (Freixas, Hartman and Mayer, 2004:477). However as it is mentioned above during the last decade the European financial landscape has changed dramatically and there has been a

continuous process of integration in European financial markets. Many studies have been conducted to test existing level of integration in European financial markets in general and stock markets in particular.

In theory, in a financially integrated area there should be no barriers which discriminate economic agents in their access to and investment of funds within that area (Hartmann, Maddaloni, Manganelli, 2003:189). Within such an environment financial instruments with identical cash flows should have the same price, also there should be no systematic differences in the portfolio allocation and sources of funding of economic agents (Hartmann, Maddaloni, Manganelli, 2003:190). In literature, analysis of the level of financial integration depends on price-based and/or quantity-based indicators. In the price-based approach, which measures discrepancies in prices or returns on assets caused by the geographical origin of the asset, *law of one price* is used, i.e. in an integrated financial market two identical financial product should be sold at the same price. The assets with the same risk should have the same expected return independent of the issuer or the investor. In other words increase in the degree of market integration should lead to the convergence of cross-country yields and a decrease in cross-sectional dispersion. For example euro area assets with the same risk which generate identical cash flows should trade at the same price (Baele, Ferrando, Hördahl, Krylova, Monnet, 2004: 11-12). Additionally, prices should be affected by the same factors and the correlation of the returns of the similar assets should increase as markets integrate (Freixas, Hartman and Mayer, 2004:479-480). In a financially integrated area regional news should have little impact compared to common or global news (Baelo, Ferrando, Hördahl, Krylova, Monnet, 2004:11). As far as the quantity based approach is concerned it can be stated that elimination of cross-border barriers should result in the increased international flows. In a financially integrated stock market agents should invest in their preferred assets independent of their location i.e. there should be no barriers. As stock markets integrate it is expected that share of domestic stocks decline in household portfolios relative to the share of foreign

stocks (Hartmann, Maddaloni, Manganelli, 2003:196). There should be no correlation between domestic saving and investment.

Much of the international finance literature has employed a capital asset pricing model (CAPM) in testing for financial market integration (Bekaert and Harvey, Dumas and Solnik 1995, Ferson and Harvey 1991, Hardouvelis et al.1999). In these studies the main idea is that expected local returns in a fully integrated market depend only to nondiversifiable international factors (Fratzscher, M., 2001:8). Different econometric techniques have been used to test level of integration in the EU stock markets.

In the following part some studies testing the level of stock market integration in the EU will be summarized. As mentioned above there are two approaches in these analyzes: price based and quantity based. As samples of price based anayses the studies of Fratzscher (2001), Croci (2004), Chelley-Steeley (1999) and as samples of quantity based approach Guiso, Haliassos, Jappelli (2002), Adam, Japelli, Menichini, Padula, Pagano (2002) will be given.

Fratzscher, in his study for testing stock market integration uses a set of 16 countries, some of which are part of the Euro area (Austria, Belgium, Finland, France, Germany, Italy, Netherlands, Spain), some of which have not adopted the Euro yet (Denmark, Sweden, UK), and five countries from outside the EU (Australia, Canada, Japan, Norway, Switzerland) for a period of 1986-2000 using trivariate GARCH model. The aim of taking such a broader sample is to analyze whether there are differences in integration between Euro members and other countries. The results of the study mainly show that;

- Stock markets in Europe are highly integrated: a shock of 1% in the Euro area leads to a change in returns of 0.344% on average in other markets whereas shocks in the USA have a similar impact of 0.359%.

- While the USA is clearly the dominant market outside the Euro area, it is no longer the only dominant market within the Euro area. Euro area market has become the dominant force for individual Euro area countries since the mid-1990s. This is true for all of the eight Euro area countries but not for markets outside of the Euro area.

- The degree of integration has strongly increased within the Euro area since the announcement of the Euro members in May 1998,

- Not only do shocks in one stock market raise volatility in other markets more now than before, but it is in particular the transmission of large and negative shocks that has increased more proportionally than the spillover of small and positive innovations.

To sum up, individual markets within the Euro area have become increasingly integrated over time. Reduced exchange rate uncertainty and convergence of monetary policy (inflation rate and interest rates) are the main factors behind the integration process. The empirical results have some interesting implications for investors. Higher integration implies that in terms of the portfolio diversification Euro area does not provide opportunities for investors, instead it is needed to focus more on diversifying across sectors or across regions. Investment banks and asset managers have begun to adopt a pan-Eurozone approach and have left their national investment desks instead they have begun to form industry-centered ones (Muller, 2004:148). In terms of policy makers another implication is that supervisors need to adopt a Euro-wide approach (Fratzscher, M., 2001:37).

Croci also studies on the question whether the integration of euro stock markets has effectively increased over the last years (Croci, 2004;1). To this end he focuses on the stock markets of Germany, France, Italy and Spain for the period January 1994 through June 2004 using the data set of time series of daily stock price indexes. The study mainly refers to pair correlations between stock returns, believing that co-movements can be used as a measurement of financial integration. It is concluded that there has been an increase in return correlations across the euro

equity markets over the last ten years and this can be interpreted as a sign of integration. According to the study stock markets are not perfectly integrated yet. Changes in investment culture, integration of trading systems, changes in structure of supervision and regulation, increase in cross-border coordination and cooperation among market authorities is needed to reach full integration.

Chelley-Steeley and Steeley use VAR analysis to analyze the degree of interdependence across markets. The study analyses the European stock markets between 1975 and 1991, comparing the transmission of shocks (as indicators of level of market segmentation) before and after the removal of the exchange controls. They concluded that market segmentation is reduced after the removal (Steeley and Steeley, 1999;473-488).

In the preceding parts of the study it has been stated that in an integrated EU stock market, prices should be affected by the common EU area factors rather than country-specific ones. If it is assumed that stock returns in euro area countries react to both local and global factors the source of total domestic stock volatility can be differentiated between local and global factors. A higher variance ratio[17] associated with euro area-wide changes points to a more integrated euro-area equity market in which stock market returns are affected by common news (ECB, 2007:16). Figure 3.1. shows that variance ratios have increased over the past 30 years with respect to both euro area-wide and US shocks. This can be interpreted as a sign of globalization of financial markets. However it should also be emphasized that the rise has been stronger for the former which means that euro area integration has proceeded faster than the worldwide integration. It should also be emphasized that, in the period 1999-2006 level of variance explained by common factors (about 38% for euro area shocks and 15% for US shocks) still shows that local shocks are still important.

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[17] Proportion of the total domestic equity volatility that can be explained by local and global factors.

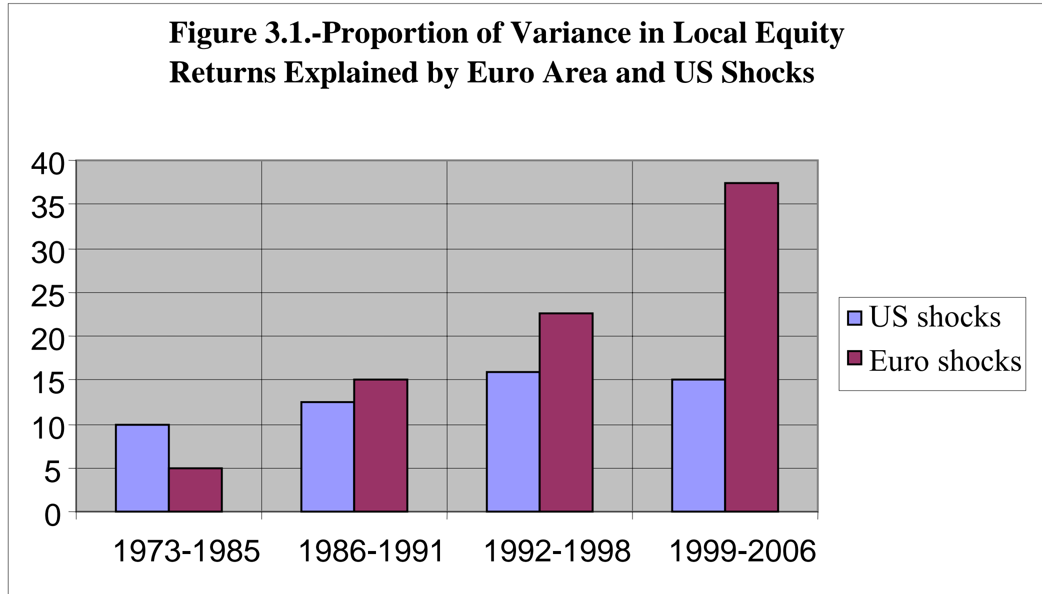

Figure 3.1- Proportion of Variance In Local Equity Returns Explained by Euro Area and US Shocks
Source: Derived and approximated from ECB, 2007:16

In addition to the above mentioned price based indicators there are some studies on quantity based indicators of stock market integration. Before mentioning these studies, it can be stated that there are some factors which cause a decrease in home bias especially within the euro area. First of all especially due to the advances in technology widespread information about stocks became available. Competition between stock exchanges resulted in a decrease in transaction costs. The introduction of single currency not only eliminated foreign exchange risk but it also contibuted to the comparability of stock prices and transparency (Baelo, Ferrando, Hördahl, Krylova, Monnet, 2004:75-76). After giving a general understanding of factors affecting the cross-border trading preferences some studies which mainly deal with the portfolio composition of investors will be mentioned.

Guiso, Haliassos and Jappelli analyzed the stock ownership of household in major European countries. In the study it was stated that EU directives on financial integration, financial liberalization, and removal of capital controls both increased the stocks available and decreased the cost of investment. Increased policy coordination required by Maastricht Treaty and use of single currency also provided access to an international set of stocks for the investors. The study concluded that although euro-area household participation in stock markets has increased in the last decade there still exists significant barriers to complete integration (Guiso, Haliassos and Jappelli, 2002:1-24).

Adam, Japelli, Menichini, Padula and Pagano studied on international portfolio diversification for investment funds, pension funds and insurance companies. The result is that between December 1997 and June 2001 the share of stocks invested in funds with Europe-wide scope increased for most countries. Figure 3.2 shows that following the introduction of the euro, euro area investors reallocated their portfolios by increasing the proportion of stocks issued by firms located in the other euro area countries (ECB, 2007:17). Sweeden and UK are exceptions of this tendency. Therefore it was concluded that there is an increased integration in euro-area stock markets however differences exists between the euro-area countries (Adam, Japelli, Menichini, Padula and Pagano, 2002:1-95).

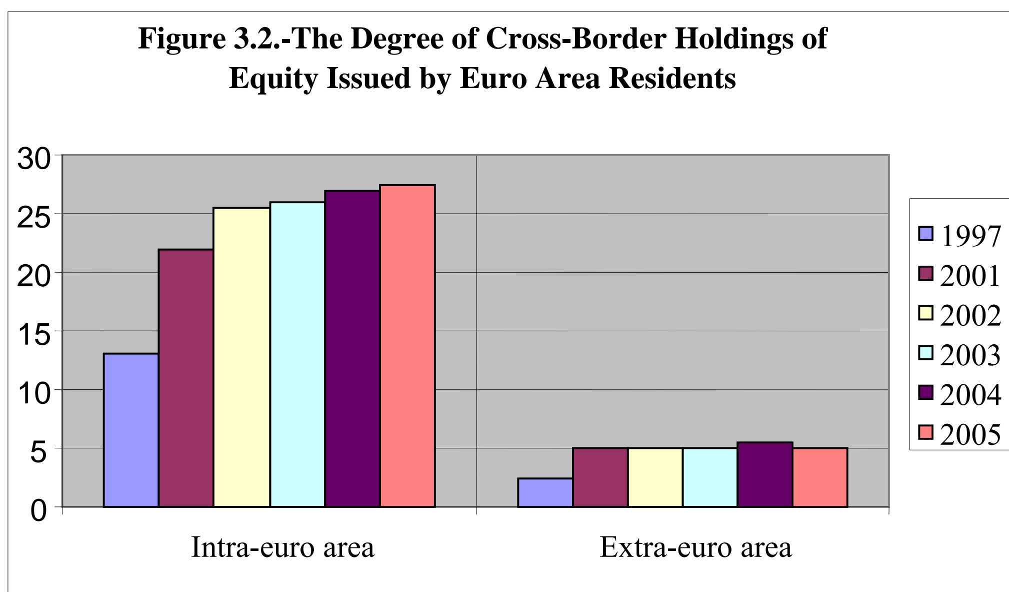

Figure 3.2-The Degree of Cross-Border Holdings of Equity Issued by Euro Area Residents
Source:Derived and approximated from ECB, 2007:17

As will be mentioned in detail in Part 5.1. of the thesis, although still remains lower than that of the US, market capitalization of euro area stock exchanges increased remarkably over the last decade. Privatization policies of the new Member States have been a major factor in this development. Cooperation and networking has been observed among stock exchanges. In order to strengthen their market position and to contribute to the realization of the stock market integration mergers among the stock exchanges had began to be realized. The stock exchanges of Amsterdam, Brussels and Paris merged in September 2000 to form Euronext which was later joined by the Lisbon Stock Exchange. Helsinki and Stockholm stock exchanges merged in Spring 2003. Internationalization of securities brokerage is also a reflection of the expansion and integration of stock exchanges.

Consolidation of post-trading infrastructures is also of paramount importance for the realization of integration in stock markets. This is required for healthy functioning of the system and also a major component of cost of doing business in securities market. Consolidations took place both at national and the European level. Euronext is an example of this development such that it experienced consolidation of stock exchanges of four above mentioned national stock markets, consolidation of national clearinghouses from five member states into a single clearinghouse (LCH Clearnet) and consolidation of settlement services in partnership with Euroclear (Muller, 2004:148-149).

To conclude; especially SMP and the Maastricht process has contributed to a great extent to the elimination of the barriers to the free flow of financial services. The FSAP and the introduction of the euro boosted this tendency. Almost complete integration has been achieved in money markets. There has also been evidence of integration in stock markets (Freixas, Hartman and Mayer, 2004:481-482). Measures indicate a rising degree of integration. Since the end of 2000, it has been seen that sector diversification in portfolios outperformed geographical diversification (Baelo, Ferrando, Hördahl, Krylova, Monnet, 2004:79). Stock returns in the various European stock markets heavily depend on common new factors. The importance of euro-area shocks in explanining stock market movements increased. In the first half of the 1980s less than 20 % of the local return variance was explained by aggregate European and US shocks however the proportion increased to more than 40% following the introduction of the euro (Baelo, Ferrando, Hördahl, Krylova, Monnet, 2004:79). Price co-movements across stocks of the firms from different industries listed in the same stock exchange have decreased whereas the correlation between the stocks of the firms from similar industries listed on different exchanges increased (Muller, 2004:147). Preference of national stocks, i.e. home bias of institutional investors has decreased over the last few years (Baele, Ferrando, Hördahl, Krylova, Monnet, 2004: 529).

However although there has been an increase in integration process European stock markets are still less integrated compared with US and Japan especially with the impediments of seperate markets and fragmented cross-border settlement systems (Hartmann, Maddaloni, Manganelli, 2003:199). It is generally accepted that the level of integration is lower in retail financial markets compared to the wholesale financial markets. Cross-border transactions are still more expensive compared to similar transactions in national markets. Also integration of stock markets has been easier for Europe-wide well-known companies with large market capitalization compared to the small firms. Differences in legal, administrative, accounting, tax and consumer protection systems, language, business culture and habits are the main obstacles that need to be solved for the achievement of the full integration.

CHAPTER 4

FUTURE OF STOCK MARKET INTEGRATION IN THE EU

The aim of this chapter is to represent the discussions related to the future of stock market integration in the EU, dealing with post-FSAP agenda and emphasizing future challenges. Since Turkey is in the process of harmonizing the legal framework with the EU, probable developments that may revise the system are also important for Turkish stock market. The agenda of the EU regarding the European stock markets are directly related with the accession negotiations in Turkey since the *acquis* is a moving target. Accordingly, post- FSAP agenda with a special reference to stock markets and challenges of integration is explored in the chapter.

4.1. Post – FSAP Agenda

European financial integration in general and stock market integration in particular has been driven forward by the FSAP (1999-2005). Undoubtedly, efforts need to be continued for the realization of the integration. White Paper on Financial Services Policy (2005-2010), (White Paper), presents the European Commission's financial policy priorities up to 2010 and forms the road map for the future agenda.

According to the White Paper from this point onward consolidation of the progress achieved is required; especially with FSAP an intense legislative activity has been realized and it is necessary to strengthen the achievements (European Commission, 2005:3). Implementation, enforcement and evaluation of the existing legislation is important; the motto of the current period can be summarized as "no more regulation", the focus heavily on timely and proper implementation of new FSAP measures. Market participants require a "regulatory pause" to absorb the current FSAP (Committee on Economic and Monetary Affairs, 2004:12).

Member States need to transpose the directives into their national legistation and regulation. The timely implementation of legislation in all member states is of paramount importance for the success of the FSAP and the success of the integration process as a whole. To monitor the process, the annual progress reports are used to show level of transposition of the directives by the Member States also the transposition workshops are organized for the implementation of the legislation. In order to control effective application of the Community legislation, increased cooperation between Member States has been given importance. Additionaly, post-FSAP supervision and enforcement of the FSAP regulation are necessities for the realization of convergence. Enforcement is the last step that will complete the picture and implementation will be kept under surveillance of the Commission.

According to the White Paper another requirement for the period in concern is the application of the better regulation agenda to future initiatives. To realize better lawmaking, open consultations and impact assessments have been used related to new legislative proposals which will be needed to abolish impediments on the way of integration. This is believed to increase the quality of the legislative activities taking into account the needs of the related parties.

As indicated earlier European financial market integration in general and stock market integration in particular are not independent of the whole process of globalization of financial markets. Accordingly the EU, being a potential financial center, needs to cooperate with major financial centers and needs to prove its competitiveness. Increasing European influence on global financial centers is also a mission according to the White Paper.

All the objectives put forward for integration of financial markets in the post-FSAP era given in the White Paper also serve for the realization of a single stock market. In addition to the above mentioned agenda items, there exist priorities specific for the stock market integration in the post-FSAP period (European Commission, 2004:23).

One major issue is the improvement of cross-border clearing and settlement systems. There are numerous clearing and settlement[18] institutions in the EU showing a fragmented system which results in higher transaction costs especially in the cross-border transactions; cross-border clearing and settlement services are both costly and inefficient compared to the national ones. For this reason the integration of clearing and settlement systems are required for the integration of stock markets. The Commission is dealing with this problem via consultation and impact assessment, the end result of which can be the formation of a regulatory framework at EU-level.

Another concept which requires further attention is corporate governance. Corporate scandals in the US as well as in Europe, also the recent turbulence in financial markets designates the importance of corporate governance. Stock market crash of 2001 and 2002, scandals and corporate failures, sub-prime mortgage crises all destroyed investor confidence in market finance to a great extent. Although there is a great degree of convergence at the level of high principles, there is no uniform set of rules so corporate governance practices show variations between Member States. (FESE, 2004:10-11). From now on importance of corporate governance, investor protection regimes, accounting standards, auditing and rating procedures increased.

Strengthening the cooperation between national regulators is also seen as a priority for the creation of a single stock market (European Commission, 2004:23). Because the following era will witness the importance of implementation and enforcement, coordination between member states gains importance, so will the

[18] Clearing is a post-trade transaction where the buyer and the seller confirm the terms of the trade and the clearing agency calculates the counterparties' obligations. Settlement is also a post-trading activity which realizes transfer of funds and asset ownership between buyer and seller. These post trading activities can be completed at agencies which are either independent or controlled by an exchange.

concept of mutual recognition. Especially with the current financial crisis which has begun in late 2007, supervision of the financial system has been put under focus. In such an environment single passport system depending on mutual recognition can survive only with effective cooperation between national authorities.

Similarly, prevention of anti-competitive behaviour is a necessity for the effective implementation of the FSAP measures and creation of a single stock market. Indeed, a crucial condition for a pan-European stock market is a well-functioning cross-border competition process. Some private agents might prefer to keep their competitive advantages instead of experiencing EU-wide competition. Also public authorities might prefer to support their national financial centers which would interfere cross-border competition (Schioppa, 2004:1). Such attitudes would destroy the integration process, so need to be prevented. Abolishment of barriers imposed on cross-border transactions by national taxation systems can also be evaluated within this context and needs to be encouraged.

Furthermore, EU is also aware of the fact that firms operate cross border in the global market place and during all this integration process they should not be put at a competitive disadvantage. European stock markets should remain internationally competitive (EPFSF, 2006:3). With this aim in mind EU also gives importance to transatlantic cooperation with the US financial actors.

As indicated above, with the impetus given by the FSAP and Lamfalussy Process, stock market integration gained momentum. However to reach the aim of a pan-European stock market, there are some challenges that will be mentioned in the next section.

4.2. Challenges of Integration in Stock Markets

For the stock market integration to proceed to the desired outcome there still exist a wide range of challenges that needs to be dealt with. Specifically improvement of the supervision and determination of the home country-host country relationship, determination of an optimum level of legislation, consistent transposition of legislation between Member States and effective implementation, integration of clearing and settlement systems and integration of the CEECS to the existing financial structure deserves to be mentioned within this context.

Firstly, as regards the challenges related with supervision White Paper has some suggestions. It mentions from the need to clarify and optimize home-host responsibilities. White Paper also points out to the need to explore delegation of tasks and responsibilities while insuring that supervisors have the necessary information and mutual trust. The necessity of improving the efficiency of supervision by avoiding duplicative reporting and information requirements, and the need for more consistent and timely cooperation and the development a real pan-EU supervisory culture are also major issues touched upon in the document (European Commission, 2005:3).

As it is mentioned in the previous chapter home country control principle is of paramount importance for the realization of integration in the stock market. Once a firm or a financial product is licenced in one member state, the firm can provide services through branches or across borders and can offer the product to the sale in the other member states. In this case, in terms of the prudential supervision, the home country supervisor is in charge of the supervision of the firm it licenced. However financial firms can also operate through subsidiaries which are licenced and supervised by the host country authorities that are responsible from the stability of their financial system since the current regime is home-country control for branches and host-country control for subsidiaries. The above given scenario puts

forward a case where the branch of the financial firm is supervised by home country authorities, whereas the subsidiary of the same company is responsible to the authorities of the host country. This creates complications for financial firms which operate cross-border. The same group can be subject to different rules of home and host countries.

When the supervision based on conduct of business is taken into account, the challenge is greater since the concepts of "home" and "host" is less clear-cut. Therefore for the stock market integration to be successful, coordination of the supervisory authorities is important but not enough. Creation of a lead supervisor who will be responsible from the operations of the firms Europe wide in cooperation with the national authorities is a possibility. The other extreme would be the formation of a federal European supervisory authority in the medium term, i.e. creation of a central body of financial supervisor who will be responsible for EU-wide operations. (Lannoo, Casey, 2005:29-30). Challenge for Europe is the authorization of a single European regulator with the responsibility and sources for the formation of a single European securities market as in the case of US SEC. The single regulator would combine the rulemaking authorithy and enforcement power over the entire European market (Pan, 2003:535). On the whole the solution to the problem of getting the home-country, host-country relationship right has not been reached yet and directives on different areas of stock market regulation try to determine the areas of supervisory responsibilities of the authorities without depending on a general framework.

At present the convergence of regulatory and supervisory activities has been supported by a system of memoranda of understanding (MOU)[19] between supervisory authorities. It should also be emphasized that especially the management of systemic risk requires increased cooperation between the related authorities (Koskenkyla, 2004:33-34).

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[19] MOU is a form of agreement between supervisors, which has no legal force, but sets out the respective tasks and obligations of both parties (Lannoo, 2002:7).

As regards the challenges regarding the obtimum level of legislation it can be said that excessive harmonization needs to be avoided. The important point is that all the agents should have uniform access to markets and should not be discriminated on the basis of country of origin for integration of stock markets to take place (Freixas, Hartmann, Mayer, 2004:483-484). Home country passport system is crucial for the development of competition and for the formation of the single market. However host-country regulations and procedures to protect national interests can have detrimental effects to the single passport system. In such cases the emphasis should be on consumer education and awareness. The system is especially suitable for institutional investors who can analyze the information disclosed thouroughly compared to the individual investors (Freixas, Hartmann, Mayer, 2004: 484).

Another aspect related with legislation is the need to consistent transposition of legislation between Member States and effective implementation. Stock market requires a system where legislation can be adopted to market needs without any delays while respecting fundamental principles of democratic institutions. Lamfalussy process is a solution to this concern where EU would enact laws according to general principles of regulation and details are left to implementing committees (Lannoo and Levin, 2004:22). Lamfalussy process, recommends that Level 1 measures should be framework directives- without detailed prescriptions. The main aim of this expectation is to fasten the process so that regulatory frameworks can be updated to be compatible to the developments in the financial sector. However, Lamfalussy procedure requires distinguishing between (level 1) framework principles and (level 2) implementing measures and in practice it is difficult to differentiate between the two. Sometimes framework directives which were designed to ease regulation and enforcement may end up with comprehensive details (Lannoo, 2002:12). The proper functioning of the Lamfalussy process at

levels 2, 3 and 4 [20] is a major factor for the success of implementation stage. So, directives need to be principle focused and the implementing measures need to be practical and implementable. However experience shows that there is a danger of over-prescriptive legislation and inconsistent transposition between Member States which would put the benefits expected from the Lamfalussy Process into danger. (FESE, 2004:3). The challenge is to attain quality protection without over-regulation (Koskenkyla, 2004:34).

In fact, inconsistent implementation may stem from member states failure to transpose the directives into national law. Due to differences in tax systems, company law and investor protection, member states may not be willing to transfer their sovereignty to the European level to protect their national interests (Dieckmann, 2005:3). Powers of member states in implementing directives cause legal uncertainties for the financial service suppliers. They abstain from expanding their business internationally due to legal uncertainty and integration of retail financial sector which is directly related to small investors is affected negatively. Therefore to maintain a dynamic integration process, internal inconsistencies should be minimized (Tison, 2006:12).

Fragmented clearing and settlement systems are also major challenges for stock market integration which especially affects retail financial servives which is the weakest link of integration process. Cross border transactions in stocks are still more expensive compared to the national ones especially due to the cost of clearing and settlemet systems. Consolidation of clearing and settlement systems is expected especially through mergers to exploit economies of scale and decrease cost of cross-border securities transactions. Existing pan-European restructuring and re-organization of the trading and post-trading infrastructure and the policy agenda can contribute substantially to stock market integration in the near future (Muller, 2004:152).

[20] Lamfalussy Process is a four level approach which has been explained above in Chapter 3.1.

Lastly, the integration of Central and Eastern European Countries (CEECs) to the newly formed financial structure is required. Although CEECs adopted the *Acquis* during the accession period, there is no doubt that coming from command economies and having underdeveloped stock markets compared to the EU-15, they will have difficulty in adopting the stock market regulations and related procedures. The above mentioned home/host country control concepts would also pose additional challenges between the systems and between the authorities with different levels of know-how and economic resources.

In the final anaysis, as mentioned in the Chapter 3.3 integration of retail stock markets is less successful compared to wholesale markets. The Commission aims to take further action to solve the problem of fragmented retail financial services market. Work in this area will be bottom-up, i.e. based on consultations on the market. (European Commission, 2005:13-14). Differences in legal, administrative, accounting, tax and consumer protection systems, language, and business culture and habits are still important challenges for integration. Especially the socio-cultural obstacles will take time to erode (Muller, 2004:151) Information costs and home-country bias are also important obstacles in the way of stock market integration. Due to cultural and linguistic differences and the distance between the countries, access to information on foreign stocks become more difficult and expensive compared to domestic stocks. Information costs are major factors in the formation of home-bias (Mc Andrews and Stefanadis, 2002:4). Consumers usually do not distinguish between foreign and national service providers as long as they are both established in local markets. Taxation, which is an important component taken into account in investment decisions of investors, is another major problem on the road of cross-border transactions. There is an urgent need to eliminate distortions caused by different tax regimes to contribute to the formation of a single market in financial services in general and stock market in particular.

CHAPTER 5

PROSPECTIVE INTEGRATION OF TURKISH STOCK MARKET WITH THE EU STOCK MARKETS

The recognition of Turkey as a candidate for membership at the Helsinki European Council in December 1999 caused the beginning of a new era for the relations between Turkey and EU. Accession negotiations began on October 3, 2005. Complying with the EU *acquis* is a major pillar for the accession process. Therefore the timely and effective adoption and the implementation of the *acquis* is of paramount importance for the negotiation process.

Accordingly completion of the alignment of stock market legislation with the EU is also a requirement. As mentioned in the previous chapters regulations in European stock markets have been revised substantially during the last decade. Integration of financial markets in general and stock markets in particular has been accepted as a building block for single market. Especially regulations brought into regulatory framework following the FSAP aimed the formation of a single stock market. Consequently even before the stage of membership, because of the alignment of the legislation, Turkish stock market will be affected from all the developments regarding the integration of financial markets in the EU. The probable effects will be discussed in the following sections however the chapter will start with general explanations regarding the Turkish stock market and the comparison especially with the EU member states.

5.1. Comparison of Turkish Stock Markets with the EU Member States' Stock Markets

Turkish stock market can be categorized as an emerging market with increasing number of publicy traded companies and a high penetration from foreign investors. The major regulation regarding the stock market in Turkey is

Capital Market Law No.2499 (CML)[21]. Capital market instruments and their issuance, public offering and sale, those who issue or offer them to the public, exchanges and other markets organized, capital market activities, capital market institutions, and the Capital Market Board are subject to the provisions of CML.

The Capital Market Board (CMB), established in 1982, is responsible for the regulation and supervision of the securities market and institutions as provided in the law, the determination of the operational principles of the capital markets, and protection of the rights and interests of investors. The CMB regulates and supervises corporations offering their securities to the public; security market intermediaries[22]; open-end mutual funds and closed-end companies; independent external auditing firms offering services to capital markets institutions; stock exchanges and secondary markets; precious metal and derivative exchanges[23] (Istanbul Gold Exchange and Turkish Derivatives Exchange Inc.-i.e.TurkDex); and other related institutions operating on capital markets such as rating agencies, clearing and depository institutions.

Turkish capital market offer intermediary services, clearing and settlement and dissemination of data. The Istanbul Stock Exchange (ISE), established as a public institution in 1985, is the only stock exchange in Turkey. ISE, serves three markets based on the type of product, disclosure rules and governance: (i) the stock market, (ii) the bonds and bills market and (iii) foreign securities market.

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[21] According to the Article 1 of the CML, the subject of the Law is to regulate and control secure and stable functioning of the capital market and to protect rights and benefits of investors with the purpose of ensuring an efficient and widespread participation by the public in the development of the economy through investing savings in the securities market.

[22] Intermediary institutions include banks and brokerage firms.

[23] There are three exchanges in Turkey. Stocks and fixed income securities are traded at the ISE, future contracts are traded at the Turkish Derivatives Exchange and precious metals at the İstanbul Gold Exchange.

As far as the technical infrastructure is concerned, the stock market owns a high quality trading infrastructure of the ISE and the settlement system of ISE Settlement and Custody Bank Inc. ISE provides settlement services for all securities and serves as the central counterparty for the futures market. Trading on the ISE was fully computerized in 1994. All stock trades are cleared and settled at the ISE Settlement and Custody Bank Inc. The Central Registry Agency Inc. (CRA), the central custodian where equities, fixed income securities and mutual funds are kept in dematerialized form, has started taking over the custody function from ISE Settlement and Custody Bank Inc since 2002 when all securities were dematerialized.

According to the CMB Decision on August 15, 1996 banks can not engage in equity market operations, they were required to transfer their equity market operations to a brokerage firm as of January 1997. Accordingly, only brokerage firms are allowed to trade equities. In all other markets, banks and brokerage firms are allowed to operate. Banks which want to be active in capital market activities need either to establish a separate financial intermediary and transfer their related licences to the newly established entity or acquire an existing intermediary.

Brokerage firms offer services in securities trading, asset management, corporate finance and margin trading. The existing system is parallel with US system and different from universal banking which is dominant in Europe. Also to prevent the probable problems of location and hardware in ISE due to the increase in the number of members of stock exchange, the number of financial intermediaries had been fixed beginning in July 26, 1991 with the assent of Ministry of State.

At the end of May 2008, there are 41 banks and 104 brokerage firms in the market. In the last decade, the number of brokerage firms fell from 142 to 104, mainly due to the 2001 crisis. In the Table 5.1, the number of active brokers is

presented according to their ownership structure. The table classifies firms according to majority ownership.

Table-5.1 Number of Active Brokerage Firms (2001-2007)

Number of Active Brokerage Firms							
	2001	2002	2003	2004	2005	2006	2007
SDIF	19	8	6	6	5	1	-
State	4	4	4	4	4	4	4
Foreign	5	9	6	6	7	18	25
Domestic	95	98	91	91	85	77	70
Total	123	119	107	107	101	100	99

Source:ACMIIT, 2008

Notes:
i) During the 2001 crisis, the bankrupt banks and their subsidiaries were overtaken by the State Deposit Insurance Fund (SDIF). The Fund didn't immediately close down the banks or their subsidiaries, but gradually slowed down their activities, sold some of them and merged others. Immediately after the crisis, the SDIF became the owner of 19 brokerage firms, the second largest group with respect to ownership. However, as of end-2007 there are no brokerage firms left within SDIF (ACMIIT, 2008, 46).
ii) State owned brokerage firms are subsidiaries of the state-owned banks which are Halkbank, Ziraatbank, Vakıfbank and Kalkınma Bank (ACMIIT, 2008, 46).

During the last few years there has been an increase in the level of FDI to financial sector in Turkey. The increase in the number of foreign-owned brokerage firms is striking. As can be seen from the Table 5.1., in 2001 the number of foreign-owned brokerage firms is 5 whereas it is 25 as at the end of 2007; i.e. 20 brokerage firms' majority stake was taken over by foreign institutions. Furthermore, there are also minority foreign holdings in 12 more firms, which are mainly bank-affiliated. Since the establishment of new brokerage firms is not permitted entrance to the market has been realized through acquisitions. The details regarding the acquisitions in the Turkish brokerage industry is given in Annex-3.

To assess the stock market's place in investors preferences, the residents' and non-residents' investment preferences are given in Table 5.2 and Table 5.3

Table-5.2 Residents' Investment Breakdown 2005-2007 (Million USD)

	2005	2006	2007	Breakdown 2007 (%)
TRY Deposits	105.616	120.193	177.763	45,00
FX Deposits	61.207	77.372	96.281	24,00
Precious Metal Deposits	72	178	131	-
Participation Bank Funds	6.237	7.675	12.616	3,00
Bonds/Bills	41.195	39.685	49.040	12,00
Eurobonds	3.986	3.851	3.717	1,00
Mutual Funds	21.891	15.660	22.756	6,00
Repo	1.107	1.567	2.357	1,00
Pension Funds	908	2.007	3.932	1,00
Common Stocks	**17.516**	**28.680**	**26.801**	**7,00**
Total	**259.377**	**286.867**	**395.395**	**100,00**

Source:ACMIIT, 2008

Table-5.3 Non-Resident's Investment Breakdown 2005-2007(Million USD)

	2005	2006	2007	Breakdown 2007 (%)
Common Stocks	**33.483**	**35.083**	**69.876**	**66,00**
Bonds/Bills	17.528	24.512	30.375	29,00
Eurobonds	634	555	376	-
Deposits	3.434	4.186	4.947	5,00
Total	**55.079**	**64.336**	**105.574**	**100,00**

Source:ACMIIT, 2008

From the Table 5.2 and Table 5.3 it can be seen that the total size of savings has reached 500.969 million US dollars at the end of 2007 and 79% of savings are held by domestic investors. In Table 5.2. which gives information on residents' investment preferences it can be observed that 69% of savings are held on bank deposits (45% in TRY and 24% in FX deposits). After deposits, the second major instrument is government bonds and bills with 13%. Common stocks represent only 7% of the investments, despite the recent strong performance of the stock market.

Foreign investors, on the other hand, have a very different portfolio allocation. They invest 66% in common stocks and 29% in government bonds as seen in Table 5.3. In two years, their portfolio size has more than doubled due to the performance of the stock market and also with investment inflows.

If the residents and non-residents are taken into account as a whole,Figure 5.1 gives the value of outstanding shares, government bonds and treasury bills between 1997-2007.

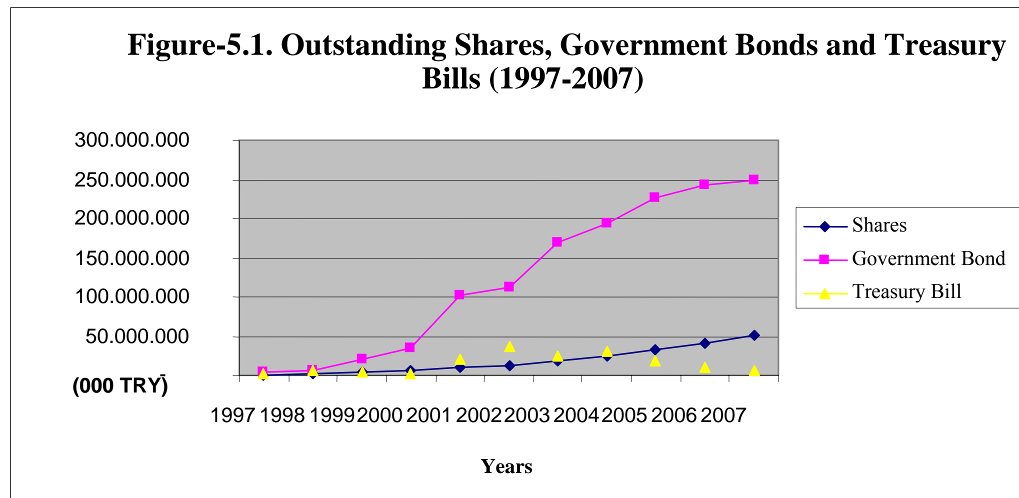

Figure 5.1. Outstanding Shares, Government Bonds and Treasury Bills (1997-2007) (000 TRY)
Source:Derived from the data downloaded from http://www.spk.gov.tr/apps/aylikbulten/index.aspx

From Figure 5.1 it can be observed that although the amount of shares in the portfolios of the investors show a steady increase over the last decade, public sector debt securites dominate the market. The evaluation of Table 5.2. and Figure 5.1. shows that the Turkish financial system is still bank based. The product range is currently limited mainly to stocks, T-bills, futures and mutual funds. For the period 1999-2005 there are no issues of corporate bonds, crowding out of private bonds by government debt can be observed. Options, warrants, mortgage securities and structured products are also not available yet.

Breakdown of equity portfolios by investor categories in Table 5.4 give valuable insights about the stock market.

Table-5.4 Breakdown of Equity Portfolios by Investor Categories (2001-2007)(million USD)

	2001	2002	2003	2004	2005	2006	2007
Domestic Investors	**5.502**	**4.723**	**8.433**	**12.788**	**18.453**	**18.707**	**27.020**
D. Individual	4.556	3.778	6.656	9.239	11.757	11.192	15.080
D.Corporate	687	730	1.277	2.200	4.331	5.839	8.838
D.Institutional	133	110	282	328	653	570	1.029
D.Other	127	105	218	1.021	1.713	1.106	2.072
Foreign Investors	**5.095**	**3.625**	**8.919**	**15.548**	**34.012**	**34.818**	**70.454**
F.Individual	49	51	85	108	135	133	202
F.Corporate	2.637	2.160	4.854	8.397	17.201	20.000	38.619
F.Institutional	2.350	1.382	3.954	7.006	16.625	14.662	31.603
F.Other	59	32	26	38	51	24	30
Total	**10.597**	**8.348**	**17.352**	**28.336**	**52.465**	**53.525**	**97.474**

Source:ACMIIT, 2008

Firstly, it can be observed from Table 5.4 that individuals' participation in stock market is low in Turkey. The number of personal investors who own ISE-

listed securities is 933.361 at the end of 2007 and this number accounts for about 1,32 percent of Turkey's population in 2007. [24]

Secondly, Turkey follows a policy that allows foreign institutional and individual investments in securities listed on the ISE. Hence, Turkish stock markets are open to foreign investors without restrictions on the repatriation of capital and profits. Actually share of foreign investors is 72,40% whereas share of domestic investors is 24,2 % as of the end of 2007 in ISE (CMB, Monthly Report, December 2007, Table VII.1). It can be observed from Table 5.4. that foreign investors' interest in the Turkish stock market has increased especially since 2004. Foreign corporations, i.e. banks and brokerage firms, and foreign institutional investors have become the major investors of the Turkish stock market (ACMIIT, 2008: 76). Actually the high level of foreign penetration has an implication in terms of the Turkish stock market. Normally stock exchanges function as a barometer of the economy, however due to the high degree of foreign penetration Turkish stock market indexes have started to respond mainly to the international financial developments. There may be situations where this outlook may prove itself to be advantageous for the market but the opposite is also true.

After describing main characteristics of the Turkish stock market, in the following part, it will be analyzed and compared with the other major stock markets especially European ones. Number of listed companies, market capitalization, stock market index, significance of stock market in national economy, share traded values and velocity are the basic parameters that will used for comparison. The data used is obtained from the World Federation of Exchanges (WFE) which has 55 members whose market capitalization constitutes 97% of global stock market capitalization.

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[24] http://www.spk.gov.tr/apps/aylikbulten/index.aspx

An important indicator regarding the stock exchanges is the number of listed companies. The Table 5.5 gives the number of listed companies for WSE countries taking into account both domestic and foreign companies.

Table-5.5 Number of Listed Companies (2006-2007)

		2007				2006	
Exchange	Total	Domestic	Foreign	Total		Domestic	Foreign
		Companies	Companies			Companies	Companies
Americas							
American SE	599	495	104	592		492	100
Bermuda SE	53	16	37	54		16	38
Buenos Aires SE	111	106	5	106		101	5
Colombia SE	90	90	0	94		94	0
Lima SE	226	188	38	221		189	32
Mexican Exchange	367	125	242	335		132	203
Nasdaq	3.069	2.762	307	3.133		2.812	321
NYSE Group	2.297	1.876	421	2.280		1.829	451
Santiago SE	241	238	3	246		244	2
Sao Paulo SE	404	395	9	350		347	3
TSX Group	3.951	3.881	70	3.842		3.790	52
Total region	**11.408**			**11.253**			
(Asia - Pacific							
Australian SE	1.998	1.913	85	1.829		1.751	78
Bombay SE	4.887	4.887	0	4.796		4.796	0
Bursa Malaysia	986	983	3	1.025		1.021	4
Colombo SE	235	235	0	237		237	0
Hong Kong Exchanges	1.241	1.232	9	1.173		1.165	8
Indonesia SE	383	383	0	344		344	0
Jasdaq	979	979	0	971		971	0
Korea Exchange	1.757	1.755	2	1.689		1.689	0
National Stock Exchange India	1.330	1.330	0	1.156		1.156	0
New Zealand Exchange	178	152	26	182		151	31
Osaka SE	477	476	1	467		466	1
Philippine SE	244	242	2	239		237	2
Shanghai SE	860	860	0	842		842	0
Shenzhen SE	670	670	0	579		579	0
Singapore Exchange	762	472	290	708		461	247

(Table-5.5 Continued)

Taiwan SE Corp.	703	698	5	693		688	5
Thailand SE	523	523	0	518		518	0
Tokyo SE Group	2.414	2.389	25	2.416		2.391	25
Total region	***20.627***			***19.864***			
Europe - Africa - Middle East							
Amman SE	245	245	0	227		227	0
Athens Exchange	283	280	3	290		288	2
BME Spanish Exchanges	3.537	3498	39	3.378		3339	39
Borsa Italiana	307	301	6	311		284	27
Budapest SE	41	39	2	42		42	0
Cairo & Alessandria SEs	435	435	0	595		595	0
Cyprus SE	141	141	0	141		141	0
Deutsche Börse	866	761	105	760		656	104
Euronext	1.155	930	225	1.210		954	256
Irish SE	73	60	13	70		59	11
Istanbul SE	319	319	0	316		316	0
JSE	411	374	37	389		359	30
Ljubljana SE	87	87	0	100		100	0
London SE	3.307	2.588	719	3.256		2.913	343
Luxembourg SE	261	34	227	260		36	224
Malta SE	16	16	0	14		14	0
Mauritius SE	70	67	3	63		62	1
OMX Nordic Exchange	851	825	26	791		765	26
Oslo Børs	248	208	40	229		195	34
Swiss Exchange	341	257	84	348		256	92
Tehran SE	329	329	0	320		320	0
Tel Aviv SE	657	643	14	606		595	11
Warsaw SE	375	352	23	265		253	12
Wiener Börse	119	102	17	113		96	17
Total region	***14.474***			***14.094***			
WFE Total	**46.509**			**45.211**			

Source : WFE

Notes:
i) Euronext figures include data from Belgium, France, Netherlands and Portugal
ii) OMX figures include data from Denmark, Estonia, Finland, Iceland, Latvia, Lithuania, and Sweden

BME Spanih Exchanges with 3.537 companies listed ranks as first within the Europe-Africa-Middle East group, London SE follows with 3.307 companies and Euronext's rank is third with 1.155 companies. ISE is 12th within 24 countries in the group with 319 companies. Also for ISE all the listed companies are domestic ones, ISE has no foreign listed companies which is a major difference compared with the stock exchanges especially with higher ranks.

Table 5.6 also gives a major indicator showing the size of the stock exchange, i.e. market capitalization.

Table-5.6 Market Capitalization of WFE Members (2006-2007) (USD millions)

Exchange	End 2007	End 2006	(% Change) 2007/2006
Americas			
American SE	257.797,0	282.801,0	-8,8%
Bermuda SE	2.731,1	2.703,5	1,0%
Buenos Aires SE	57.070,2	51.240,1	11,4%
Colombia SE	101.956,0	56.204,3	81,4%
Lima SE	69.386,5	40.021,6	73,4%
Mexican Exchange	397.724,6	348.345,1	14,2%
Nasdaq **(#4)**	4.013.650,3	3.865.003,6	3,8%
NYSE Group **(#1)**	15.650.832,5	15.421.167,9	1,5%
Santiago SE	212.910,2	174.418,8	22,1%
Sao Paulo SE	1.369.711,3	710.247,4	92,8%
TSX Group **(#8)**	2.186.550,2	1.700.708,1	28,6%
Total region	***24.320.319,8***	***22.652.861,5***	***7,4%***
Asia – Pacific			
Australian SE	1.298.315,0	1.095.858,0	18,5%
Bombay SE **(#10)**	1.819.100,5	818.878,6	122,1%
Bursa Malaysia	325.290,3	235.580,9	38,1%
Colombo SE	7.553,2	7.768,9	-2,8%
Hong Kong Exchanges **(#7)**	2.654.416,1	1.714.953,3	54,8%
Indonesia SE	211.693,0	138.886,4	52,4%
Jasdaq	120.653,8	112.200,6	7,5%
Korea Exchange	1.122.606,3	834.404,3	34,5%
National Stock Exchange India	1.660.096,9	774.115,6	114,5%

(Table-5.6 Continued)

New Zealand Exchange	47.485,6	44.816,5	6,0%
Osaka SE	212.202,2	183.668,4	15,5%
Philippine SE	103.006,9	68.269,8	50,9%
Shanghai SE **(#6)**	3.694.348,0	917.507,5	302,7%
Shenzhen SE	784.518,6	227.947,3	244,2%
Singapore Exchange	539.176,6	384.286,4	40,3%
Taiwan SE Corp.	663.716,0	594.659,4	11,6%
Thailand SE	197.129,4	140.161,3	40,6%
Tokyo SE Group **(#2)**	4.330.921,9	4.614.068,8	-6,1%
Total region	***17.919.931,0***	***11.950.247,8***	***50,0%***
Europe - Africa - Middle East			
Amman SE	41.216,4	29.729,5	38,6%
Athens Exchange	264.960,8	208.256,1	27,2%
BME Spanish Exchanges	1.799.834,0	1.322.915,3	36,1%
Borsa Italiana	1.072.534,7	1.026.504,2	4,5%
Budapest SE	46.195,6	41.934,5	10,2%
Cairo & Alexandria SEs	139.273,8	93.496,4	49,0%
Cyprus SE	29.474,3	16.157,8	82,4%
Deutsche Börse **(#9)**	2.105.197,8	1.637.609,8	28,6%
Euronext **(#3)**	4.222.679,8	3.712.680,8	13,7%
Irish SE	143.905,3	163.269,5	-11,9%
Istanbul SE	286.571,7	162.398,9	76,5%
JSE	828.185,3	711.232,3	16,4%
Ljubljana SE	28.794,0	15.180,7	89,7%
London SE **(#5)**	3.851.705,9	3.794.310,3	1,5%
Luxembourg SE	166.077,9	79.513,6	108,9%
Malta SE	5.633,4	4.503,5	25,1%
Mauritius SE	7.919,1	4.958,5	59,7%
OMX Nordic Exchange	1.242.577,9	1.122.705,0	10,7%
Oslo Børs	353.353,1	279.910,4	26,2%
Swiss Exchange	1.271.047,7	1.212.308,4	4,8%
Tehran SE	43.885,0	36.314,6	20,8%
Tel Aviv SE	235.056,4	161.731,7	45,3%
Warsaw SE	211.620,2	151.809,0	39,4%
Wiener Börse	236.448,4	199.121,0	18,7%
Total region	***18.634.148,5***	***16.188.551,8***	***15,1%***
WFE Total	**60.874.399,3**	**50.791.661,1**	**19,9%**

Source : WFE

Notes:
i) Euronext figures include data from Belgium, France, Netherlands and Portugal
ii) OMX figures include data from Denmark, Estonia, Finland, Iceland, Latvia, Lithuania, and Sweden

Table 5.6 divides the major stock exchanges in three categories: Americas, Asia-Pasific and Europe-Africa-Middle East. NYSE Group, Shangai SE, and Euronext are the biggest stock exchanges in terms of the market capitalization within their groups. ISE ranks as 10th in terms of market capitalization in Europe-Africa-Middle East Group. Table 5.6. also shows that total market capitalization of WFE members has increased 19,9% in 2007 compared to the previous year. For Europe-Africa-Middle East Group total market capitalization has risen 15,1 % whereas market capitalization of ISE has increased 76,5 %, well above the average for the same period due to the performance of stock market and also inflows of funds.

Table 5.7 compares the market capitalization of ISE with European Stock Exchanges.

Table-5.7 Market Capitalization: ISE and European Stock Exchanges (Dec.31, 2007) (Million Eur)

Rank	**Exchange**	**Value at Month End (EURm)**
1	Euronext	2.888.313,00
2	London Stock Exchange	2.634.577,30
3	Deutsche Börse	1.439.955,31
4	Spanish Exchanges (BME)	1.231.086,44
5	SWX Swiss Exchange	869.377,30
6	OMX Nordic Exchange	849.923,31
	EU average	**594.899,36**
7	Borsa Italiana	733.613,72
	ISE	197.748,00
8	Oslo Børs	241.682,84
9	Athens Exchange	181.233,20
10	Wiener Börse	161.730,70
11	Warsaw Stock Exchange	144.323,31
12	Luxembourg Stock Exchange	113.597,35
13	Irish Stock Exchange	98.431,20
14	Prague Stock Exchange	47.987,44

(Table-5.7 Continued)

15	Budapest Stock Exchange	31.527,90
16	Bucharest Stock Exchange	21.523,88
17	Cyprus Stock Exchange	20.160,41
18	Ljubljana Stock Exchange	19.695,10
19	Bulgarian Stock Exchange	14.820,75
20	Bratislava Stock Exchange	4.554,99
21	Malta Stock Exchange	3.854,02

Source : WFE

Notes:
i) Euronext figures include data from Belgium, France, Netherlands and Portugal
ii) OMX figures include data from Denmark, Estonia, Finland, Iceland, Latvia, Lithuania, and Sweden

Table 5.7 ranks the European Stock Exchanges in terms of market capitalization and also includes ISE to make a comparison. Of the ten biggest stock markets by domestic market capitalization in 2007, three is European Stock Markets, namely, Euronext, London SE, Deutsche Börse. From Table 5.7. it can be seen that ISE ranks as the eight following the Borsa Italiana and preceeding Oslo Børs with its market capitalization of 197.748 million Euro which is well below the EU Average – 594.899,36 million Euro.

The Table 5.8 gives the stock market indexes for the years 2006 and 2007 and the percentage change in the indexes. For ISE “ISE National 100 Index” has been used with the base year 1986 and the beginning value is 1. The value of indexes are not comparable however comparison of year end changes is meaningful.

Table-5.8 Stock Market Indexes of WFE Members (2006-2007)

Exchange	Name of Index		2007 Year-end	2006 Year-end	% Change end 2007/2006
Americas					
American SE	*Amex Composite Index*	*P*	2.410,00	2.056,00	17,2%
Bermuda SE	*BSX Index*	*P*	4.909,90	4.860,32	1,0%
Buenos Aires SE	*General Index*	*R*	121.652,60	103.164,27	17,9%
Colombia SE	*IGBC*	*P*	10.694,18	11.161,14	-4,2%
Lima SE	*General Index (IGBVL)*	*R*	17.524,79	12.884,20	36,0%
Mexican Exchange	*Price & Quotations Index (IPC)*	*P*	29.536,83	26.448,32	11,7%
Nasdaq	*Nasdaq Composite*	*P*	2.652,28	2.415,29	9,8%
NYSE Group	*NYSE Composite*	-	9.740,32	9.139,02	6,6%
Santiago SE	*IGPA*	*P*	14.076,25	12.373,68	13,8%
Sao Paulo SE	*Bovespa Index*	*R*	63.886,00	44.473,00	43,7%
TSX Group	*S&P/TSX Composite*	*P*	13.833,06	12.908,39	7,2%
Asia - Pacific					
Australian SE	*ASX/S&P All Ordinaries*	*R*	6.421,00	5.644,30	13,8%
Bombay SE	*BSE-500 Index*	*P*	8.592,43	5.270,76	63,0%
Bursa Malaysia	*Composite (KLCI)*	*P*	1.445,03	1.096,24	31,8%
Colombo SE	*All Share Price Index*	*P*	2.540,99	2.722,36	-6,7%
Hong Kong Exchanges	*S&P/HKEx Large Cap Index*	*P*	33.708,99	24.378,76	38,3%
Indonesia SE	*JSX Composite*	*P*	2.745,83	1.805,52	52,1%
Jasdaq	*Jasdaq Index*	*P*	72,17	86,19	-16,3%
Korea Exchange	*KOSPI*	*P*	1.897,13	1.434,46	32,3%
National Stock Exchange India	*S&P CNX 500*	*P*	5.354,70	3.295,05	62,5%
New Zealand Exchange	*NZSX All Index*	*R*	4.106,53	4.118,33	-0,3%
Osaka SE	*300 Common Stock Index*	*P*	1.677,11	1.884,40	-11,0%
Philippine SE	*PSE Index*	*P*	3.621,60	2.982,54	21,4%
Shanghai SE	*SSE Composite Index*	*P*	5.261,56	2.675,47	96,7%
Shenzhen SE	*SZSE Composite Index*	*P*	1.447,02	550,59	162,8%
Singapore Exchange	*All-Sing Equities Index*	*P*	969,70	783,28	23,8%
Taiwan SE Corp.	*TAIEX*	*P*	8.506,28	7.823,72	8,7%
Thailand SE	*SET*	*P*	858,10	679,84	26,2%
Tokyo SE Group	*TOPIX*	*P*	1.475,68	1.681,07	-12,2%

(Table-5.8 Continued)

Europe - Africa - Middle East					
Amman SE	*ASE Index 100*	*P*	3.675,00	3.014,00	21,9%
Athens Exchange	*ATHEX Composite Price Index*	*P*	5.178,83	4.394,13	17,9%
BME Spanish Exchanges Barcelona	*BCN Global-100*	*P*	1.193,94	1.134,75	5,2%
BME Spanish Exchanges Bilbao	*Bolsa Bilbao 2000*	*P*	2.626,55	2.577,47	1,9%
BME Spanish Exchanges Madrid	*General Index (IGBM)*	*P*	1.642,01	1.554,93	5,6%
BME Spanish Exchanges Valencia	*IGBV Index*	*P*	1.359,19	1.268,02	7,2%
Borsa Italiana	*MIB Index*	*P*	28.525,00	31.005,00	-8,0%
Budapest SE	*BUX*	*R*	26.235,63	24.764,18	5,9%
Cairo & Alexandria SEs	*CASE 30*	*P*	10.549,74	6.973,41	51,3%
Cyprus SE	*CSE General Price Index*	*P*	4.820,72	3.900,39	23,6%
Deutsche Börse	*CDAX*	*P*	478,65	407,16	17,6%
Euronext Amsterdam	*AAX All Share Index*	*P*	784,78	748,77	4,8%
Euronext Brussels	*BAS*	*P*	12.947,59	13.489,35	-4,0%
Euronext Lisbon	*PSI General*	*R*	4.123,90	3.485,63	18,3%
Euronext Paris	*SBF 250*	*P*	3.956,31	3.940,27	0,4%
Irish SE	*ISEQ Overall Index*	*P*	6.934,35	9.408,12	-26,3%
Istanbul SE	*ISE National 100*	*P*	55.538,13	39.117,46	42,0%
JSE	*FTSE/JSE All Share Index*	*P*	28.957,97	24.915,20	16,2%
Ljubljana SE	*Slovene Stock Exchange Index SBI 20*	*P*	11.369,58	6.382,92	78,1%
London SE	*FTSE All Share*	*P*	3.286,67	3.221,42	2,0%
Luxembourg SE	*Lux General Price Index*	*P*	1.929,39	1.592,51	21,2%
Malta SE	*MSE Index*	*P*	4.937,75	4.873,46	1,3%
Mauritius SE	*SEMDEX*	*P*	1.852,21	1.204,46	53,8%
OMX Nordic Exchange	*OMX Nordic All Share- PI*	*P*	229,67	229,18	0,2%
Oslo Børs	*Oslo Bors Benchmark Price Index*	*P*	347,09	321,22	8,1%
Swiss Exchange	*Swiss Performance Index (SPI)*	*R*	6.925,44	6.929,18	-0,1%
Tehran SE	*TEPIX*	*P*	9.736,57	10.074,47	-3,4%
Tel Aviv SE	*General Share Index*	*R*	1.002,60	815,65	22,9%
Warsaw SE	*WIG*	*R*	55.648,54	50.411,82	10,4%

(Table-5.8 Continued)

Wiener Börse	*Wiener Börse Index (WBI)*	*P*	1.653,79	1.676,70	-1,4%
P : Price Index					
R : Return Index					

Source : WFE

Notes:
i) Euronext figures include data from Belgium, France, Netherlands and Portugal
ii) OMX figures include data from Denmark, Estonia, Finland, Iceland, Latvia, Lithuania, and Sweden

The Table 5.8 shows that ISE ranks fourth within the group with its yearly stock index movement of 42% in 2007 compared to the previous year.

Stock market's significance in the national economy is also a major indicator and Table 5.9 gives the GDP, domestic market capitalization for WFE members and the ratio the to indicators for the year 2006.

Table-5.9 Stock Market's Significance in the National Economy of WFE Members, 2006

		2006	
Exchange	GDP [1]	Domestic market capitalization	%
Americas			
American SE	13.246,6	282,8	2,1%
Bermuda SE	NA	2,7	-
Buenos Aires SE	213,4	51,2	24,0%
Colombia SE	143,2	56,2	39,3%
Lima SE	95,6	40,0	41,8%
Mexican Exchange	845,6	348,3	41,2%
Nasdaq	13.246,6	3.865,0	29,2%
NYSE Group	13.246,6	15.421,2	116,4%
Santiago SE	145,3	174,4	120,0%
Sao Paulo SE	1.088,0	710,2	65,3%
TSX Group	1.236,8	1.700,7	137,5%
Asia - Pacific			
Australian SE	761,4	1.095,9	143,9%

(Table-5.9 Continued)

Bombay SE	932,2	818,9	87,8%
Bursa Malaysia	154,9	235,6	152,1%
Colombo SE	26,1	7,8	29,8%
Hong Kong Exchanges	189,5	1.715,0	904,9%
Jakarta SE	371,2	138,9	37,4%
Jasdaq	4.261,8	112,2	2,6%
Korea Exchange	911,7	834,4	91,5%
National Stock Exchange India	932,2	774,1	83,0%
New Zealand Exchange	112,9	44,8	39,7%
Osaka SE	4.261,8	183,7	4,3%
Philippine SE	123,1	68,3	55,5%
Shanghai SE	2.683,0	917,5	34,2%
Shenzhen SE	2.683,0	227,9	8,5%
Singapore Exchange	136,9	384,3	280,8%
Taiwan SE Corp.	NA	594,7	-
Thailand SE	216,1	140,2	64,9%
Tokyo SE	4.261,8	4.614,1	108,3%
Europe - Africa - Middle East			
Amman SE	14,1	29,7	210,8%
Athens Exchange	257,4	208,3	80,9%
BME Spanish Exchanges	1.286,9	1.322,9	102,8%
Borsa Italiana	1.945,4	1.026,5	52,8%
Budapest SE	124,6	41,9	33,7%
Cairo & Alexandria SEs	108,2	93,5	86,5%
Cyprus SE	19,1	16,2	84,7%
Deutsche Börse	3.044,7	1.637,6	53,8%
Euronext [3]	3.677,6	3.712,7	101,0%
Irish SE	231,8	163,3	70,4%
Istanbul SE	406,9	162,4	39,9%
JSE [2]	245,0	711,2	290,3%
Ljubljana SE	39,2	15,2	38,7%
London SE	2.543,8	3.794,3	149,2%
Luxembourg SE	43,6	79,5	182,4%
Malta SE	6,7	4,5	67,1%
Mauritius SE	6,3	5,0	78,3%
OMX	1.011,7	1.122,7	111,0%
Oslo Børs	345,6	279,9	81,0%
Swiss Exchange	388,8	1.212,3	311,8%
Tehran SE	NA	36,3	-
Tel Aviv SE	148,4	161,7	109,0%
Warsaw SE	364,3	151,8	41,7%
Wiener Börse	340,1	199,1	58,6%

Source : WFE
Notes:
i) Euronext figures include data from Belgium, France, Netherlands and Portugal
ii) OMX figures include data from Denmark, Estonia, Finland, Iceland, Latvia, Lithuania, and Sweden.

There are 24 countries within the Europe-Africa-Middle East group and ISE's rank is 22nd with the domestic market capitalization which is 39,90 % of the GDP. For Swiss Exchange the ratio is 311,80%, for Luxembourg SE 182,40%, for London SE 149,2%. As far as this indicator is concerned, the best performer is Hong Kong Exchange with a ratio of 904% which is well above the European counterparts'. At this point it should be stated that the major aim of integration of Turkish stock markets with the European stock markets is to increase the share of stock market in the GDP.

And lastly Table 5.10 gives the share traded values and turnover velocity for European stock exchanges for the years 2006 and 2007.

Table-5.10 Share Traded Values and Turnover Velocity in the European Stock Exchanges and ISE (USD millions)

	Share Traded Values			Turnover Velocity	
	2007	2006	(%change)	2007	2006
Exchange					
Athens Exchange	168.665,2	107.893,0	56,3%	64,0%	58,6%
BME Spanish Exchanges	2.969.519,1	1.933.793,4	53,6%	191,9%	167,0%
Borsa Italiana	2.312.534,3	1.591.187,8	45,3%	204,1%	162,9%
Budapest SE	47.689,4	31.157,7	53,1%	104,0%	88,3%
Cairo & Alexandria SEs	60.196,4	48.083,6	25,2%	53,6%	58,5%
Cyprus SE	5.109,9	3.703,6	38,0%	22,0%	34,1%
Deutsche Börse	4.324.928,4	2.737.195,3	58,0%	208,4%	173,7%
Euronext	5.639.760,7	3.853.321,4	46,4%	136,9%	116,4%
Irish SE	136.936,2	81.669,4	67,7%	84,0%	59,6%

(Table-5.10 Continued)

Istanbul SE	294.295,0	222.724,0	32,1%	129,7%	141,3%
JSE	423.731,8	311.041,4	36,2%	52,5%	48,9%
Ljubljana SE	4.495,6	2.049,7	119,3%	18,5%	17,6%
London SE	10.333.685,9	7.571.698,6	36,5%	154,2%	124,8%
Luxembourg SE	278,7	263,8	5,7%	0,2%	0,3%
Malta SE	89,0	259,4	-65,7%	1,8%	5,4%
Mauritius SE	413,5	212,2	94,9%	6,3%	4,1%
OMX Nordic Exchange	1.864.668,1	1.332.369,5	40,0%	137,0%	134,5%
Oslo Børs	548.106,9	405.877,9	35,0%	145,4%	144,3%
Swiss Exchange	1.886.309,6	1.396.533,6	35,1%	133,9%	130,2%
Warsaw SE	88.096,8	56.372,9	56,3%	43,4%	45,4%
Wiener Börse	130.065,3	82.049,1	58,5%	55,6%	50,2%
Total region	***31.366.205,9***	***21.859.878,4***	***43,5%***		

Source:WFE

The comparison of share traded values in Table 5.10 show that ISE has the rank of 10. Due to the high trading values of the first three markets (London, Euronext and Deutsche) EU average value of share trading (1.547.264,04 million US dollars) is 5,26 times higher than the ISE. To compare the liquidity levels turnover velocity, found with the division of total value of share trading by market capitalization, can also be used. In terms of the liquidity the first three exchanges are Deutsche Börse (208,4%), Borsa Italiana (204,1%) and BME Spanish Exchanges (191,9%). The rank of ISE is 9th with a turnover velocity of 129,7%.

To sum up, with the end of three decades of high inflation, prospects of EU accession and improved regulation, Turkish stock market is undergoing a paradigm shift and has grown considerably over the last five years. Major factors leading to this development can be given as macroeconomic stability program which started to be implemented following the crisis in 2001, Turkey's EU membership prospects, global tendency of increased risk taking and depending on these factors increasing levels of foreign portfolio investment. The share of foreign investors in ISE at the end of 2007 is 72% -a high percentage when compared to the level in 2002 which is 45%.

ISE has 319 listed companies with a market capitalization of 286.571,7 million US dollars at the end of 2007. Market capitalization is 39,9% of GDP. So it can be stated that stock market has recovered substantially from the 2001 crisis. The market index (ISE-100) fell sharply during and after the crisis (from about 19,200 to 7,600 in September 2001), but has been rising since the end of 2003 and reached 58,864.34 in October 15, 2007 (lifetime highest). Traded value also recovered substantially from the drop in the 2001 crisis, reaching 294.295 million US dollars in 2007. Some companies have begun to raise funds in the market again and the number of listed companies began to rise. However due to the global financial turbulence the market index fell sharply to 33.919,76 in July 3, 2008 and especially due to the high level of foreign investor involvement in the ISE the index perdormance is expected to react international financial developments.

5.2. Turkish Stock Market and Adoption of the *Acquis*

As mentioned in the previous chapters the foundations for an integrated financial market in Europe have been laid especially with FSAP. EU have common rules for accounting, insurance, prospectuses[25], capital adequacy, market abuse and transparency. To be competitive in a globalized capital market, there is a need for an open and transparent legal framework which respects the balance between economic freedom and consumer protection. Accession to the EU requires countries to adapt their legislative framework to the norms and standards of the EU, i.e. the "*acquis* communautaire". In a fast changing sector, regulatory framework needs to be evaluated continually to ensure that it is relevant for the needs of the market, facilitates innovation and also serves to investor confidence. So, the *Acquis* which involves an evolving body of financial sector legislation is a tool for forming a renewed financial sector development strategy for the new member states (Passamonti, L., 2004:13).

[25] Document disclosed to the public during the sale of the capital market instruments, which includes all the necessary information that investors would need in making their investment decisions.

1995 White Book gives the criteria for EU membership and distinguishes two stages; Stage I and Stage II. Stage I includes the measures that need to be implemented as soon as possible, whereas Stage II is related with measures that need to be taken before full accession. The EU Commission aims to support candidate countries for the implementation of the *Acquis* with programmes such as Phare[26] and Twinning[27].

As far as the stock markets are concerned, the adoption of the *Acquis* mainly involves the free movement of capital and the free provision of financial services.

The formation of institutions that ensures existence of stable, proper functioning financial markets is also of paramount importance. As mentioned in the previous chapters, an independent central bank, competent supervisory authorities, a regulatory framework and market infrastructure are all major components that serve the above mentioned aim (Lannoo, 2000:300).

According to National Program, Turkey's membership to the EU will be negotiated on 35 chapters. As mentioned above in terms of the stock markets, the adoption of the *Acquis* mainly involves free movement of capital and free provision of financial services. Adoption of Company Law according to the EU legal framework can also be evaluated as related with the stock market legislation (The details of commitments of Turkey related to the financial sevices, free movement of capital and Company Law according to the Program for Allignment of the *Acquis*[28] is given in the Annex 4.

[26] Phare program cofinances institution building and investment.

[27] Twinning program provides for the long term assistance of officials from Member States to the candidate countries.

[28] Disclosed in www.abgs.gov.tr

5.2.1. Probable Effects on Legal Framework

The CMB has started to studies for harmonizing regulations with the EU *acquis*, Turkish securities regulations and practice are currently undergoing a substantive review. The EU Twinning Project "Assisting the Capital Markets Board of Turkey (CMB) to comply fully with European Union capital markets standards" began in the context of pre-accession assistance, with the support of the Federal Ministry of Finance of Germany, the Federal Financial Supervisory Authority (Bafin), and the Deutche Bundesbank. The duration of the project is January 2006 to December 2007. The objective is to complete the alignment of capital markets legislation with the *acquis* and its proper implementation. The project is multidimensional; it involves mainly preparation of draft capital markets legislation in accordance with the *acquis,* also some training sessions for the proper implementation of the legislation.[29] Within this context, CMB has drafted legislative amendments that will substantially upgrade the Capital Market Law that is scheduled to be introduced into Parliament in 2008 and the secondary legislations which will be introduced following the enactment of the CML have also been drafted to a great extent during the project. The components of the project are summarized in the Annex-5 which gives the general framework of the project which involves the adoption of the *acquis* related to the capital markets.

It should be taken into account that the *acquis* includes the FSAP which involves new ways of doing business at the EU scale without specific reference to the needs of the acceding countries, so in harmonizing the regulations with the *acquis*, the new member countries need also shape their regulations according to their national objectives (Passamonti, L., 2004:16). During the studies regarding allignment with the *acquis*, changes that would affect market participants negatively are taken into account and adoption of regulations for which the market is not ready for are postponed to a later date. Accordingly studies concerning the alligment with the *acquis* will continue until the accession with the EU. In terms of the stock

[29] Detailed information can be found in http://www.cmb.gov.tr/filesys/twinning/eng/index.html

markets the amendments in CML and the related communiqués that will be needed to harmonize with the European stock market regulations and will be realized during the accession period can be given as follows.

Updating the regulations related to stock exchanges is necessary to harmonize with developments especially brought in the EU stock markets with FSAP. Within this context the concept of "stock exchange" will be redefined parallel to EU implementations. The necessity of stock exchanges to be public legal entities will be abolished, i.e. stock exchanges can be found in the form of corporations. Accordingly, the authorization and operation of the exchanges will be redefined. MTFs and systematic internalizers which do not exist in the current legal framework will be defined.

Regulations regarding the intermediary procedures and services will be enhanced and harmonized with the EU regulations. The concept of "investment firm" needs to be used instead of the term "brokerage firm" parallel to the definition in the MIFID.The content of the investment services and licensing will also be redefined. New standards for investment advice and portfolio management, also classification of investors according to their knowledge and experience will be brought into agenda. Non-core activities will be defined and enhanced to give a revenue creating item for investment firms.

"Best execution principle" will be used in the stock market transactions. Introduction of high level requirements on pre- and post-trade transparency will accompany the implementation of best execution principle.

The procedures regarding the issuance of the securities will be shortened, regulations regarding disclosure will be developed so that investors will have access to thorough, adequate and timely information. To realize this aim, the procedure for the approval of the prospectus which contains all the necessary information needed for investment decisions regarding the stocks sold to public will be revised

according to the EU regulations and the time period for the approval of the prospectus will be shortened in the CML and the related communiqués.

To have a smooth functioning stock market, building the investor confidence is of paramount importance. As part of the protection of investors regulations related to crime and punishment will be enhanced and dissuasiveness will be increased. In this context insider trading and manipulation will be redefined parallel to the Market Abuse Directive of the EU. Additionally, the level of investor protection will be improved through the expansion of the scope of Investor Protection Fund, and the increase in the amount of the compensations. At present, the Investment Protection Fund covers only stocks. Brokerage firms claim that if the scope of the Fund is extended, the stock investors' protection will deteriorate. However parallel to the EU regulations the compensation scheme needs to be revised to provide guaranty to all financial instruments.

Through the regulations related with shareholder rights, the influence of shareholder in decision making processes will be increased, minority rights[30] will be improved.

As given in the previous chapters, the regulations brought by FSAP are even new to the EU member states. There is a main trade-off between the welfare of the users and the preservation of the stability of the existing financial intermediaries. Cross-border provision of financial products may benefit investors but may harm the existing intermediaries. Actually competition needs to be preserved whereas investors' choice needs to be enhanced. Accordingly, especially in the adoption of the regulations related to MIFID, a transitionary period will be needed, i.e. the regulation will be fully adopted prior to the accession. This will give a chance to the

[30] The rights set forth in Articles 348, 356, 359, 366, 367 and 377 of the Turkish Commercial Code that can, under Article 341, be exercised by shareholders representing ten percent of the equity capital of the company. In the case of publicly held joint stock companies, these rights may be exercised by shareholders representing at least one twentieth of the equity capital according to CML Article no.11. of the paid-in capital of the company

related parties to adopt themselves according to this new system and to preserve their market shares as much as possible. Additionally, during the harmonization process, full and open consultations need to be given to all the related parties involved in the financial sector, existing and potential.

5.2.2. Probable Economic Effects on the Stock Market

Adoption of the *acquis* for acceding countries constitutes a real challenge especially in the financial sector. As mentioned in the previous chapters European financial integration is still in progress and even the member states may experience difficulties in adopting the new legal framework brought into agenda by FSAP. Indeed, *acquis* is a moving target adoption of which may have both favorable and unfavorable effects depending on the development level of the acceding country's financial markets in general and existing firms competitive capabilities in particular.

It should also be stated that since the regulations regarding the stock markets have beeen reshaped recently in the EU the experiences of EU-15 or newly acceding countries can not be used to assess the economic implications regarding the integration with a pan-European stock market. New entrants to the EU membership, namely CEECs, also cannot be used for the comparison since these have the background of command economies different from the Turkish system. Accordingly the economic effects of adopting these new set of rules are assessed taking into account economic theory, the Commission's expectations, the rationale behind the changes in regulations and also some tendencies evident even with the start of the accession negotiations.

Probable accession of Turkey to the EU will affect the Turkish stock market in various ways, however even before the accession due to the requirement of adopting the *acquis* the probable effects will begin to be experienced following the adoption of the legal framework.

Basically amendment of CML and the related communiques aim to have a legislative framework harmonized with the EU mainly to enhance the investment environment and also improve the functioning of the market. Existence of standards harmonized with the developed financial markets and also their proper implementation would help to build confidence in both domestic and international investors. The *acquis* outlines a number of sound standards for capital market supervision, corporate governance and transparency, which if adopted, would bring Turkey's capital market and financial supervision into closer alignment also with the IOSCO principles.

Benefits expected from the integration of stock markets in the EU has been evaluated in Chapter 2.2. Turkey, as an acceding country, by harmonizing the regulatory framework of the stock markets with the *acquis* would also benefit from the merits of an integrated stock market.

Adopting the *acquis* will have major effects in every dimension of the stock market and dealing with the probable effects of MIFID would be a good starting point. MIFID is the most significant piece of financial services legislation that the EU has enacted and a central pillar of the FSAP. So adoption of MIFID would have an effect beyond the adoption of other regulations, redefining the functioning of the stock market as a whole and changing the infrastructure. Therefore understanding scope and functions of the MIFID which have been discussed in the Chapter 3.2. is a prerequisite for assessing the effects of the adoption of the Directive.

With the adoption of the MIFID all the firms performing investment services and activities will be subject to MIFID for both their investment and ancillary services. Actually, reception and transmission of orders, execution of orders on behalf of clients, dealing on own account, portfolio management, underwriting, investment advice and placing of financial instruments needs to be performed under the scope of the MIFID. In terms of the investments, any of the investments in

transferable securities, investment funds, money market instruments, financial futures, interest rate, currency and equity swaps, commodity derivatives, and options on the above given investments will be within the scope of the MIFID.

First of all, attitude of MIFID towards the use of "single passport" and probable effects needs to be mentioned. MIFID foresees a "single passport" system enabling investment firms to operate through the EU so Turkish stock market will also be a part of the system. Firms covered by MIFID are required to be authorized and regulated in their home state. Brokerage firms, banks and stock exchanges would offer cross-border services on the basis of their home-country authorization, i.e. emphasis on home state supervision will be prevailing. To explain it briefly; MIFID passport would enable any entity incorporated and regulated in one jurisdiction to provide services within MIFID's scope from its "home state" across EU without being regulatory oversight by host state regulators. As far as the branches opened in host states they will be subject to host state regulations but permission to open branches will be automatic, host state may not impose additional requirements.

Through the use of the "passport" investment firms would have a chance to benefit from marketing a wider range of investment services and financial products through branches, subsidiaries and tied agents abroad. Pooling of liquidity would reduce stock specific volatility (FSA, 2006:3). However this system would also form a challenge especially for Turkish brokerage industry which may come across a serious competition from the brokerage firms operating on a pan-European basis. Representatives of the sector may demand the prevention of foreign financial intermediaries establishing new financial intermediaries in Turkey. They may be reluctant to open up the market to foreign institutions. However the Commission's attitude is such that accession countries must be in a position to apply the *acquis* and the scope for exceptions is limited (Lannoo, 2000, 312). As a result, Turkish investment firms will need to sustain their competitiviness in terms of both financial strength and quality of the service they provide to consumers. Emphasis on home

state supervision will also increase the importance of cooperation and coordination between the supervisors especially in the periods of financial distress.

MIFID with its pro-competition effects is expected to create significant structural changes in Turkish stock markets when adopted. Another major development brought by MIFID is the abolition of concentration rule which is a major change in the trade of stocks. ISE will no longer be the only venue that the orders related with stocks would be executed. MTFs and systematic internalizers, as explained in Chapter 3.2., will be the other venues where stocks will be traded. The same stock will be traded in many different venues and not just at different prices but at different trading costs. Pre-trade and post trade transparency and the related disclosure requirements will be defined. With time financial services firms will discover which venues are the most efficient and prefer them.

So with the adoption of MIFID, banks and brokerage firms will have a chance to compete fairly with ISE. For the investment firms there will be opportunities to act as systemic internalisers for liquid shares, to serve internal and external clients. Actually the ISE would need to compete with both the European stock exchanges and also domestic and European brokerage firms and banks. Domestic intermediaries would also be under the risk of loosing their market share to foreign pan-European counterparts. So competition between these venues to offer the best practice is expected in Turkish stock market. Additionally authorization of private companies for operating exchanges will be enabled, which means that stock exchange will be required no more to be a public entity.

However, organization, operations and business strategies of all the actors in the sector will be effected. Efficiency, financial strength, quality of the service provided will needs to be strengthened to compete with international counterparts. Firms will be required to make dynamic readjustments to stay competitive. Within this context consolidation of especially small investment firms may be brought into

agenda of the financial sector. Consolidation with other domestic firms or having foreign shareholders that would bring know-how and capital may be needed.

The third major effect of the implementation of MIFID on Turkish stock market is related with the requirement of the “best execution principle”. Investment firms will have the obligation to take all reasonable steps to obtain the best possible result for the investors in the execution of the orders taking into account price, cost, speed, likelihood of execution. Clients will be categorized and investor protection will be defined accordingly.

Investment firms with a legal obligation to find the best possible price for their clients will need to look across a number of venues. Calculating the best venue for a particular client order will be challenging. This would require investment in technology, firms that invest in smart order routing systems would have an advantage over those that do not make the necessary investments.There will be a need of investment in IT structure and upgrading systems. Actually this could create a disadvantegous position for smaller, traditional, national firms in the financial sector and in the medium term big pan-European firms that can afford to make the necessary investments may survive. So with the adoption of MIFID Turkish financial intermediaries will also need to adopt the system, they will incur some costs and to be competitive mergers between the financial intermediaries may take place. In terms of the investors the best execution principle creates advantages in that having the best executed price would minimize the cost and the expected return on the investment would increase.

Lastly, with the adoption of MIFID Turkish banks can adopt universal banking, i.e. they may directly engage in stock market activities, so they would liquidate their existing financial intermediaries. However those that do not want to engage directly with stock market may also keep their financial intermediaries. The fixing of the number of financial intermediaries woud also be abolished.

Advisors and commodity firms coming within MIFID's scope would see an increase in their capital requirements since firms within the scope of the MIFID will be subject to EU capital requirements regime set out in the Capital Requirements Directive which came into force in January 1, 2007. Actually, as mentioned above, the cost of implementing MIFID is likely to be significant. The activities that will lead to major costs are implementation of changes in procedures, information technology, client documentation and controls. MIFID involves requirements covering a wide range of activities such as senior management responsibilities, compliance functions and arrangements, internal audit and risk functions, internal systems and controls, outsourcing of critical functions, managing conflicts of interest. So all financial service providers will be required to review their internal procedures.

Investment firms would need to change their business models substantially. Banks would be required to review their internal policies and processes. All these changes are likely to affect IT systems of related parties. They would face a stiffer competition and greater transparency and this would affect their profit margins, so only small number of best prepared is expected to survive. Also in terms of the infrastructure such as clearing and settlement systems consolidation would be expected through partnerships, mergers and acquisitions similar to the experiences of the EU as mentioned in the previous parts of the study.

The above given developments which will be brought by MIFID will also have indirect effects in the Turkish stock market which deserves to be mentioned. Due to the increased competition trading volumes can be expected to increase (Lannoo, Casey, 2006:10). The increase in trade volumes can create a decrease in trading costs due to economies of scale. Best execution principle, improved disclosure standards, enhancement of investment advisory and portfolio management activities can stimulate the confidence of retail investors and their investments in stock markets can increase. Increased level of returns from the investments may even cause an increase in the level of savings. Increased

competitiveness of the financial industry is expected to increase the level of employment in the sector. All the above mentioned benefits would likely to increase the share of stock market in the national economy, and create a positive growth effect for the economy as a whole. This is similar to the expectations of the Lisbon Strategy and and thought as the major benefit that is probable from Turkish stock maket's integration with European stock markets.

It should also be stated that during the accession period changes that would affect market participants negatively are taken into account and adoption of regulations for which the market is not ready for are postponed to a later date. Accordingly studies concerning the alligment with the *acquis* will continue until the accession. In the meantime the related parties would have a chance to adopt the requirements to stay competitive in this newly formed structure. As can be seen from the above, adoption of the *acquis* would entirely create a new structure and operations will be redefined. But effects of adopting the *acquis* is not limited to the provisions that MIFID brings as will be mentioned below.

Apart from MIFID's there will be other effects of adopting the *acquis*. Free movement of capital is expected to increase inflow of FDI in financial sector. There has already been an increase in FDI in financial sector which is evident from the increase of the number of foreign-owned financial intermediaries (5 in 2001 and 25 as of the end of 27).

Additionally, as mentioned in the previous parts of the study, the single financial market in general and stock market in particular is expected to foster competition. Financial service providers would increase. Increasing competition should act to increase productivity since under-performing businesses that do not meet consumer needs would loose market share. This will be felt in the financial sector (for banks, brokerage firms and stock exchanges) since in the single passport regime financial intermediaries that have licences in the EU member states will

have to the possibility of direct access in the Turkish stock market through distance marketing or through establishment of subsidiaries or opening of branches.

Equally important, the single financial market aims to form a borderless capital pool, especially for wholesale operators (Passamonti, L., 2004:13). However the economies of scale advantage gained by these operators including Turkish financial intermediaries could also benefit Turkish retail investors and small and medium sized enterprises.

Local Turkish firms would have a chance to borrow from domestic banks, or from foreign branches or even from non-resident banks with a comparable degree of consumer protection also they can issue debt instruments Europe-wide to raise funds which is not widespread in Turkish financial markets due to the crowding out effect. Additionally the firms that want to raise funds would have the access to a pan-European stock market and would have an opportunity to decrease their cost of capital. As mentioned in the previous section with a single prospectus based on common accounting and disclosure standards, and converging stock market infrastructure Turkish companies would meet a larger base of investors with different levels of risk taking tendencies compared to the domestic investors. However to benefit from the pan-European stock market Turkish publicly traded companies need to te competitive and transparent; better market conduct and corporate governance which are also major items in the agenda of the EU will make the difference for firms to be prefered by investors.

Accordingly, a potential development area which would benefit from being part of a single stock market is public offerings. There are 140 companies listed on the ISE out of the top 1.000 industrial companies in Turkey. In other words, 860 of the largest industrial companies are not listed yet. This could be interpreted as the potential of the IPO market (ACMIIT, 2008, 81).

In terms of the investors, Turkish residents (companies and individuals) would have a chance to access a pan-European stock market. Investors would have an easy access to stocks of the foreign firms and they would take the advantage of expertise, economies of scale and risk diversification offered by financial sector operating at a global level (Passamonti, 2004:15). Better shaped strategies for investors would bring better risk adapted financial products with the end result of increased returns on savings. Expected increase in the investor confidence would raise the level of savings, (FSA, 2006:4).

Similarly, being part of a single stock market, adopting the Europe-wide standards would also bring some new financial instruments into the Turkish investment sphere which would benefit all the parties involved, i.e. investors issuers and investment firms. Turkey has the basis for a reasonably sized capital market, with a per-capita income of roughly USD 5,000 and a large population. Compared to 2001, the market has risen, regulation has improved, some new equity issues have begun, and infrastructure is good, as described above. Thus, future growth prospects depend on the development of new products.

Before concluding the chapter two possible implications of a probable accession needs to be mentioned. As mentioned in Chapter 5.1. Turkish stock market has grown considerably over the last five years and as explained in the related section there is an increase in the portfolio investments. This tendency has some positive implications. Firstly, foreign investors have a longer investment span compared to the residents. Their average holding period (or investment horizon) is calculated as 275 days for 2007. The shortest investment span was in 2004, seven months again a long period of time compared with the Turkish investors holding period of one month (ACMIIT, 2008, 78). Secondly Turkish stock market needs institutional investors with a longer term vision that would have a mission of stabilizing Turkish emerging stock market. Domestic institutional investors' equity holdings are 3,8% of domestic investment in stocks whereas 38% of investment in stocks is from institutional foreign investors (ACMIIT, 2008, 75). However as

mentioned in the Chapter 3.3., following the membership, Turkish stock market would no longer be used for portfolio diversification, sectors in general and firms in particular will gain importance.

Another possible implication though has a longer time span, is that in case of joining EMU, it would require a reduction in exchange rate volatility and also would require a reduction in the interest rates. Monetary policy coordination with the ECB necessitates lower inflation which would help decrease long term interest rates. This would create an advantegous position in terms of investments. However as Turkey heavily depend on foreign portfolio inflows attracted by high levels of interest rates to finance her current account deficit in case of accession she will no longer have a tool to finance the deficit by means of short term portfolio inflows. This would require a change in paradigm in the finance of current account deficit which is mainly financed through portfolio investments due to high levels of interest rates.

CHAPTER VI

CONCLUSION

The main aim of this thesis is to evaluate the stock market integration in the EU and to analyze the probable effects of integration with European stock markets on stock market in Turkey as an acceding country.

The second chapter of the thesis provided a historical, conceptual and theoretical framework for financial market integration of which stock market integration is an inseparable part. To this end, first of all the global environment as the background of financial integration has been examined. It has been observed that financial integration in the EU is not independent from the general process of internationalization and globalization which gained momentum with the dominance of neoliberalism in the late 1980s. Similarly, current policy outcomes of the Turkish financial system have also been affected from the international political economy and also from the efforts to harmonize national monetary governance and financial governance arrangements (Bakır, 220:179). EU, through the accession process, International Monetary Fund and the World Bank, through technical support and financial assistance for reforms, "serve as the external anchors for institutionalization and harmonization of the Turkish financial regulatory regime" (Bakır, 2006:180). Additionally, improvement of the investment climate which would enable FDI and portfolio inflows is a major objective of the economic policies.

The integration of financial markets has been a policy priority for the EU especially in 1990s. Lisbon Strategy (2000) specifically formulated the goal of making Europe "the most dynamic, knowledge- based economy in the world by 2010". So European integration has gained momentum towards the objective of improved global competitiviness and financial market integration was an important tool to reach this objective.

According to the theory of finance, in its broadest sense, financial markets are expected to direct scarce resources to the best possible investment alternatives. Therefore, properly functioning financial markets are of primary importance for the national economies and integration of financial markets can create the synergy that can even enlarge the expected benefits from the financial industry. Thus integration of financial markets is an integral part of the general process of economic integration in the EU. According to the literature on the effects of financial integration there are both overall economic effects and microeconomic effects for issuers and investors. To summarize overall effects; integrated financial markets are broadened and deepened and an increase in efficiency is expected. Lower transaction costs and increased liquidity in an integrated market result in better allocation of resources. The decrease in the cost of capital facilitates enhanced growth and employment. Through the use of disciplined macroeconomic policies, a favorable investment environment is created and an increase in the inflow of funds is expected. In terms of the firms, they would issue equity on a pan-European market with lower costs, facilitating the funding of investments, the end result of which would be a probable increase in productivity and an increase in growth rate for the member states since availability of funds creates opportunities for increased levels of investments, innovations, productivity, growth and employment. An integrated financial market provides investors a wide range of financial products, giving them the opportunity of a diversified portfolio with an increase in expected returns and an icrease in marginal propensity to save and an increase in the wealth of the EU accordingly.

Financial intermediaries will also have an opportunity to serve a broader market. However in the new environment, financial intermediaries, stock exchanges and firms that raise funds from the stock markets need to increase the efficiency to compete with foreing counterparts. Sustaining competitiveness will especially be challenging for the member states with less developed financial systems compared with especially EU-15.

This chapter also puts forward that the creation of a single market in financial services in the EU has been realized through some major steps. SMP with its emphasis on the primacy of economic issues was a major step. The concepts of "minimum harmonization" and "mutual recognition" brought into agenda by SMP formed the basis for financial market integration. EMU which demands a common monetary policy and also convergence of fiscal policies was another important step. The use of a single currency eliminates currency risk and the transaction costs of conversion of one currency into another, as well as providing price transparency. So the formation of EMU is of paramount importance for the realization of common market in general and an integrated capital market in particular. Another major step is the formation of the FSAP which is seen as the roadmap for financial integration with its emphasis in renewing the regulatory framework of financial services. Lisbon Strategy which accepts the financial integration as a building block of single market also created a momentum in the process. Lastly Lamfalussy Process brings a revolution to the regulatory process to make FSAP applicable. It is a four level approach which aims to simplify and fasten the legislative process. According to this approach, framework of required regulations needs to be adopted by the European Parliament and the Council on a proposal by the Commission and the technical details will be decided upon with the interaction of the Commission, CESR and ESC.

The Third Chapter aims to concentrate on the regulation and supervision of the stock market and also explore the level of the integration of stock markets in the EU depending on the empirical findings of the studies in literature. FSAP, adopted in May 1999, targeted to complete the legislative framework by 2005. It includes over 42 measures to establish a common framework with the main objectives of the creation of a single wholesale market, open and secure retail markets, prudential rules and supervision and suitable conditions for an optimal single financial market. Lamfalussy Approach which aims to form an efficient regulatory system to respond timely and effectively to the market developments, simplified the rule-making

process and is considered as a building block in the integration of stock markets since February 2002. With these developments centralization of the rulemaking and supervisory coordination has been achieved to a great extent.

With FSAP the regulatory framework of the stock markets has been changed substantially. The Prospectus Directive and the Market Abuse Directives are some examples of the recent directives however MIFID is the most significant regulation which will redefine the functioning of the stock market and a central pillar of the FSAP. MIFID aims to facilitate greater financial integration especially by establishing a common regulation for stock markets, creating a passporting regime, abolition of concentration rules, simplifying the regulatory regime for brokerage firms' cross-border services, bringing a Europe-wide regime of pre trade and post trade transparency in stock trading, creating a Europe-wide obligation for intermediaries to deliver "best execution" for their clients, facilitating cooperation of regulators across Europe (FSA, 2006:4-5).

With the focus on possible mechanisms, some comments can be made about the probable benefits of MIFID on European stock markets. Markets are expected to become deeper and more liquid, combined with greater competition and reduced transaction costs, cost of capital may decrease. The reduction in the cost of capital may cause an increase in investment and a rise in GDP across the EU. These are the so-called second-round, i.e. indirect benefits (FSA, 2006:18). There are also some first-round, i.e. direct benefits to the European stock markets which are attributable to MIFID. Improved regulation is expected to cause improved functioning of the markets. MIFID simplifies the passporting regime which would lead to increased cross-border competition and greater stock market integration. Abolition of concentration rules might enhance competition between exchanges, MTFs and internalizers. Best execution principle leads to improved prices and reduced prices for investors. Additionally, requirements for firms to disclose their execution policies might impose discipline on cost which would also be favorable in terms of investors (FSA, 2006:13-14). Therefore an overall increase in efficiency and

competitiveness is evident from the above given benefits with an emhasis on greater integration of stock markets in the EU.

During the last decade there has been a continuous effort for integration of small and bank-based market systems of Europe. In literature there have been some studies to test whether or not the goal has been achieved at least to some extent. In these studies the tests have been performed based on law of one price approach or quantity based approach. According to the law of one price approach, within an integrated area, financial instruments with the identical cash flows should have the same price, in other words the instruments with the same risk should have the same expected return. As far as the quantitiy based approach has been concerned, prices should be affected by the same news and correlation of the returns of similar stocks is increased; i.e. regional news should have little impact compared to global news in an integrated area. The empirical studies reveal that individual stock markets in the EU have become increasingly integrated over time but they are not perfectly integrated yet. Especially integration in retail markets is lower compared to the wholesale markets. Chapter 3 confirms that with integration, cross-country yields should converge and cross-country dispersions should narrow within the single market.

Chapter 4 is devoted to the discussions related to the future of stock market integration in the EU, dealing with post-FSAP agenda and emphasizing future challenges. It can be observed that the motto of the current period is “no more regulation” with the emphasis on implementation, enforcement and evaluation of the existing regulations. Improvement of cross-border clearing and settlement systems, attention on corporate governance, strengthening the cooperation between national regulators, prevention of anti-competitive behaviour, transatlantic cooperation are all the post-FSAP agenda items related with stock markets.

Following the issues related with post-FSAP agenda, the Chapter also expands on the future challenges on the way of stock market integration in the EU,

which is also important for Turkish stock market as a candidate country for EU membership.

Improvement of supervision and getting the home country-host country relationship right is a main issue which needs to be tackled in the EU. The formation of a single stock market is based on mutual recognition and single passport systems. So, member states need to coordinate with each other especially in the recent environment of financial turbulence. Consistent transposition of legislation and effective implementation is important, the lack of which may create anti-competitive behaviour in terms of the market participants and cause the service providers to abstain from serving international customers. Lastly the integration of CEECs, which have recently acceded to EU, to the single stock market is also a challenge. Coming from command economies and with underdeveloped stock markets they are expected to have more difficulty in implementation of the newly adopted regulation. Also home-country host country relationships would pose additional challenges between EU-15 and new entrants with different levels of know-how and economic resources.

In light of the framework formed in Chapters 2, Chapter 3 and Chapter 4, Chapter 5 analyses prospective integration of Turkish stock markets with the EU stock markets. First of all the Turkish stock market has been introduced with its basic parameters and also compared especially with major EU member states stock markets in terms of the basic indicators. In its broadest sense Turkish stock market is an emerging market with increasing number of publicly traded companies and a high level of foreign investor penetration. The number of listed companies is 319 with a market capitalization of 197.748 million Euro at the end of 2007. Market capitalization has a rank of 8th within the EU but it is well below the EU average (594.899 million Euro). CMB is responsible for the regulation and supervision of the stock market and ISE is the single stock exchange. Different from the universal system which is dominant in Europe, banks are not allowed to trade in stocks similar to the US system. Also number of financial firms has been fixed beginning in July

1991. Public sector debt securities dominate the securities market, residents' investment preferences show that 69 % of the total assets are held in the form of bank deposits. Turkish financial system is bank based, individuals' participation in stock market is low. Actually ISE has been involved in a high degree of foreign investors' penetration; 72,4% at the end of 2007. The Turkish stock market has recovered from the crisis in 2001 to a great extent. End of three decades of high inflation, prospects of EU membership and improved regulatory framework are all major factors that helped the recovery.

Turkish stock market regulations have been updated to become competitive within the context of globalization of financial markets. Accession to the EU requires the adoption of the legislative frameworks to the norms and standards of the *acquis*. So Turkey as a candidate country for EU membership is also in a position to adopt the *acquis*. According to the National Program Turkey's membership to the EU will be negotiated on 35 chapters. In terms of the stock market, adoption of the *Acquis* mainly involves free movement of capital and free provision of financial services. Adoption of Company Law according to the EU legal framework is also related with the stock market regulations. CMB has started an EU Twinning project which aims to adopt the Turkish securities market standards to the European ones. Within this context, CML and the related communiqués have started to be updated. During the legal studies of harmonization with the Aquis, the procedures for registration with the CMB and the disclosure requirements are to be revised. Stock exchanges will be redefined and the requirement of being a public legal entity will be abolished. MTFs and systematic internalizers which do not exist in the current stock markets will be defined. The concept of "investment firm" will be used instead of "brokerage firm" and the operations will be redefined. "Best execution principle" will be used in the stock market transactions. Introduction of high level requirements on pre-trade and post-trade transparency will accompany the implementation of best execution principle. New standards for investment advice and portfolio management, also classification of investors according to their knowledge and experience will be brought into agenda. Shareholder rights and minority rights, as

defined in the Turkish Commercial Code, will be improved. The scope of Investment Protection Fund will be extended to include all the financial instruments. Regulations related with crime and punishment will be enhanced.

The regulations brought by FSAP which forms a regulatory framework for a single market in financial services are new even to the existing member states. Functioning of the stock market has been revised substantially in the EU so during the adoption of the *acquis* in Turkey some of the regulations are harmonized without any delay. However in cases where the financial sector needs some time for adaptation, if the market is not ready, adoption of the related regulations is postponed to a later date before the accession. Transitional provisions will be used until Turkey's membership to the EU. However during this study the changes that are required for harmonization with the *acquis* are taken as a whole since the probable effects of accession have been discussed.

Since the legal framework related with stock markets in the EU has been renewed to a great extent recently, probable effects can not be inferred from the accession of EU-15 or recent member states' experiences. Additionally, newly acceded CEECS were previously command economies financial market structures of which are incomparable with Turkish markets. Accordingly the probable effects on Turkish stock market have been analyzed depending on theoretical expectations, the formal explanations regarding the changes in the regulations, Commission's expectations on stock market integration in the EU and also some tendencies evident even with the start of the accession negotiations with the EU.

As mentioned before with FSAP the general framework has been revised to a great extent. Especially the adoption of the MIFID will redefine the functioning of the Turkish stock market. First of all MIFID gives investment firms a single passport allowing them to operate throughout the EU on the basis of authorization in their home member state. For the Turkish case this would result in an increase in the number of investment firms which would require Turkish investment firms to

sustain their competitiviness in terms of both financial strength and quality of the service they provide to consumers. Home state supervision will be prevailing in the system and cooperation between the supervisors will be much more important.

Another major implication brought by MIFID is the abolishment of the concentration rule, i.e. ISE would no longer be the single venue where the stock trades have been executed. Also authorization of private companies for operating exchanges will be enabled. New transaction platforms, MTFs and systematic internalizers, will be defined with the necessary disclosure requirements about the transactions. ISE and domestic financial intermediaries will be subject to competition from the pan-European investment firms, MTFs and systematic internalizers. ISE will compete with foreign stock exchanges and also domestic and international trading platforms. Investors will have an opportunity to reach best possible venue for their transactions. However, organization, operations and business strategies of all the actors in the sector will be effected. Efficiency, financial strength, quality of the service provided will need to be strengthened to compete with international counterparts. Firms will be required to make dynamic readjustments to stay competitive. Within this context consolidation of especially small investment firms may be brought into agenda of the financial sector. Consolidation with other domestic firms or having foreign shareholders that would bring know-how and capital may be needed.

The third major effect of adopting the MIFID will be the requirement of “best execution principle”. Investment firms will have the obligation to take all reasonable steps to obtain the best possible result for the investors when executing the orders. They need to take into account price, costs, speed, likelihood of execution in realizing the best execution. Clients will be categorized and investor protection will be defined accordingly. In terms of the direct effect of this development, there will be an increased need of investment in IT infrastructure and upgrading systems for the investment firms. For the investors the best execution

principle is advantegous in that having the best exequted price during the purchase of the financial instrument, their expected return on the investment will increase.

The above mentioned objectives will also have indirect effects in the stock market. Due to the increased competition trading volumes can be expected to increase (Lannoo, Casey, 2006:10). The increase in trade volumes can create a decrease in trading costs due to economies of scale. Best execution principle, improved disclosure standards, enhancement of investment advisory and portfolio management activities can stimulate the confidence of retail investors and their investments in stock markets can increase. Increased level of returns from the investments may even cause an increase in the level of savings. All the above mentioned benefits would increase the share of stock market in the national economy with a positive growth effect for the economy as a whole.

Apart from MIFID there will be other effects of adopting the *acquis*; free movement of capital is expected to increase inflow of FDI in financial sector. There has already been an increase in FDI in financial sector which is evident from the increase of the number of foreign-owned financial intermediaries (5 in 2001 and 25 as of the end of 27). Banks would also engage in stock market activies and the fixing of the number of financial intermediaries woud be abolished.

In terms of the firms which can fulfill the requirements of the European legal framework there will be an opportunity of raising funds to finance their investments and operations from the pan-European stock market, so their cost of capital may decrease.

Lastly, investors will have an opportunity to access different financial instruments offered from intermediearies with operations on a European scale. Accordingly Turkish stock market will also adopt the requirements of the competitive pan-European stock market and new financial instruments will be introduced to the system.

The adoption of the *acquis* will also involve some costs as mentioned in detail in Chapter 5. Actors participating in the stock market will have to incur some costs (due to reorganization, investment in IT, etc) to sustain their competittiviness. There are also some major implications that also need to be taken into account in assessing the effects of integration to the EU stock market. Being part of a single stock market, Turkish stocks would no longer be preferred for portfolio diversification since they will be evaluated within the single stock market of the EU. Only individual performances of the firms would make the difference to be preferred by foreign investors. Therefore institutional firms taking into account corporate governance principles with prospects that investors would value would have an opportunity to raise funds from the domestic and/or European stock markets or venues.

Another possible implication, though has a longer time span, is that in case of joining EMU, interest rates should converge with other member states. Turkey would no longer have an opportunity to finance the current account deficit by short term foreign portfolio investments. This would require a change in paradigm in the finance of foreign account deficit.

In conclusion, financial market integration has been a policy priority in Europe. This tendency is not independent from the general globalization of financial markets especially with the dominance of neoliberalism in the world in the 1980s. Especially with the free flow of capital, countries and/or regions have been competing to become major financial centres. In that sense states were competing to attract FDI or portfolio investment by creating favorable environments for the investors. EU has also seen financial market integration as a key determinant of competitiveness and with FSAP, renewed the legal framework to form a pan-European stock market. Turkey as a candidate country of EU membership is also in a position to adopt the *acquis* before the accession.

It can be argued that there may be resistance to the changes in the regulations from the interested parties whose operations would be affected during the process of adopting the *acquis*. However, regarding this issue two comments can be made. First of all in the EU case, it can be seen that the technicality of the subject matter makes it difficult for the non-expert parties to form and opinion on policy questions involved. There is no strong resistance from the parties which are non-experts, which are not directly involved (Mügge, 2007, 12). The same would also be true for the Turkish case. Secondly, as mentioned throughout the thesis, changes in legal framework that would require some time for adoption are postponed. However, adoption of the *acquis* is the commitment of the acceding countries so prior to accession, the adoption has to be realized, which means that the realization of the requirements are not negotiable.

It can also be asked whether we would still witness similar outcomes even if Turkish stock market would not be integrated with that of the EU as a result of globalization or international financial market integration. As mentioned in the second chapter, it can be argued that the process of European financial market integration is not independent of the globalization of financial markets. In an era of free capital movements Turkish stock market is not immune from these developments. To compete with the other financial markets, to be a major financial center, Turkish stock markets have always aimed to harmonize the existing legal framework with the regulations of major financial markets, to present international investors a level playing field. However, as stated above, the goal of accession to the EU has become “one of the main driving forces” for broadly defined legal, economic and financial reforms in Turkey (Bakır, 2006:179). Accordingly the EU serves as an “external anchor” for adopting the current regulations in a predetermined calendar which would otherwise have a possibility of facing counter-pressures or which would otherwise may be realized in a longer time-span.

In the final analysis, adoption of European legal framework of stock markets will have numerous effects especially through the formation of a competitive

environment, the end result of which is a probable increase in the share of stock markets in the economy and a positive effect on growth rate according to the mainstream economic theories. It is hoped that this study will lead to build an understanding about the probable effects of the process of being part of a single stock market on Turkish stock market. Taking into account that European stock market integration is a challenging process which still continues, being part of such a process may also involve some unpredictable conclusions. However, it should be stated that ex-post analysis of the effects of integration of Turkish stock market with the European stock markets can only be realized following the full adoption and implementation of the EU *acquis*, so it can form the subject of another future study.

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APPENDICES

APPENDIX-1

EC TREATY

(CONSOLIDATED VERSIONS OF THE TREATY ON EUROPEAN UNION AND OF THE TREATY ESTABLISHING THE EUROPEAN COMMUNITY)

CHAPTER 4

CAPITAL AND PAYMENTS

Article 56 EC (ex Article 73b)

1. Within the framework of the provisions set out in this Chapter, all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited.

2. Within the framework of the provisions set out in this Chapter, all restrictions on payments between Member States and between Member States and third countries shall be prohibited.

Article 57 EC (ex Article 73c)

1. The provisions of Article 56 shall be without prejudice to the application to third countries of any restrictions which exist on 31 December 1993 under national or Community law adopted in respect of the movement of capital to or from third countries involving direct investment - including in real estate - establishment, the provision of financial services or the admission of securities to capital markets.

2. Whilst endeavouring to achieve the objective of free movement of capital between Member States and third countries to the greatest extent possible and without prejudice to the other Chapters of this Treaty, the Council may, acting by a qualified majority on a proposal from the Commission, adopt measures on the movement of capital to or from third countries involving direct investment - including investment in real estate - establishment, the provision of financial services or the admission of securities to capital markets. Unanimity shall be required for measures under this paragraph which constitute a step back in Community law as regards the liberalisation of the movement of capital to or from third countries.

Article 57(1) was adjusted by Article 18 of the Act of Accession 2003 for Estonia and Hungary.

Article 58 EC (ex Article 73d)

1. The provisions of Article 56 shall be without prejudice to the right of Member States:

(a) to apply the relevant provisions of their tax law which distinguish between taxpayers who are not in the same situation with regard to their place of residence or with regard to the place where their capital is invested;

(b) to take all requisite measures to prevent infringements of national law and regulations, in particular in the field of taxation and the prudential supervision of financial institutions, or to lay down procedures for the declaration of capital movements for purposes of administrative or statistical information, or to take measures which are justified on grounds of public policy or public security.

2. The provisions of this Chapter shall be without prejudice to the applicability of restrictions on the right of establishment which are compatible with this Treaty.

3. The measures and procedures referred to in paragraphs 1 and 2 shall not constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital and payments as defined in Article 56.

See also Declaration Nr. 7 on Article 73d. This refers to Article 58(1)(a). The date contained in this declaration is affected by Annex IV referred to in Article 22 of the Act of Accession 2003 (Estonia).

Article 59 EC (ex Article 73f)

Where, in exceptional circumstances, movements of capital to or from third countries cause, or threaten to cause, serious difficulties for the operation of economic and monetary union, the Council, acting by a qualified majority on a proposal from the Commission and after consulting the ECB, may take safeguard measures with regard to third countries for a period not exceeding six months if such measures are strictly necessary.

Article 60 EC (ex Article 73g)

1. If, in the cases envisaged in Article 301, action by the Community is deemed necessary, the Council may, in accordance with the procedure provided for in Article 301, take the necessary urgent measures on the movement of capital and on payments as regards the third countries concerned.

2. Without prejudice to Article 297 and as long as the Council has not taken measures pursuant to paragraph 1, a Member State may, for serious political reasons and on grounds of urgency, take unilateral measures against a third country with

regard to capital movements and payments. The Commission and the other Member States shall be informed of such measures by the date of their entry into force at the latest. The Council may, acting by a qualified majority on a proposal from the Commission, decide that the Member State concerned shall amend or abolish such measures. The President of the Council shall inform the European Parliament of any such decision taken by the Council.

APPENDIX-2

EC TREATY
(CONSOLIDATED VERSIONS OF THE TREATY ON EUROPEAN UNION AND OF THE TREATY ESTABLISHING THE EUROPEAN COMMUNITY)

CHAPTER 2
RIGHT OF ESTABLISHMENT

Article 43

Within the framework of the provisions set out below, restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be prohibited. Such prohibition shall also apply to restrictions on the setting-up of agencies, branches or subsidiaries by nationals of any Member State established in the territory of any Member State.

Freedom of establishment shall include the right to take up and pursue activities as self-employed persons and to set up and manage undertakings, in particular companies or firms within the meaning of the second paragraph of Article 48, under the conditions laid down for its own nationals by the law of the country where such establishment is effected, subject to the provisions of the Chapter relating to capital.

CHAPTER 3
SERVICES

Article 49

Within the framework of the provisions set out below, restrictions on freedom to provide services within the Community shall be prohibited in respect of nationals of Member States who are established in a State of the Community other than that of the person for whom the services are intended.

The Council may, acting by a qualified majority on a proposal from the Commission, extend the provisions of the Chapter to nationals of a third country who provide services and who are established within the Community.

APPENDIX-3

FREE MOVEMENT OF CAPITAL

LEGISLATION CONSIDERED BENEFICIAL TO BE ENACTED (LAW)

LEGISLATION CONSIDERED BENEFICIAL TO BE ENACTED IN PERIOD 2007-2008 (01/10/2007 – 30/09/2008)

Reference No.	Name of the Legislation to be Amended/Enacted	Objective/Scope	Stage -	EU Legislation Envisaged to Comply with	Institution Responsible for the Preparation of the Legislation
04.0708.1.01	Amendment to the Decree Law No. 91 on Stock Exchanges	Removal of restrictions to capital movements		Directive 88/361/EEC	Capital Markets Board

SECONDARY LEGISLATION ENVISAGED TO BE ENACTED IN YEAR 2009

Reference No.	**Name of the Legislation to be Amended/Enacted**	**Objective/Scope**	**Stage**	**EU Legislation Envisaged to Comply with**	**Institution Responsible for the Preparation of the Legislation**
04.2009.2.02	Amendment of the Implementing Regulation on the Establishment and Working Principles of Stock Exchanges	Removal of restrictions to capital movements.		Directive 88/361/EEC	Capital Markets Board
04.2009.2.03	**04.2009.2.03** Amendment of Implementing Regulation on Istanbul Stock Exchange (ISE) Quotation	Removal of restrictions to capital movements.		Directive 88/361/EEC	Capital Markets Board
04.2009.2.04	Amendment of the Communiqué Series III No. 20 on registering Foreign Capital Market Instruments with the Board and their Sale	Removal of restrictions to capital movements.		Directive 88/361/EEC	Capital Markets Board
04.2009.2.05	Amendment of the Communiqué Series VII No. 14 on Entering Foreign Investment Fund Share to the Board Records and their Sale	Removal of restrictions to capital movements.		Directive 88/361/EEC	Capital Markets Board

(Cont.)

04.2009.2.06	Amendment of the Communiqué Series V No. 46 on the Principles Concerning Intermediation Activities and Intermediary Institutions	Removal of restrictions to capital movements.		Directive 88/361/EEC	Capital Markets Board
04.2009.2.07	Amendment of the Implementing Regulation on the Principles concerning the Establishment and Activities of Pension Mutual Funds	Enables private sector securities to be supplied in a more competitive environment and allows to raise the demand.		Directive 88/361/EEC	Capital Markets Board
04.2009.2.08	Amendment of the Implementing Regulation on Stock Exchanges	Enables private sector securities to be supplied in a more competitive environment and allows to raise the demand.		Directive 88/361/EEC	Capital Markets Board
04.2009.2.09	Amendment of Implementing Regulation Investors' Protection Fund	Enables private sector securities to be supplied in a more competitive environment and allows to raise the demand.		Directive 88/361/EEC	Capital Markets Board

FINANCIAL SERVICES

LEGISLATION CONSIDERED BENEFICIAL TO BE ENACTED (LAW)

LEGISLATION CONSIDERED BENEFICIAL TO BE ENACTED IN PERIOD 2007-2008 (01/10/2007 – 30/09/2008)

Reference No.	Name of the Legislation to be Amended/Enacted	Objective/Scope	Stage -	EU Legislation Envisaged to Comply with	Institution Responsible for the Preparation of the Legislation
09.0708.1.02	Amendment of the Decree Law on Stock Exchanges	Harmonization of quotation rules with the EU legislation		Directive 2001/34/EC	Capital Markets Board
09.0708.1.01	Capital Markets Law **(The prospectus in which the single passport rule, that enables free operation within the community based on the authorization of a EU member state, becomes valid, and provisions established to this end in the harmonization of issues such as collective investment corporations, investment services, etc. could be applied only after membership.)**	Ensuring our legislation on capital markets to become ready for membership by drawing up a fully harmonized law and related communiqués to the EU legislation.	Technical studies are in progress within the institution	- Directive 85/611/EEC - Directive 97/9/EC - Directive 2003/6/EC - Directive 2003/71/EC amending directive 2001/34/EC - Directive 2004/39/EC of the European Parliament and of the Council - Directive 2004/109/EC	Capital Markets Board

(Cont.)

09.0708.1.02	Amendment of the Decree Law on Stock Exchanges	Harmonization of quotation rules with the EU legislation		Directive 2001/34/EC	Capital Markets Board

LEGISLATION CONSIDERED BENEFICIAL TO BE ENACTED IN YEARS 2009 (01/10/2009) – 2013

Reference No.	**Name of the Legislation to be Amended/Enacted**	**Objective/Scope**	**Stage -**	**EU Legislation Envisaged to Comply with**	**Institution Responsible for the Preparation of the Legislation**
09.0913.1.03	Capital Markets Law	Ensuring our legislation on capital markets to become ready for membership by drawing up a fully harmonized law to the EU legislation.		Directive 98/26/EC -Directive 2002/47/EC	Capital Markets Board

SECONDARY LEGISLATION (REGULATIONS, IMPLEMENTING REGULATIONS, COMMUNIQUÉS, CIRCULARS, ETC) **ENVISAGED TO BE ENACTED AND DOCUMENTS SUCH AS STRATEGIES, PLANS AND PROGRAMS ENVISAGED TO BE DRAFTED**

SECONDARY LEGISLATION ENVISAGED TO BE ENACTED IN YEAR 2007

Reference No.	**Name of the Legislation to be Amended/Enacted**	**Objective/Scope**	**Stage -**	**EU Legislation Envisaged to Comply with**	**Institution Responsible for the Preparation of the Legislation**
09.2007.2.10	Communiqué on the Principles concerning the Presentation of Financial Recommendations and the Disclosure of Conflicts of Interes	Harmonization with the EU legislation on the presentation of investment recommendations	Studies shall be enforced according to the calendar of the Twinning Project	Commission Directive 2003/125/EC implementing Directive 2003/6/EC as regards the fair presentation of investment recommendations and the disclosure of conflicts of interest	Capital Markets Board

SECONDARY LEGISLATION ENVISAGED TO BE ENACTED IN YEAR 2008

Reference No.	Name of the Legislation to be Amended/Enacted	Objective/Scope	Stage -	EU Legislation Envisaged to Comply with	Institution Responsible for the Preparation of the Legislation
09.2008.2.10	Amendment of the Communiqué on the Principles of Disclosure of Special Cases to the Public	Harmonization with the EU legislation as regards transparency requirements in public disclosure of publicly held companies.		Council Directive 2004/109/EC on the harmonization of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market	Capital Markets Board
SECONDARY LEGISLATION ENVISAGED TO BE ENACTED IN YEAR 2009					
09.2009.2.01	Amendment of the Implementing Regulation on the Establishment and Working Principles of Stock Exchanges	Preparation of fully harmonized legislation with the EU legislation on the admission of securities to official stock listing. .		Directive 2001/34/EC of the European Parliament and of the Council	Capital Markets Board
09.2009.2.02	Amendment of Implementing Regulation on Quotation of Istanbul Stock Exchange (ISE)				

(Cont.)

09.2009.2.03	Communiqué on the Capital Adequacy of Intermediary Institutions	Enacting legislation fully harmonized with the EU legislation on capital adequacy		Directive 2006/49/EC of the European Parliament and of the Council	Capital Markets Board
09.2009.2.04	Amendment of the Communiqué on the Principles regarding Investment Funds	Aims at making our capital markets ready for membership		Council Directive 85/611/EEC	Capital Markets Board
09.2009.2.05	Amendment of the Communiqué on the Principles and Rules regarding the Financial Statements and Reports of Securities Investment Funds				
09.2009.2.06	Amendment of the Communiqué on the Principles as regards Portfolio Management Activity and the Institutions to Undertake this Activity				
09.2009.2.07	Amendment of the Communiqué Series V, No. 46 on the Principles of Intermediation Activities and Intermediary Institutions	Enacting legislation fully harmonized with the EU legislation. Making the necessary amendments to the legislation in relation to investment services and stock exchanges fully harmonized with the EU legislation, and		Commission Directive 2004/72/EC implementing Directive 2003/6/EC of the European Parliament and of the Council as regards accepted market practices, the definition of inside	Capital Markets Board
09.2009.2.09	Communiqué on the Public Disclosure of Information Drawn up in Companies Registered to the Stock Exchange				

		to portfolio management and investment counseling within the scope of harmonization studies to be carried out.		information in relation to derivatives on commodities, the drawing up of lists of insiders, the notification of managers' transactions and the notification of suspicious transactions Council Directive 2004/39/EC	
09.2009.2.09	Communiqué on the Principles in relation to the Identification of Manipulative Orders and Operations, and Accepted Market Practices	Drawing up legislation fully harmonized with the EU legislation		Commission Directive 2003/124/EC Implementing Directive 2003/6/EC of the European Parliament and of the Council as regards the definition and public disclosure of inside information and the definition of market manipulation	Capital Markets Board
09.20092.2.10	Communiqué on the Public Disclosure of Information Drawn up in Companies Registered to the Stock Exchange				

(Cont.)

09.2009.2.11	Communiqué on Exemptions for Buy-Back Programs and Maintaining the Price Stability of Financial Instruments	Legislation in harmony with the EU legislation.		Commission Regulation No. 2273/2003 implementing Directive 2003/6/EC as regards buy-back programs and stabilization of financial instruments	Capital Markets Board
09.2009.2.12	Amendment of the Communiqué on the Principles as regards the Exemption Conditions and Exclusion from the Board Register of Issuers	Harmonization of prospectus principles in public offerings with the EU legislation.		Directive 2003/71/EC of the European Parliament and of the Commission on the prospectus to be published when securities offered to the public or admitted to trading and amending Directive 2001/34/EC	Capital Markets Board

(Cont.)

09.2009.2.13	Amendment of the Communiqués on Sale and Inclusion of Securities to the Board Register	Harmonization of prospectus principles in public offerings with the EU legislation.		Commission Regulation No. 809/2004 implementing Directive 2003/71/EC as regards information contained in prospectuses as well as the format, incorporation by reference and publication of such prospectuses and dissemination of advertisements	Capital Markets Board
09.2009.2.14	Amendment of the Communiqué on the Principles as regards Portfolio Management Activity and the Institutions to Undertake this Activity				
09.2009.2.15	Amendment of the Communiqué on the Principles as regards Investment Counseling Activity and the Institutions to Undertake this Activity				
09.2009.2.16	Amendment of the Implementing Regulations on Stock Exchanges				

SECONDARY LEGISLATION ENVISAGED TO BE ENACTED IN YEARS 2010 – 2013

Reference No.	**Name of the Legislation to be Amended/Enacted**	**Objective/Scope**	**Stage -**	**EU Legislation Envisaged to Comply with**	**Institution Responsible for the Preparation of the Legislation**
09.1013.2.13	Draft Implementing Regulation on the Protection Fund for Investors	Enacting an legislation fully harmonized with the EU legislation for the protection of investors; amendment of the gradual liquidation regulation		Directive 97/9/EC of the European Parliament and of the Council	Capital Markets Board
09.1013.2.14	Amendment of the Regulation on the Gradual Liquidation of Intermediary Institutions				

COMPANY LAW

LEGISLATION CONSIDERED BENEFICIAL TO BE ENACTED (LAW)

LEGISLATION CONSIDERED BENEFICIAL TO BE ENACTED IN PERIOD 2007-2008 (01/10/2007 – 30/09/2008)

Reference No.	Name of the Legislation to be Amended/Enacted	Objective/Scope	Stage -	EU Legislation Envisaged to Comply With	Institution Responsible for the Preparation of the Legislation
06.0708.1.02	Capital Market Law	Preparation of a law fully in harmony with the EU legislation on Corporate Law.	Technical studies are in progress within the institution	- Directive 77/91/EEC - Directive 78/855/EEC - Directive 82/891/EEC - Directive 2004/25/EEC	Capital Markets Board

SECONDARY LEGISLATION ENVISAGED TO BE ENACTED IN YEAR 2009

Reference No.	Name of the Legislation to be Amended/Enacted	Objective/Scope	Stage -	EU Legislation Envisaged to Comply With	Institution Responsible for the Preparation of the Legislation
06.2009.2.06	Amendment of the Communiqué on the Principles of Registered Capital System	Harmonization of the registered capital system for publicly held companies with the EU legislations	Technical studies are in progress within the board	Directive 77/91/EEC	Capital Markets Board

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06.2009.2.07	Amendment of the Communiqué on the Principles and Rules concerning Financial Statements and Reports in the Capital Market	Harmonization of annual Financial Statements of publicly held companies with the EU legislations	Technical studies are in progress within the board	Directive 78/660/EEC	Capital Markets Board
06.2009.2.08	Amendment of the Communiqué on the Principles regarding Merger Operations	Harmonization of merger operations of publicly held companies with the EU legislations	Technical studies are in progress within the board	Directive 78/855/EEC	Capital Markets Board
06.2009.2.09	Amendment of the Communiqué on the Principles of Registering Shares at the Board and Sale of Shares	Harmonization of demerger operations of publicly held companies with the EU legislations	Technical studies are in progress within the board	Directive 82/891/EEC	Capital Markets Board
06.2009.2.10	Amendment of the Communiqué establishing the procedures and principles of Consolidated Financial Statements and Accounting for Participations in the Capital Market	Harmonization of consolidated financial statements of publicly held companies with the EU legislation	Technical studies are in progress within the board	Directive 83/349/EEC	Capital Markets Board
06.2009.2.11	Amendment of the Communiqué on the Principles of Voting on Commission at the General Assembly of Publicly Held Companies and Takeover	Harmonization of takeovers of publicly held companies with the EU legislation Technical studies are in progress within the board Technical studies are in progress within the board	Technical studies are in progress within the board	Directive 2004/25/EC	Capital Markets Board

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06.2009.2.12	Amendment of the Communiqué on Capital Market Independent Audit Standards	Harmonization of independent audit standards in the capital market with the EU legislation	Technical studies are in progress within the board	Directive 2006/43/EC amending Directives 78/660/EEC and 83/253/EEC, and annulling Directive 84/253/EEC	Capital Markets Board

Source:www.abgs.gov.tr
Program for Allignment with the Acquis

APPENDIX-4

ACQUISITIONS IN THE TURKISH BROKERAGE INDUSTRY

Acquisitions in the Brokerage Industry (2005-2007)						Acquisition
	Previous Name	Current Name	Seller	Buyer	Stake	Date
1	TEB Yatırım Men. Değ. A.Ş. *	TEB Yatırım Men. Değ. A.Ş.	Domestic	Foreign	42.1%	10/02/2005
2	Tezal Men. Değ. A.Ş.	Opus Men. Değ. A.Ş.	Domestic	Domestic	100.0%	15/03/2005
3	HC İstanbul Men. Değ. A.Ş.	EFG İstanbul Men. Değ. A.Ş.	Foreign	Foreign	100.0%	06/05/2005
4	Stok Men. Değ. A.Ş.	Tera Men. Değ. A.Ş.	Domestic	Domestic	98.0%	24/06/2005
5	Bender Men. Değ. A.Ş.	Deutsche Securities Men. Değ. A.Ş.	Foreign	Foreign	100.0%	29/07/2005
6	Ticaret Men. Değ. A.Ş.	Ticaret Yatırım Men. Değ. A.Ş.	Domestic	Foreign	100.0%	02/08/2005
7	Global Men. Değ. A.Ş.	Global Men. Değ. A.Ş.	Foreign	Foreign	20.0%	30/09/2005
8	Dış Yatırım Men. Değ. A.Ş.	Fortis Yatırım Men. Değ. A.Ş.	Domestic	Foreign	89.3%	21/11/2005
9	Garanti Yatırım Men. Kıy. A.Ş.*	Garanti Yatırım Men. Kıy. A.Ş.	Domestic	Foreign	20.0%	22/12/2005
10	C Men. Değ. A.Ş.	Pozitif Men. Değ. A.Ş.	Domestic	Foreign	99.0%	29/12/2005
11	Pamuk Yatırım Men. Değ. A.Ş.	Kapital Men. Değ. A.Ş.	Domestic	Domestic	95.1%	30/05/2006
12	Bumerang Men. Değ. A.Ş.	Galata Men. Değ. A.Ş.	Domestic	Domestic	100.0%	09/06/2006
13	Arı Menkul Kıymetler A.Ş.	UBS Men. Değ. A.Ş.	Domestic	Foreign	100.0%	14/07/2006
14	Finans Yatırım Men. Değ. A.Ş.	Finans Yatırım Men. Değ. A.Ş.	Domestic	Foreign	89.7%	28/07/2006
15	İktisat Men. Değ. A.Ş.	Orion Investment Men. Değ. A.Ş.	Domestic	Foreign	100.0%	03/08/2006
16	Menka Men. Değ. Tic. A.Ş.	Sardis Men. Değ. A.Ş.	Domestic	For.-Dom.	100.0%	01/09/2006
17	Deniz Yatırım Men. Kıy. A.Ş.	Deniz Yatırım Men. Kıy. A.Ş.	Domestic	Foreign	75.0%	28/09/2006
18	Deniztürev Men. Değ. A.Ş.	Deniztürev Men. Değ. A.Ş.	Domestic	Foreign	75.0%	28/09/2006
19	Ekspres Yatırım Men. Değ. A.Ş.	Ekspres Yatırım Men. Değ. A.Ş.	Domestic	Foreign	74.9%	28/09/2006
20	Yapı Kredi Yatırım M. D. A.Ş. *	Yapı Kredi Yatırım Men. Değ. A.Ş.	Domestic	Foreign	43.6%	28/09/2006
21	Angil Men. Değ. A.Ş.	Morgan Stanley Men. Değ. A.Ş.	Domestic	Foreign	100.0%	27/10/2006
22	Tat Men. Değ. A.Ş.	Merrill Lynch Men. Değ. A.Ş.	Domestic	Foreign	100.0%	05/12/2006
23	Ak Yatırım Men. Değ. A.Ş.	Ak Yatırım Men. Değ. A.Ş.	Domestic	Foreign	20.0%	06/12/2006
24	As Men. Kıy. A.Ş.	BGC Partners Men. Değ. A.Ş.	Domestic	Foreign	100.0%	22/12/2006
25	Inter Yatırım Men. Değ. A.Ş.	Unicorn Capital Men. Değ. A.Ş.	Domestic	Foreign	81.8%	28/12/2006
26	Baran Men. Değ. A.Ş.	Credit Suisse İstanbul Men. Değ. A.Ş.	Domestic	Foreign	100.0%	08/02/2007
27	Dundas Ünlü Men. Değ. A.Ş.	Standard Ünlü Men. Değ. A.Ş.	For.-Dom.	Foreign	61.3%	01/03/2007
28	Şeker Yatırım Men. Değ. A.Ş.*	Şeker Yatırım Men. Değ. A.Ş.	Domestic	Foreign	34.0%	15/03/2007
29	Gisad Men. Değ. A.Ş.	Daruma Men. Değ. A.Ş.	Domestic	Domestic	100.0%	01/06/2007
30	Ata Yatırım Men. Kıy. A.Ş.*	Ata Yatırım Men. Kıy. A.Ş.	Domestic	Foreign	7.1%	04/07/2007
31	Opus Men. Değ. A.Ş.	Citi Men. Değ. A.Ş.	Domestic	Foreign	100.0%	11/09/2007
32	MNG Men. Kıy. Yatırım A.Ş.	Lehman Brothers Men. Değ. A.Ş.	Domestic	Foreign	100.0%	17/09/2007
33	Eti Men. Kıy. A.Ş.	Eti Men. Kıy. A.Ş.	SDIF	Domestic	100.0%	19/10/2007
34	Form Men. Değ. A.Ş.	Credit Agricole Cheuvreux M. D. A.Ş.	Domestic	Foreign	100.0%	13/12/2007

Source: TSPAKB

* Acquired stake less than %50.

APPENDIX-5

The Objectives and Major Components of the Project "Assisting the CMB to comply fully with European Union capital markets standards"

Objective	Completion of the alignment of capital markets legislation with the EU *acquis* and its proper implementation
Component 1	Adoption of capital markets legislation in accordance with the EU *acquis*
Market Abuse	Capital Market Law for adopting the EU Market Abuse Directive (2003/6/EC)
Communiques	-Public Disclosure of Regulated Information for Listed Companies -Principles Regarding Manipulative Behaviours/Accepted Market Practices -Exemption for Buy-back Programmes and Stabilisation of Financial Instruments -Production and Dissemination of Financial Recommendations -Principles Concerning Intermediary Activities and Intermediary Institutions
Prospectus	CML for adopting the Prospectus Directive (2003/71/EC)
	Communique regarding information contained in prospectuses as well as the format, incorporation by reference, and publication of such prospectuses and dissemination of advertisements
Investor Compensation	CML for adopting the Investor Compensation Directive (97/9/EC)
Investment Funds	CML +3 Communiqus for adopting the UCITS Directive (85/611/EC), amended by Directives 2001/107/EC+2001/108/EC
Auditing	Amending Communique Serial:X, No:22 Regarding Auditing Principles in Capital Markets for Adopting the Auditing Directive
Clearing and Settlement	CML for Adopting the Settlement Finality Directive and The Financial Collateral Arrangements Directive
Capital Adequacy	Communique Regarding the Capital and Capital Adequacy of Investment Firms
Corporate Law	Proposals for Amending the Turkish Commercial Code and the CML regarding the First, Second, Third and Sixth Council Directives
Drafts for the II.İstanbul Conference (Nov.7, 2007)	Markets in Financial Instruments Directive (MIFID) Transparency Directive Directive on Takeover Bids

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Component 2	Strengthening the administrative capacity of the CMB (Review of operational procedures of CMB and comparison with “best practice”, preparation of operational manuals)
Component 3	Design of a regulatory impact assessment (RIA) system (RIA guidelines approved by the Board and training sessions held)
Component 4	Training of staff

Source: Derived from http://cmb.gov.tr/files/twinning/eng/