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Sherman vs. Goliath?: Tackling the Conglomerate Dominance Problem in Emerging and Small Economies—Hong Kong as a Case Study

*Thomas K. Cheng**

Abstract: This article explores a competition problem that has been long neglected in the two major competition law jurisdictions, the United States and the European Union, conglomerate dominance or aggregate concentration. With their continental scale, the U.S. or the EU economies are unlikely to be dominated by conglomerates. However, conglomerates have been found to be common in small economies and emerging economies. Conglomerates no doubt have their advantages. Yet they also pose some serious economic power issues and distort competition in a variety of ways, the latter of which has been relatively unexplored in the literature. This article catalogs these issues and distortions and proposes two sets of responses to them: direct regulation of conglomerates and competition law enforcement. These two sets of solutions to some extent alleviate the detrimental effects of conglomerates. However, they do not get to the root of the problem, domination of an economy by large conglomerates. Using Hong Kong as an example, this article illustrates the application of these two sets of solutions and their limitations.

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I. INTRODUCTION

Conglomerates are a competition problem that has been long neglected in the United States and the European Union (EU), the two leading competition law jurisdictions in the world. Due to the size of their economies, they are unlikely to be dominated by any corporate group or groups, no matter how large these groups are. Yet there are a considerable number of countries in the world whose economies are dominated by conglomerates. A survey conducted by this author and collaborator Professor Michal Gal with the assistance of United Nations Conference on Trade and Development shows that a high percentage of the respondent countries are afflicted by high aggregate concentration (in fact, half out of the thirty-two of them are).[1] Yet, in no more than twenty percent of them do their competition laws specifically address aggregate concentration.[2]

One wonders why conglomerates emerge and why they are more prevalent in some countries than others. There are a number of explanations for this. One reason is the small size of the economy. Conglomerates are more likely to emerge in small economies because as a successful firm grows, it will eventually hit a limit imposed by the size of the market, which is constrained by the size of the economy. If it wants to continue growing, it must explore a new market (apart from overseas expansion). Over time, this firm will branch into more and more sectors until it eventually becomes a

[1] Michal S. Gal & Thomas K. Cheng, *Aggregate Concentration: A Study of Competition Law Solutions*, 4 J. ANTITRUST ENFORCEMENT 282, 296 (2016).
[2] *Id*.

conglomerate. This is especially likely if there is a dominant sector in the economy that dwarfs other sectors in importance, such as real estate, mining, or oil and gas. Firms that are successful in these sectors will have sufficient ammunition to branch out to other sectors. And the heft they have gained in their large home sector means that they will be very well resourced against rivals in the new sector. Hong Kong and Israel are some examples of small economies dominated by conglomerates.

Emerging economies have also been found to have a high incidence of conglomerates. This may be due to the various advantages of conglomerates that will be discussed below, such as economies of scale and scope, overcoming missing institutions, risk sharing, and internal capital and factor markets, which are particularly relevant in the emerging economy setting. Firms tend to conglomerate to take advantage of these advantages. And when some firms start to do that, other firms may do so too as a preemptive measure. Lastly, conglomerates may emerge as a consequence of a deliberate government policy. The South Korean government was renowned for intentionally grooming conglomerates to drive the country's industrialization effort. While they made important contributions to the country's industrialization, the consensus is that they have outlived their usefulness and the country is still paying the price of that policy in the form of a high degree of aggregate concentration.

Given that aggregate concentration or conglomerate dominance is common in so many countries, one wonders why so few competition laws have specific provisions to tackle it. One reason could be that no country seems to have found an effective solution to the problem. Japan and South Korea have tried some fairly prescriptive rules that directly regulate conglomerate size and their internal operations, but their effectiveness has been questioned. There are other ways to tackle conglomerate dominance. In addition to problems caused by their economic power, conglomerates are also more prone to a range of anticompetitive practices. Jurisdictions in which conglomerates dominate should be particularly vigilant against conglomerates. What this article seeks to explore are what are the advantages and disadvantages of conglomerates, what are the economic power and competition issues they raise, and what are the possible solutions to those issues. It then uses Hong Kong as an example to illustrate how a particular jurisdiction should deal with conglomerates under its competition law. Hong Kong is chosen because it is one of the latest advanced economies to have adopted competition law (in 2012). It is also a place where conglomerates have been a particularly serious problem; it has consistently topped The Economist's Crony Capitalism Index for years, besting even Russia by a wide margin. Even though Hong Kong is chosen for illustration, the analytical framework put forward in this article can be readily applied to other countries.

This article is divided into seven Parts. After the Introduction, Part II outlines the various advantages of conglomerates, followed by a discussion in Part III of their various disadvantages and the economic power issues they raise. Part IV focuses specifically on how conglomerates are prone to distort competition through a myriad of anticompetitive conduct. Part V examines possible responses under competition law to the economic power and competition issues raised in the previous two Parts. Part VI applies competition law tools in the specific context of Hong Kong under the recently enacted Competition Ordinance. Part VII concludes the article.

II. THE ADVANTAGES OF CONGLOMERATES

Before delving more deeply into the issues, it is worthwhile to first define what exactly a conglomerate is. Khanna and Yafeh define a business group as consisting of "legally independent firms, operating in multiple (often unrelated) industries, which are bound together by persistent formal (e.g., equity) and informal (e.g., family) ties."[3] Khanna and Rivkin supplement this definition by observing that members of a business group "are accustomed to taking coordinated actions."[4] Some commentators distinguish between conglomerates and corporate groups, using the former to refer to a firm that operates in multiple sectors by way of internal divisions, and the latter to refer to a group of companies that do business in multiple markets.[5] This article draws no such distinction.

At this juncture, it is important to clarify the concepts of conglomerate dominance and aggregate concentration. The two of them share many similarities. Both are concerned with the extent to which economic activities and productive assets are concentrated in the hands of a small number of economic operators. Various measures of aggregate concentration attempt to quantify the control exercised by a small number of economic operators over the economy. However, there is a difference between aggregate concentration and conglomerate dominance in that the former includes the largest economic operators in its measurements, drawing no distinction between whether these operators are single-industry firms or multi-industry corporate groups, whereas the latter only focuses on conglomerates.[6]

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[3] Tarun Khanna & Yishay Yafeh, *Business Groups in Emerging Markets: Paragons or Parasites?*, 45 J. ECON. LITERATURE 331, 331 (2007) [hereinafter Khanna & Yafeh I].

[4] Randall Morck et al., *Corporate Governance, Economic Entrenchment, and Growth*, 43 J. ECON. LITERATURE 655, 671 (2005) (quoting Tarun Khanna & Jan W. Rivkin, *Estimating the Performance Effects of Business Groups in Emerging Markets*, 22 STRATEGIC MGMT. J. 45, 47 (2001)).

[5] Khanna & Yafeh I, *supra* note 3, at 333.

[6] This is important because some of the competition problems observed in Hong Kong for which

Aggregate concentration usually refers to the economic power issues created by the sheer size of economic operators. This article uses the term conglomerate dominance to refer to the anticompetitive potential of conglomerates in addition to the economic power issues created by them. It will mainly use the term conglomerate dominance for the sake of consistency. However, the term aggregate concentration will also be used when the distinction between the two terms is less important in the context and aggregate concentration is used in the literature being referred to. This is especially the case in the discussion about the measurements and quantification of economic control in the literature, which almost always uses the term aggregate concentration.

Aggregate concentration is measured in a variety of ways. It is almost always measured in the form of the amount of something that is held or accounted for by a certain number of top firms in the economy. The choice of the number of firms is always somewhat arbitrary, and probably depends to some extent on the size of the economy. For instance, Berle and Means chose the top two hundred firms in their measurement of aggregate concentration. That would be appropriate given the size of the U.S. economy.[7] However, for an economy like Hong Kong's or Israel's, the top two hundred corporate groups or large firms would probably account for almost the entire economy. Meanwhile, there are a number of variables that can be used, such as assets, employment, and value added. Berle and Means used assets as the variable, which, as Weiss observes, tends to overstate aggregate concentration, among other problems.[8] Meanwhile, employment would tend to underestimate aggregate concentration, despite some of its advantages as a measure.[9] Available employment data also do not allow for accurate measurement and will lead to estimation errors.[10] Value added would be the most appropriate measure for aggregate concentration if one was concerned about the relative share of economic activity of large companies.[11] Another advantage of value added is that it is comparable across sectors, regardless of the nature of economic activity.[12] The problem

conglomerates are allegedly responsible, such as multimarket forbearance and tying, would be much more likely to take place if the economic operator operates in multiple markets.

[7] *See* Leonard W. Weiss, *The Extent and Effects of Aggregate Concentration*, 26 J. L & ECON. 429, 430 (1983).

[8] *See id.*; Lawrence J. White, *What's Been Happening to Aggregate Concentration in the United States? (And Should We Care?)* 9–10 (NYU WORKING PAPER No. EC-02-03, 2001), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1292649.

[9] *See* Weiss, *supra* note 7, at 430.

[10] White, *supra* note 8, at 10.

[11] *Id.* at 8.

[12] *Id*.

is that value added data are much harder to come by.[13] Therefore, most measures of aggregate concentration one finds tend to be based on assets, market capitalization, or GDP.

Conglomerate dominance is manifested in two main ways. Conglomerates may distort the economy by their sheer size, which may result in restricted access to capital for small- and medium-sized enterprises (SMEs), crowding out of SMEs and entrepreneurs, and outsized political influence. This article broadly refers to them as economic power issues. They may also distort the markets by anticompetitive conduct, like every other firm in the economy. However, by virtue of their multimarket operations and superior financial resources, there are reasons to believe that they are more prone to certain anticompetitive practices.

Conglomerates carry a variety of advantages that allow them to be more efficient in their operations. These advantages include reaping economies of scale and scope, overcoming the missing institutions problem, provision of an internal capital and factor market, risk sharing, sharing of brand goodwill, and facilitating access to the international capital markets. It is important to evaluate the advantages and disadvantages of conglomerates as it would allow us to ascertain their net benefits to the economy. If they create net harm to the economy, regulatory intervention may be called for.

A. Economies of Scale and Scope

Conglomerates often benefit from economies of scale and scope. With their superior financial resources, conglomerates can ensure that their various lines of business operate at an optimal scale and reap economies of scale. Of course, there is nothing about conglomerates that render them uniquely capable of capturing scale economies. A single-industry firm with the requisite resources and market share can similarly benefit from economies of scale. Conglomerates, however, are probably more advantageously positioned to enjoy economies of scope. A conglomerate that produces multiple products that share a common technology, component, or knowhow can benefit from economies of scope by sharing the common element across the various production lines. Moreover, the different lines of business of a conglomerate can share their overhead costs, such as accounting costs and human resource costs. A conglomerate can also achieve bulk discounts in its purchase of various external professional services such as advertising, public relations, legal, auditing, consulting services by pulling together the demand of its various divisions and subsidiaries.

Empirical evidence, however, does not provide overwhelming support

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13 *Id*. at 11.

on the ability of group companies to enjoy economies of scale. Weiss reports that "[t]he large conglomerate acquisition of the 1950s and 1960s still controlled by the acquiring firms in 1975 had profits and growth rates similar to those of the industries in which they operated. There is little evidence that such mergers yielded important economies or market power."[14] Khanna and Palepu also find that there is no difference in the performance of group-affiliated and independent firms in India.[15]

B. Overcoming Missing Institutions

Another advantage of conglomerates is that by providing opportunities for intragroup transactions, they obviate the need for transactions with external parties, which minimizes reliance on the legal and judicial systems and avoids problems with contract enforcement. Khanna and his coauthors have been vocal proponents of this strength of conglomerates. Khanna and Yafeh assert that "[l]imited contract enforcement, weak rule of law, corruption, and an inefficient judicial system should all lead to high transaction costs between unrelated parties. Under such circumstances, intragroup trade, within the context of long-run relationships supported by family and other social ties, may be relatively cheap and efficient."[16] This means that conglomerates should have a particular advantage over independent firms in countries in which legal institutions are especially weak and the rule of law cannot be taken for granted. There is in fact some empirical evidence supporting the notion that corporate groups are more prevalent in environments in which contracting is more difficult.[17] Khanna and Palepu find evidence for the conclusion that "the most diversified business groups add value by replicating the functions of institutions that are missing in this emerging market."[18] Evidence from the Philippines is consistent with this thesis, while evidence from Chile and Indonesia is not.[19] On the whole, the evidence seems to point in different directions.

C. Risk Sharing

Conglomerates have at their disposal superior financial resources,

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[14] Weiss, *supra* note 7, at 448.

[15] Tarun Khanna & Krishna Palepu, *Is Group Affiliation Profitable in Emerging Markets? An Analysis of Diversified Indian Business Groups*, 55 J. FIN. 867, 874 (2000) [hereinafter Khanna & Palepu I].

[16] Khanna & Yafeh I, *supra* note 3, at 341.

[17] *Id*. at 348.

[18] Khanna & Palepu I, *supra* note 15, at 887.

[19] Khanna & Yafeh I, *supra* note 3, at 341.

which make market entry and risk sharing easier. Conglomerates can gather the financial resources of their various subsidiaries or lines of business to enter a particular market, which would allow them to enter markets that may prove too costly for their independent competitors. By virtue of their diversified operations, conglomerates can also spread operational risks across their different lines of business. Difficulty in a particular industry is unlikely to cause an existential threat to a conglomerate given its diversified operations. Again, there is evidence that corporate groups achieve risk sharing in some countries. Khanna and Yafeh find that risk sharing is a characteristic of corporate groups in some countries, such as South Korea, and to a lesser extent, Thailand and Taiwan.[20] However, they do not find a clear relationship between the extent of group diversification and the prevalence of intragroup risk sharing.[21] In contrast, Masulis and his coauthors note that there is a substantial body of evidence showing that risk sharing is an important consideration in the ownership decisions within a corporate group and that family groups benefit from the ability to finance high-risk, capital-intensive firms that could otherwise have difficulty obtaining external funding.[22]

The flip side of risk sharing is the diversification discount. It is a well-documented fact that companies with a diverse range of businesses suffer from a valuation discount as compared to their single-industry peers in the United States.[23] Therefore, while diversifying into a range of businesses helps to spread the risks of operation, it also lowers firm value. Diversification can be both beneficial and costly to shareholders. It can be beneficial to the extent that the firm or the corporate group possesses certain attributes, such as unique managerial talent, technology, or group goodwill, which can be deployed to a range of industries. However, diversification can be inefficient if it is motivated by a desire for empire building. The evidence seems to be mixed as to whether diversification is value-enhancing or reducing. Masulis and his coauthors note that market value for assets and return on assets are both lower for group companies, family owned or

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[20] Tarun Khanna & Yishay Yafeh, *Business Groups and Risk Sharing around the World*, 78 J. BUS. 301, 318 (2005) [hereinafter Khanna & Yafeh II].

[21] *Id*.

[22] Ronald W. Masulis et al., *Family Business Groups around the World: Financing Advantages, Control Motivations, and Organizational Choices*, 24 REV. FIN. STUD. 3556, 3579 (2011).

[23] Philip G. Berger & Eli Ofek, *Diversification's Effect on Firm Value*, 37 J. FIN. ECON. 39, 39 (1994); Raghuram Rajan, Henri Servaes & Luigi Zingales, *The Cost of Diversity: The Diversification Discount and Inefficient Investment*, 55 J. FIN. 35, 35 (2000); David S. Scharfstein & Jeremy C. Stein, *The Dark Side of Internal Capital Markets: Divisional Rent-Seeking and Inefficient Investment*, 55 J. FIN. 2537, 2537 (2000); Karl Lins & Henri Servaes, *International Evidence on the Value of Corporate Diversification*, 54 J. FIN. 2215, 2215 (1999). *But see* John R. Graham, Michael L. Lemmon & Jack G. Wolf, *Does Corporate Diversification Destroy Value?*, 57 J. FIN. 695, 695 (2002).

otherwise, than nongroup companies.[24] Meanwhile, Khanna and Palepu report no group discount for conglomerates.[25] In fact, in emerging economies, not only is there no diversification discount, there even seems to be a premium for corporate diversification.[26] Claessens and his coauthors find a diversification premium for Indonesia, the Philippines, and Thailand and a diversification discount for Hong Kong and Taiwan.[27] This led Khanna and Yafeh to conclude that diversification discount is inversely related to the level of development of markets and institutions.[28] Khanna and Palepu discern a U-shaped relationship between diversification and firm performance. They find that performance of group affiliates declines relative to independent firms as diversification increases, until a certain threshold is passed and then the performance surpasses that of independent firms.[29]

D. Sharing of Group Goodwill

As mentioned in the discussion of economies of scale and scope, conglomerates can share common costs and benefits. One of the things that a conglomerate can share across the group is group reputation and goodwill. By building a strong brand name for the group, a conglomerate can transfer the customer recognition garnered in one line of business to another. This goodwill is particularly helpful when a conglomerate is entering a new industry. As compared to an independent firm, which would be unfamiliar to consumers, a conglomerate company can tap into the goodwill that has been accumulated by other group companies over the years and will be recognized by consumers right away. Group reputation is especially relevant to groups that compete internationally. It has been noted that "a brand name is extremely valuable in export-oriented economies such as Korea's, where companies compete against established multinationals for a worldwide

[24] Masulis et al., *supra* note 22, at 3587–89.

[25] Khanna & Palepu I, *supra* note 15, at 869.

[26] Khanna & Yafeh I, *supra* note 3, at 336.

[27] Stijn Claessens et al., *When Does Corporate Diversification Matter to Productivity and Performance? Evidence from East Asia*, 11 PACIFIC BASIN FIN J. 365, 379–82 (2003). The coefficients for SEGN for Indonesia, the Philippines, and Thailand are positive while those for Hong Kong and Taiwan are negative. Note that the results for these economies are statistically insignificant.

[28] Khanna & Yafeh I, *supra* note 3, at 336.

[29] Khanna & Palepu I, *supra* note 15, at 869, 882. In fact, the existence of a diversification discount and the evidence that family groups provide valuable support to group companies lead Masulis and his coauthors to conclude that "group affiliation is subject to an endogenous selection effect," meaning that "groups use pyramids to fund particular types of firms that otherwise would find it difficult to obtain external financing." Masulis et al., *supra* note 22, at 3595. Therefore, there is an inherent bias in the sample of pyramidal group companies such that a direct comparison between them and independent firms would not be entirely appropriate.

customer base."[30]

Goodwill is not only a factor for consumers, it is also relevant to contractual counterparties. This is especially the case in countries in which the legal institutions are weak and the rule of law is suspect. A contractual counterparty can rely on the general reputation of the group in terms of upholding contracts and on the fact that a group company would be particularly hesitant to jeopardize the group's overall reputation because of its ramifications for the entire group. As Morck and his coauthors note, "[w]hen institutions are weak, doing business with strangers is dangerous and unreliable. This impedes the operation of labor, capital, knowledge, and product markets. However, families with reputations for fairness and good management practices are especially sought after as business partners in such environments."[31] A group company may seem a more reliable contractual counterparty.

There is evidence that corporate groups are economically motivated to cultivate their reputation and protect their goodwill. According to Masulis and his coauthors, "[c]omparisons of group and non-group firms along several transparency related dimensions show that group firms are highly visible to the market, suggesting that they have incentives to protect their reputations, rather than exploiting a lack of transparency."[32] Khanna and Palepu document how India's Tata Group carefully manages its group reputation by defining standards and business values that need to be met for a group company to be allowed to use the Tata name and by sending independent professionals to conduct periodic business audits to ensure compliance.[33] Group goodwill is an important asset that is carefully managed and strategically shared among group members to obtain a competitive advantage.

E. Provision of Internal Capital Market

Conglomerates perform the important function of providing an internal capital market for group companies. The conglomerate headquarters often allocate funds across divisions and subsidiaries and hopefully move internal funds to their most efficient use within the group. This internal source of funding is particularly important in countries where the capital markets are less sophisticated or liquid and where there are serious frictions in these

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[30] Tarun Khanna & Krishna Palepu, *The Right Way to Restructure Conglomerates in Emerging Markets*, HARV. BUS. REV., Jul.–Aug. 1999, at 125, 129 [hereinafter Khanna & Palepu II].

[31] Morck et al., *supra* note 4, at 672.

[32] Masulis et al., *supra* note 22, at 3580.

[33] Khanna & Palepu II, *supra* note 30, at 133.

markets.[34] This could be the case where there are high information costs in the domestic capital markets due to poor accounting disclosures or perceived corporate governance problems, which cause lenders or investors to demand high returns as compensation for the perceived risks undertaken. In fact, Almeida and Wolfenzon remark that weak investor protection keeps firms from raising external finance unless internal funds are available as seed money.[35] As Khanna and Palepu observe, "[w]hen institutional mechanisms such as [financial intermediaries and financial regulators] are underdeveloped or missing, transaction costs rise, and the economy's scope for growth is limited accordingly."[36] Information costs are minimized within a conglomerate due to the common ownership of the borrower and the lender. Common control of the borrower would give the lender access to accurate financial information about the borrower that may otherwise be unavailable to an external lender. Therefore, an internal lender will demand a lower rate of return and an internal borrower can obtain funds at lower costs. The internal capital market is not only valuable to young, risky, fast-growing firms that may face serious liquidity constraints,[37] but it has also been shown to be similarly relevant for mature, slow-growing firms.[38]

Empirical evidence confirms that internal capital markets exist within corporate groups[39] and that corporate groups are more common in emerging markets where legal institutions are weak and the capital markets are still developing.[40] India's Tata Group is an example of how such an internal capital market works effectively.[41] Evidence from both Chile and South Korea lends support to the notion that as financial markets become more mature and sophisticated, the benefits of being part of a diversified corporate group are eroded.[42] In fact, the role of the internal capital market in helping to solve information problems has been confirmed in Japan as well.[43] Hoshi and his coauthors find that in Japan, investments by independent firms are much more sensitive to liquidity.[44] Furthermore, studies have shown that

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[34] Stijn Claessens, Joseph P. H. Fan & Larry H. P. Lang, *The Benefits and Costs of Group Affiliation: Evidence from East Asia*, 7 EMERGING MARKET REV. 1, 2 (2006); Khanna & Palepu II, *supra* note 30, at 126; Morck et al., *supra* note 4, at 671.

[35] Heitor V. Almeida & Daniel Wolfenzon, *A Theory of Pyramidal Ownership and Family Business Groups*, 61 J. FIN. 2637, 2666–67 (2006).

[36] Khanna & Palepu II, *supra* note 30, at 126.

[37] Masulis et al., *supra* note 22, at 3560.

[38] Claessens, Fan & Lang, *supra* note 34, at 17.

[39] Khanna & Yafeh I, *supra* note 3, at 339.

[40] *Id*. at 2.

[41] Morck et al., *supra* note 4, at 689.

[42] Khanna & Palepu II, *supra* note 30, at 133; Khanna & Yafeh I, *supra* note 3, at 338.

[43] Takeo Hoshi et al., *Corporate Structure, Liquidity, and Investment: Evidence from Japanese Industrial Groups*, 106 Q.J. ECON. 33, 34 (1991).

[44] *Id*. at 36.

"external capital availability is negatively correlated with the prevalence of family groups across economies, especially those organized under a pyramidal structure."[45] Therefore, the internal capital markets within corporate groups both help to remedy the illiquidity of the external capital markets and to reduce the information costs of lending.

However, not all is positive about the internal capital market function of conglomerates. First, some studies have cast doubt on whether the provision of funding by a conglomerate will necessarily improve the profitability of member companies. Weiss reports that conglomerates do not seem to be allocating more funds to more profitable businesses and that firm product growth almost depends entirely on industry growth.[46] Second, and more importantly, some commentators have argued that efficient allocation of capital within conglomerates may actually distort the overall allocation of capital across the economy.[47] A controlling shareholder in a conglomerate has incentives to over allocate capital to internal projects and to ignore external projects that may be even more profitable than internal ones. Shin and Park have argued that the internal capital markets within Korean *chaebols* (conglomerates) are in fact inefficient and result in overinvestment in group companies with unprofitable investment opportunities.[48] A related line of criticism is that the pooling of finances among group companies and the provision of debt guarantees by group companies for each other's external debts obfuscates the economics of individual companies and subsidizes unprofitable businesses.[49] In Japan, it has been observed that the internal funding from *keiretsu* [Japanese corporate groups] keeps afloat unprofitable businesses and results in inefficient use of capital.[50] It has been asserted that the overall welfare impact of internal capital markets within corporate groups is ambiguous.[51]

F. Provision of Internal Factor Market

Apart from providing an internal capital market, a conglomerate can also provide an internal market for other factors of production such as labor and managerial talent. This, again, is an advantage that is more applicable to emerging economies. It has been observed that "[i]n economies where

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45 Masulis et al., *supra* note 22, at 3559.

46 Weiss, *supra* note 7, at 447.

47 Morck et al., *supra* note 4, at 675.

48 Hyun-Han Shin & Young S. Park, *Financing Constraints and Internal Capital Markets: Evidence from Korean Chaebols*, 5 J. CORP. FIN. 169, 171 (1999).

49 Khanna & Palepu II, *supra* note 30, at 132.

50 *See* Sadahiko Suzuki & R. Wright, *Financial Structure and Bankruptcy Risks in Japanese Companies*, 16 J. INT'L BUS. STUD. 97 (1985).

51 Khanna & Yafeh I, *supra* note 3, at 339.

external markets for professional managers are thin and underdeveloped, a group's internal market structure can lead to more investment in recruiting, training, and greater incentives for employees to develop 'group specific human capital.'"[52] In countries such as South Korea, India, and Chile, the availability of professional managerial education is limited while the demand for managerial talent far outstrips supply.[53] What some corporate groups, such as Samsung in South Korea, have done is build an internal managerial market and provide extensive training for managers by bringing in world-class faculty.[54] A conglomerate can afford to do that because it achieves economies of scale in the provision of managerial training. Due to its size and diverse operations, the number of managers who need to be trained at any given point in time is bound to be large and its superior financial resources allow it to build a top-notch program. Another advantage of a conglomerate is that the general managerial skills of its employees can be deployed in different lines of business,[55] especially when entering a new market. This helps to smooth market entry by providing a readily available pool of managerial talent. The now-defunct Korean *chaebol*, Daewoo, is a prime illustration of that.[56] Khanna and Palepu find evidence that in Chile and India, the enhanced profitability of group companies is primarily due to advantages in labor and factor markets.[57]

G. Facilitating Access to International Capital Markets

Some commentators have reported that conglomerates have disproportionately good access to the international capital markets. For example, Indian group companies tend to enjoy privileged access to the international capital markets.[58] This is hardly surprising, as international lenders will seek out trustworthy borrowers with sufficient assets as collaterals for the loans. And given the size and prominence of these group companies in the domestic economy, the international lenders will have greater confidence in their creditworthiness. First, these group companies are more likely than smaller domestic stand-alone firms to have a substantial international reputation, being often reported in the international press. Second, given the size of these conglomerates and the number of people they

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52 Morck et al., *supra* note 4, at 672.

53 Khanna & Palepu II, *supra* note 30, at 129.

54 *Id*.

55 Khanna & Yafeh I, *supra* note 3, at 336.

56 Khanna & Palepu II, *supra* note 30, at 129.

57 Tarun Khanna & Krishna Palepu, *Policy Shocks, Market Intermediaries, and Corporate Strategy: The Evolution of Business Groups in Chile and India*, 8 J. ECON. MGMT. STRATEGY 271, 275–76 (1999) (hereinafter Khanna & Palepu III).

58 Khanna & Palepu I, *supra* note 15, at 870, 885.

employ, the international lenders may rightly or wrongly believe that the conglomerates' national governments will not let them fail if they run into financial trouble, because of the possible implications on domestic employment. For example, the Tata Group employs 600,000 people.[59] Samsung reportedly employed 275,000 people as of September 2014.[60] Third, conglomerates that are active in the international markets are more likely to have adopted international accounting and corporate governance standards, which will give their lenders greater confidence. Fourth, given the overall size of these conglomerates, the size of any particular loan will be quite small in comparison. So long as the lenders ask for a guarantee from the assets of other affiliates, their loans will benefit from a larger pool of collateral. Likewise, conglomerates are also likely to have better access to the international equity capital markets. A firm that has a global reputation is much more likely to be successfully listed in overseas stock exchanges than an obscure domestic firm. It will be easier for an internationally known firm to attract retail investors, which could be key to a successful listing.

The question is, how does the domestic economy benefit from the improved access to international capital markets of conglomerates? To the extent that conglomerates' access to international capital markets frees up domestic capital, other firms may benefit by having greater access to funds. It was mentioned earlier that the development of internal capital markets within conglomerates may distort domestic overall capital allocation. If conglomerates are now more willing to release their own capital to the domestic economy (perhaps because they are able to earn a greater return from lending to other domestic firms than the interest they pay in the international capital market), this overall domestic distortion will be alleviated. In a way, these internationally reputable conglomerates serve as conduits of foreign capital to the domestic economy.

III. THE DISADVANTAGES OF CONGLOMERATES—ECONOMIC POWER CONCERNS

Conglomerates also bring with them a host of disadvantages, some of which are more of a corporate governance or general economic nature, some of which are more related to competition. The former ones include high agency costs, crowding out of SMEs and entrepreneurs, distortion of access to financial markets, overall welfare effects, and political economy concerns. Agency costs, and the related problems of pyramidal structure and tunneling,

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59 *See* Tata Group, *Tata Fast Facts*, http://www.tata.com/pdf/Tata_fastfacts_final.pdf.

60 Ron Amadeo, *Samsung has more employees than Google, Apple, and Microsoft combined*, ARS TECHNICA (Sept. 25, 2014), http://arstechnica.com/gadgets/2014/09/samsung-has-more-employees-than-google-apple-and-microsoft-combined/.

are corporate governance-related. The remainder of these disadvantages can be said to fall under the rubric of economic power concerns, meaning they are the inherent consequences of the size and breadth of conglomerates. This Part and Part IV will survey the various disadvantages and competition problems of conglomerates. Part V will attempt to offer some solutions.

A. Corporate Governance Problems—High Agency Costs

The high agency costs of conglomerates arise from the fact that many of them use the pyramidal structure, under which a holding company owns a stake in subsidiaries, which in turn own stakes in subsidiaries, so on and so forth. Assuming that at every level the controlling shareholder owns 50% plus one share, by the third level, the holding company will only have 12.5% of the cash flow rights.[61] However, by virtue of its majority stake at every level, it will retain control rights over every subsidiary. According to Bebchuk and his coauthors, pyramidal structures combine the incentive problems associated with both controlled structure and dispersed ownership in a single ownership structure.[62] It is believed that "the agency costs imposed by controlling shareholders who have a small minority of the cash-flow rights in their companies can be an order of magnitude larger than those imposed by controlling shareholders who hold a majority of the cash-flow rights."[63] What makes matters worse is that in most public companies, a stake much smaller than majority is often enough to confer control because the individual shareholders seldom if ever vote in annual meetings.[64] It has been estimated that a voting stake of ten to twenty percent is sufficient to confer control.[65] For example, the famous Swedish family, the Wallenbergs, has voting control over ABB, an international engineering giant, while retaining

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[61] Pyramidal structures create significant agency costs because of the divergence between control rights and cash-flow rights. The problem is particularly acute when there is a project that generates substantial private benefits to the controlling shareholder, but only mediocre benefits for shareholders as a whole. The controlling shareholder will have the incentive to divert resources to pursue non-profit-maximizing projects that generate significant private benefits, which he alone keeps. Meanwhile, the controlling shareholder will have little incentive to maximize firm value as he only retains a small portion of the value through his small cash-flow rights. This state of affairs harms existing shareholders by denying them profit-maximizing projects and also raising their financing costs. Outside investors will expect opportunistic behavior by the controlling shareholder of a pyramidal structure and demand a higher rate of return for it. *See* Morck et al., *supra* note 4, at 676.

[62] Lucian A. Bebchuk et al., *Stock Pyramids, Cross-Ownership, and Dual Class Equity: The Mechanisms and Agency Costs of Separating Control from Cash-Flow Rights*, *in* NATIONAL BUREAU OF ECONOMIC RESEARCH CONFERENCE REPORT: CONCENTRATED CORPORATE OWNERSHIP 295 (Randall K. Morck ed., 2000).

[63] *Id*. at 296.

[64] Morck et al., *supra* note 4, at 661–64.

[65] *Id*.

only 5% of the cash flow rights.[66] Claessens and his coauthors find that a 20% stake is sufficient to control most Asian companies.[67] Control is further augmented by placing family members in senior executive positions within the group, which is common in Asian companies.[68]

Not every conglomerate, however, uses the pyramidal structure. Pyramidal structures are popular in some countries but not in others. For example, pyramidal groups are widely found in South Korea, Thailand, Indonesia, Malaysia, Turkey, and Mexico,[69] while they are almost completely absent in Austria and Czech Republic.[70] In their global survey of 28,635 firms in 45 countries, Masulia and his coauthors find that about one-third of corporate groups employ the horizontal structure while two-thirds of them adopt the pyramidal structure.[71] Claessens and his coauthors find that only a quarter of non-widely held companies in Hong Kong are controlled through pyramidal structures.[72] However, a casual survey conducted by this author shows that the pyramidal structure is very common among the leading conglomerates in Hong Kong.

The controlling shareholder can also pursue what is known as tunneling, which consists of diverting assets and income to the higher-tiered firms within the pyramidal structure and dumping losses and liabilities to the lower-tiered firms.[73] Despite it being a widely discussed phenomenon in the academic literature, Khanna and Yafeh note that the empirical evidence on the prevalence and severity of tunneling is far from clear.[74] In particular, Cheung and his coauthors find that tunneling does not seem to be a serious problem among conglomerates in Hong Kong.[75] This is consistent with the finding of studies that indicates that the control premium in Hong Kong is very low (in fact it was found to be negative), which suggests that there is adequate protection for minority shareholders, including from tunneling, in Hong Kong.[76]

Finally, the pyramidal structure can also produce what is known as the entrenchment effect, which essentially allows the controlling shareholder to

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[66] *Id*. at 665.
[67] Claessens, Fan & Lang, *supra* note 34, at 5–6.
[68] Morck et al., *supra* note 4, at 665.
[69] Khanna & Yafeh I, *supra* note 3, at 346.
[70] *See* Masulis et al., *supra* note 22, at 3568.
[71] *Id*. at 3569–70.
[72] Claessens, Fan & Lang, *supra* note 34, at 14.
[73] Morck et al., *supra* note 4, at 679.
[74] Khanna & Yafeh I, *supra* note 3, at 346.
[75] Yan-Leung Cheung et al., *Tunnelling, Propping, and Expropriation: Evidence from Connected Party Transactions in Hong Kong*, 82 J. FIN. ECON. 343, 383–84 (2006).
[76] Tatiana Nenova, *The Value of Corporate Voting Rights and Control: A Cross-Country Analysis*, 68 J. FIN. ECON. 325, 334 (2003).

enjoy the private benefits of control robustly, without worrying about the possibility of takeover or reaction from minority shareholders.[77] Morck and his coauthors describe control pyramids as "simple and highly effective antitakeover devices,"[78] obviating the need for other antitakeover mechanisms such as the poison pill or staggered boards. This is a classic problem for a firm with a controlling stake, and there is considerable empirical evidence for it.[79] However, what makes it worse for pyramidal structures is that such structures suffer both from this problem and the separation of ownership and control that afflicts firms with dispersed ownership.

B. Distortion of Access to Financial Markets

As explained earlier, the fact that conglomerates engender an internal capital market can distort allocation of capital economy-wide. According to Almeida and Wolfenzon, this is largely due to financial market imperfections caused by inadequate investor protection and the weak pledgeability of capital by a controlling shareholder to an outside investor in a weak investor protection regime.[80] Intuitively, the distortion arises from the fact that a controlling shareholder cannot credibly commit to a certain return to capital following an investment. Therefore, whatever return the controlling shareholder commits to, it will always be subject to a discount. A conglomerate that may have capital to spare faces two options: one is to deploy the capital internally to a less profitable project, and the other is to lend capital to an outside firm that has a more profitable use of the capital, and can promise a higher return to the conglomerate than what the internal project can generate.[81] However, after the inadequate investor protection discount, the return to the conglomerate may now be lower than the return from its internal project.[82] The conglomerate thus would choose the internal

[77] Morck et al., *supra* note 4, at 677.

[78] *Id*.

[79] *See, e.g.*, W. Bruce Johnson et al., *An Analysis of Stock Price Reaction to Sudden Executive Deaths: Implications for Managerial Labor Market*, 7 J. ACCT & ECON. 151 (1985); Myron B. Slovin & Marie E. Sushka, *Ownership Concentration, Corporate Control Activity, and Firm Value: Evidence from the Death of Inside Blockholders*, 48 J. FIN. 1293 (1993); Paolo F. Volpin, *Governance with Poor Investor Protection: Evidence from Top Executive Turnover in Italy*, 64 J. FIN. ECON. 61 (2002); Igor Filatotchev et al., *Privatization, Insider Control and Managerial Entrenchment in Russia*, 7 ECON. OF TRANSITION 481 (1999); Abe De Jong & Chris Veld, *An Empirical Analysis of Incremental Capital Structure Decisions under Managerial Entrenchment*, 25 J. BANKING & FIN. 1857 (2001); Mine Ugurlu, *Agency Costs and Corporate Control Devices in the Turkish Manufacturing Industry*, 27 J. ECON. STUD. 566 (2000).

[80] Hector Almeida & Daniel Wolfenzon, *Should Business Groups Be Dismantled? The Equilibrium Costs of Efficient Internal Capital Markets*, 79 J. Fin. Econ. 99, 104–05 (2006).

[81] *Id*.

[82] *Id*.

project even though on an economy-wide basis, the external project would be more efficient. Inadequate investor protection hence creates a bias for internal projects, which reduces allocative efficiency even though the internal capital markets within conglomerates may be efficient.[83] This allocative distortion would be particularly serious if there was a dearth of capital available to outside firms. In fact, Almeida and Wolfenzon argue that the more efficient is the internal capital allocation, the greater is the economy-wide allocative distortion.[84]

Knowing this allocation distortion in the external market, firms will have greater incentives to conglomerate in order to reduce their reliance on the external capital market.[85] This in turn gives other firms the incentive to conglomerate preemptively, which creates a positive feedback mechanism for conglomeration.[86] It has been observed that following the reforms of *chaebols* in South Korea, which included the breakup of the Daewoo Group, hitherto one of the largest conglomerates in South Korea, capital availability to independent firms improved.[87] Such reforms are likely to face resistance because the existing conglomerates will use their political influence to lobby against improving investor protection to preserve their financing advantages. Morck and his coauthors observe that "to preserve their privileged positions under the status quo, such elites might invest in political connections to stymie the institutional development of capital markets and to erect a variety of entry barriers. These economywide implications can be serious."[88] They postulate that this phenomenon, which they call economic entrenchment, is a positive feedback loop, "whereby weak institutions place sweeping corporate governance powers in the hands of a tiny elite group, who then lobby for weak institutions to preserve their concentrated control over the countries large corporations."[89]

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83 *Id*.

84 *Id*. at 116–17.

85 *Id*. at 102.

86 *Id*. Preemptive conglomeration ultimately generates multiple equilibrium levels of conglomeration. Almeida and Wolfenzon further observe that "countries with intermediate investor protection might be stuck in an equilibrium with too much conglomeration. The same institutional environment can support two very different equilibria in terms of the degree of conglomeration and the efficiency of capital allocation. However, even if the low conglomeration equilibrium is socially superior, there might be no natural mechanism to allow the economy to move to the more desirable equilibrium." *Id*. at 125–26. In that case, they suggest that direct government intervention, including a possible breakup of the conglomerates, may be necessarily to move the economy to a more allocatively efficient equilibrium. *Id*. at 126.

87 *Id*. at 129–30.

88 Morck et al., *supra* note 4, at 657.

89 *Id*. at 711. Another way in which conglomerates can distort access to capital is when its sheer size relative to the rest of the economy is such that they attain a certain degree of price setting power in the domestic capital market. In fact, Morck and his coauthors postulate that when a conglomerate decides

C. Crowding out of SMEs and Entrepreneurs

The flip side of the advantage of a conglomerate's superior financial resources is that these same resources allow conglomerates to squeeze out SMEs and render entrepreneurship increasingly difficult. It is obviously very difficult for SMEs to compete with a well-funded subsidiary of a conglomerate, which can reap substantial economies of scale and source inputs at substantial bulk discount. In a small economy in particular, if conglomerates are seen to embrace every profitable business opportunity and go after every profitable sector, it will have a deterrent effect on entrepreneurship. This is because budding entrepreneurs may reasonably think that as soon as they enter a promising line of business, the conglomerates will follow suit with superior financial resources. Morck and his coauthors assert that "entrusting the governance of huge slices of a country's corporate sector to a tiny elite can bias . . . obstruct entry by outside entrepreneurs, and retard growth."[90] Weiss postulates that "if a very large firm enters a market made up of small firms, its size will intimidate the other firms in the market, and thus dampen competition."[91]

D. Overall Economic Welfare Effects

A number of commentators have argued that conglomerates could lead to suboptimal economic performance and overall welfare loss. This is largely due to the size of the conglomerates in relation to the overall economy. If a small number of families control conglomerates that account for a substantial part of the economy, their suboptimal behavior may become a macroeconomic problem. Poor corporate governance in a select few firms take on systemic importance when the firms involved span the economy. This was very much the case in South Korea during the Asian Financial Crisis, when it was discovered that corporate governance issues in the *chaebols* led to extensive over-leveraging, which threatened to jeopardize the overall economy.[92] Shleifer and Wolfenzon posit that the agency costs created by the

whether to supply capital to an external user, it may consider the impact of the investment on its capital market power as the investment may allow the external user to accumulate wealth. *Id*. at 688. This may result in further allocative inefficiency in the economy, augmenting the distortionate effect described in the previous paragraphs. However, this is admittedly unlikely to happen unless the economy is relatively small or the conglomerate at issue is truly dominant in size.

90 *Id*. at 657.

91 Weiss, *supra* note 7, at 437. However, Weiss did not find much correlation between absolute firm size and the profitability of conglomerates, leading him to conclude that this problem, which he terms entrenchment, to be insignificant. *Id*. at 442.

92 Jong-Sung You, *Transition from a Limited Access Order to an Open Access Order: The Case of South Korea*, *in* IN THE SHADOW OF VIOLENCE: POLITICS, ECONOMICS, AND THE PROBLEMS OF

misappropriation of wealth by controlling shareholders raise costs of capital to the whole corporate sector and thus impede growth.[93] It also has been argued that the capital market distortion resulting from conglomerate dominance may alter overall investment level, skew the capital expenditure across projects, firms, and groups, and may ultimately compromise economic growth.[94]

There are divergent views on the overall welfare effects of conglomerates in the economy. Studies have been conducted on the relative performance of group firms versus independent firms. Their results are varied. Some studies report that pyramidal groups outperform independent firms in emerging economies.[95] As reported earlier, there seems to be a diversification premium in some emerging economies, which lends strength to the argument that group firms have superior performance. In some other countries, the relative performance of group firms and independent firms has evolved over time. The Korean *chaebols* used to be traded at a premium until around 1994, when the premium became a discount.[96] And these *chaebols* exhibited worse performance than independent firms during the Asian Financial Crisis.[97] However, these firm-specific comparisons do not shed much light on the overall welfare effects of conglomerates as their superior performance may be due to the advantages they obtain, such as from distortion of the capital market, which would undermine overall social welfare. Some studies attempt to measure the overall effects of conglomerates directly. While most commentators seem to agree that the welfare effects of conglomerates are negative, Khanna and Yafeh argue that their impact on social welfare is ambiguous and circumstance-specific.[98]

E. Political Economy Concerns

Apart from problems of purely economic nature, conglomerates also raise political economy issues. These issues arise from the fact that conglomerates will inevitably attempt to influence the government to obtain their desired policy outcomes. As mentioned earlier, conglomerates may

DEVELOPMENT 293, 309–10 (Douglass C. North et al. ed., 2013); *see also* Chee Keong Low, *A Road Map for Corporate Governance in East Asia*, 25 NW. J. INT'L L. & BUS. 165, 166 (2004).

93 Andrei Shleifer & Daniel Wolfenzon, *Investor Protection and Equity Markets*, 66 J. FIN. ECON. 3, 16 (2002).

94 Morck et al., *supra* note 4, at 693.

95 *See, e.g.*, Tarun Khanna & Jan W. Rivkin, *Estimating the Performance Effects of Business Groups in Emerging Markets*, 22 STRATEGIC MGMT J. 45, 57 (2001).

96 Khanna & Yafeh I, *supra* note 3, at 337.

97 Jae-Seung Baek et al., *Corporate Governance and Firm Value: Evidence from the Korean Financial Crisis*, 57 J. FIN. ECON. 265, 270 (2004).

98 Khanna & Yafeh I, *supra* note 3, at 334.

lobby the government to maintain poor investor protection so as to preserve their power and influence. They may lobby for policies that preserve or expand their corporate governance powers and to shield them from challenges by the minority shareholders in order to sustain their control. This is important because what determines their influence is not what they own, but what they control.[99] So long as they maintain the current state of affairs under which they can control a company with 10% to 20% of the voting shares and can control companies further down the pyramid structure with even less cash-flow rights, they will preserve their political clout. Pyramids are said to magnify political influence the same way they magnify corporate control.[100] In addition to lobbying for policies to help protect their corporate control, conglomerates will also demand measures that will shield them from competition, such as trade barriers or favorable licensing policies that help keep potential rivals out of the market.

What makes lobbying by conglomerates particularly worrying is their size, which allows them to reap economies of scale and scope in political lobbying.[101] As Ayal observes, "'the larger the firm, the easier for it to overcome the fixed cost of lobbying, and the higher the returns will be'. Fixed costs are one of the contributing factors to economies of scale, and when returns are proportional to affected size . . . , size does matter."[102] He further observes that "[t]he larger the affected interest, the more prominent are economies of scale. The more interests affected, in multiple industries, the more prominent are economies of scope."[103] Given the size of a conglomerate's business interest, the affected interest is obviously large. Therefore, the economies of scale will be substantial. And given the range of industries a conglomerate operates in, the economies of scope will be significant as well.

Apart from substantial economies of scale and scope, which render them particularly effective lobbyists, conglomerates also benefit from financial advantages. With the substantial financial resources at their disposal, conglomerates can offer hefty upfront payments to government officials, which would be beyond the reach of smaller firms.[104] Moreover, a conglomerate owner, by virtue of its common control, can effectively overcome the collective action problem and marshal the resources of the

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[99] Morck et al., *supra* note 4, at 674.

[100] *Id*. at 657.

[101] Adi Ayal, *The Market for Bigness: Economic and Competition Agencies' Duty to Curtail It*, 1 J. ANTITRUST ENFORCEMENT 221, 225 (2013).

[102] *Id*. at 227.

[103] *Id*. at 226.

[104] Morck et al., *supra* note 4, at 695.

various group companies to finance the lobbying activities.[105] In contrast, a trade association that contains the same number of independent firms as members would face much greater obstacles due to the free-rider problem. The controlling shareholder of a conglomerate can also make use of tunneling to reap the direct benefits of lobbying while offloading the lobbying costs to minority shareholders.[106] Such tunneling can greatly increase the cost-effectiveness of lobbying for conglomerate owners.

In addition, with their deep pocket and political connections, conglomerates tend to outlast independent firms, which allows them to operate as long-term repeat players in the lobbying game. Conglomerates can thus build longer lasting relationships with government officials and render their longer-term promises, such as a promise of postretirement employment, more credible. It has also been argued that family-controlled conglomerates have stronger incentives over time to use lobbying to maintain their economic position. This is because over time, the entrepreneurial abilities and managerial skills of the descendants of the founders of family-owned conglomerates should regress to the population mean.[107] When they can no longer compete with their business acumen, these conglomerates will resort to political means to protect their competitive position.

There is empirical evidence that shows that family-owned conglomerates exercise outsized political influence. Morck and Yeung find a significant correlation between signs of political influence and family control.[108] Countries with a considerable number of family-owned conglomerates have poor compliance with tax law, high degree of corruption, poor judicial efficiency, inefficient bureaucracy, and high regulatory barriers to entry.[109] Jacobs finds that "aggregate concentration of assets . . . has a strong negative influence on effective corporate tax rates."[110] The larger the firms in the economy, the greater their ability to lobby for lower corporate tax rate. His study leads Jacobs to conclude that "aggregate concentration leads to political distortions that may outweigh these technical advantages [of conglomerates]. It is dangerous in any democratic political system for a few to have political influence that clearly outweighs all others."[111] Meanwhile, some studies have cast doubt on the correlation between

[105] *Id*.

[106] *Id*. at 696.

[107] *See generally* Francesco Caselli & Nicola Gennaioli, *Dynastic Management* (NBER WORKING PAPER No. 9442, 2003), http://www.nber.org/papers/w9442.

[108] Randall Morck & Bernard Yeung, *Family Control and the Rent-Seeking Society*, 28 ENTREPRENEURSHIP: THEORY AND PRACTICE 391, 402 (2004).

[109] *Id*.

[110] David Jacobs, *Corporate Economic Power and the State: A longitudinal Assessment of Two Explanations*, 93 AM. J. SOC. 852, 852 (1988).

[111] *Id*. at 877.

aggregate concentration and influence on policies.[112]

IV. CONGLOMERATE DISTORTION OF COMPETITION

Apart from economic power concerns derived from the sheer size and operation of conglomerates, conglomerates are also susceptible to a range of competition-distorting conduct, which, by virtue of their multimarket operations and size, conglomerates are better positioned than other firms to perpetrate. The particular anticompetitive potential of conglomerates has been relatively unexplored in the literature. It is important to examine this potential in order to formulate the appropriate competition law response to conglomerates. These include mutual interdependence, parallel exclusion, interlocking directorate, predatory pricing, tying, exploitative practices, entry deterrence or loss of potential competition, and cross-subsidization. The first three implicate multifirm conduct, while the remainder are unilateral behavior. It is possible to rely on traditional competition law tools to address some of them. For the rest, there are perhaps no ways to tackle them short of banning the corporate group structure or placing direct restrictions on the growth and internal operations of conglomerates. Of course, not every conglomerate will commit these anticompetitive practices. The argument is only that conglomerates are more likely than stand-alone firms to commit them. Some of these competition problems, in fact, are only applicable to conglomerates.

A. Multifirm Conduct

A conglomerate on its own obviously does not give rise to concerns about multifirm conduct. But when there are a number of conglomerates and they operate in multiple markets against each other, their repeated interaction in multiple markets makes multifirm conduct among them a serious issue. This is because conglomerates do not exist in isolation. If the economic conditions or historical development of a country are conducive to the emergence of conglomerates, there is usually more than one of them. If these conglomerate companies are simply engaged in price fixing or other forms of cartel conduct, existing competition law is well equipped to tackle such conduct. However, because of the repeated interaction among conglomerate companies, it may be easier for them to coordinate their conduct short of express collusion. This is where existing competition law falls short. Moreover, repeated interaction of conglomerates within multiple markets

[112] *See, e.g.*, Lester Salaman & John Siegfried, *Economic Power and Political Influence*, 71 AM. POL. SCI. REV. 1026, 1031 (1977).

also means that they are more likely to act in parallel with each other. If the parallel conduct excludes new rivals, what arises is what Hemphill and Wu have called parallel exclusion. This is a genuine competition concern but has thus far not been fully recognized as such.

1. Mutual Interdependence

Conglomerates have been said to promote mutual interdependence and to facilitate multimarket collusion.[113] Bernheim and Whinston argue that "multimarket contact relaxes the incentive constraints governing the implicit agreements between firms, and that this has the potential to improve firms' abilities to sustain collusive outcomes" and that "multimarket contact allows the development of 'spheres of influence,' which enable firms to sustain higher levels of profits and prices."[114] A number of scenarios can lead to such interdependence. The first involves members of conglomerates competing with each other in a number of markets. The idea is that when firms interact and compete in multiple markets, it will be easier for them to police a cartel formed in any particular market. Deviation in one market will invite retaliation in multiple markets, which will magnify the pain that fellow cartel members can inflict upon the cheater.

Bernheim and Whinston, however, have criticized this theory by arguing that the possibility of multimarket punishment does not deter cheating; it will simply cause the cheater to cheat in all markets.[115] They propose a different reason for why multimarket contact can facilitate collusion. They argue that so long as there are different numbers of firms in different markets or the firms attach more weight to future outcomes in some markets than in others, the conglomerates can pool together their incentive constraints across markets and use their surplus enforcement power in one market to discipline a cartel member in a different market.[116] In particular, they argue that multimarket contact may allow firms to transfer their enforcement power from a rapidly growing market to a slowly growing market (the consequence of punishment becomes more important in a rapidly growing market because it happens in the future), from a market in which actions are directly observable and immediately punishable to markets in which there are substantial detection and punishment lags, or from a market

[113] Mutual interdependence only arises in the conglomerate context when the same set conglomerates operate in the same markets, which obviously need not be the case. To the extent that different conglomerates operate in different markets, mutual interdependence will be less of a concern.

[114] B. Douglas Bernheim & Michael D. Whinston, *Multimarket contact and collusive behavior*, 21 RAND J. ECON. 1, 2 (1990).

[115] *Id*. at 3.

[116] *Id*. at 6–8.

with low demand to a market with high demand (it has been argued that collusion is countercyclical, and therefore it is easier to sustain collusion in low demand).[117]

Apart from increasing the leverage of the cartelists over each other, multimarket contact can also facilitate collusion by increasing the level of trust among potential cartel members. When the conglomerates have been coexisting in the economy for a long time and interact with each other in multiple markets, they are more likely to have built up a certain level of trust among themselves over the years. This would make it easier for them to reach a consensus on the terms of collusion and obviate the need for direct communication before those terms can be reached. The level of trust is likely to be even higher if the conglomerates are owned by powerful families, who are likely to have personal relationships with each other. This means that both express collusion and tacit collusion would be easier.

Mutual interdependence need not lead to collusion. It may merely cause the conglomerate members to compete with each other less. Conglomerate members may compete with each other in some markets and may supply each other in other markets.[118] A firm in Conglomerate A (A1) may be less keen to compete rigorously with a firm in Conglomerate B (B1) because another firm in Conglomerate A (A2) supplies to another firm in Conglomerate B (B2), and B2 is an important customer of A2. A1 will take into account the ramifications for A2 when deciding how hard to compete with B1. A variation of this is if instead of A2 relying on B2's business, B2 relies on A2 to supply an important input. B1 may then hesitate to compete rigorously with A1 for fear of jeopardizing B2's supply of input. In fact, it has been argued that, in the extreme case, A1 or B1 may withdraw from the market at issue, or if entry has not taken place, may refrain from market entry for fear of offending an important customer or supplier.[119]

The supply relationship can also be used as a punitive mechanism to police a cartel in another market. A2 can threaten to cut off supply to B2 in order to induce B1 to abide by the cartel agreement. Whether this is likely to materialize will depend on the relative importance of the various markets to the conglomerates. If the sale by A2 to B2 is so large that Conglomerate A cannot afford to lose it, then the threat to cut off supply to discipline B2 would not be credible. However, in that case, the threat to stop the purchase by B2 to discipline A1 would bite. Likewise, the threat to cut off supply would lack credibility if B2 can replace the supply easily, meaning that the input market for B2 is competitive.

[117] *Id*. at 9.
[118] Weiss, *supra* note 7, at 435.
[119] *Id*.

Another variation of the above scenario is where different conglomerates are competitors with each other in various markets, some are strong in some markets but weak in others. In that case, a conglomerate may hesitate to push its advantages in the market in which it is strong for fear that it will be hit hard in the market in which it is weak.[120] The leverage here is not a supply relationship, but a conglomerate's relative weakness in a market. While the conglomerates stop short of outright colluding with each other, their mutual forbearance may deprive the markets of competitive vigor. Bernheim and Whinston go further and argue that "when firms differ in their costs across markets, multimarket contact can facilitate the maintenance of collusive prices through the development of spheres of influence."[121] In such circumstances, the firms will develop spheres of influence and take over the entire market in which they are more efficient while sustaining collusive supracompetitive prices in their markets.[122] They further argue that the creation of spheres of influence facilitates collusion by raising profit on the equilibrium path and reducing the possible gains from defection.[123]

There are probably other variations or permutations of the mutual forbearance scenarios described above. The central idea is that when conglomerates interact in multiple markets, their competitive decisions are no longer made within the context of the immediate market. These decisions take into account other markets in which the conglomerates operate, and the interactions in other markets may be used as leverage to restrain competition in the first market. Obviously, the more diversified are the conglomerates, the more likely that this will happen.[124] It is possible that the number of markets in which conglomerates operate in an economy becomes so large that they come to accept a situation of live-and-let-live and an unspoken truce applies to all the sectors.

Despite the intuitive appeal of the above theories, the empirical evidence thus far has not provided strong support for mutual interdependence. Based on student experiments involving conglomerate markets, Phillips and Mason conclude that conglomeration does not lead to increased cooperation across the board, observing that "what was cooperative becomes more competitive, and what was competitive becomes more cooperative."[125] Country-specific observations yield mixed results. Weinstein and Yafeh find that Japanese *keiretsus* competed vigorously rather

[120] *Id*. at 436.

[121] Bernheim & Whinston, *supra* note 114, at 14.

[122] *Id*. at 12–13.

[123] *Id*. at 13.

[124] Weiss, *supra* note 7, at 436.

[125] Owen R. Phillips & Charles F. Mason, *Mutual Forbearance in Experimental Conglomerate Markets*, 23 RAND J. ECON. 395, 405 (1992).

than colluded with each other in the 1980s.[126] However, Kurgan-van Hentenryk argues that the Belgian business groups facilitated the cartelization of the Belgian coal industry between the two world wars.[127]

2. Parallel Exclusion

Parallel exclusion is a relatively new concept in competition law. It was put forward by Hemphill and Wu in 2013.[128] They define parallel exclusion as "self-entrenching conduct, engaged in by multiple firms, that harms competition by limiting the competitive prospects of an existing or potential rival to the excluding firms."[129] The key distinguishing feature of parallel exclusion is the lack of a horizontal agreement among the perpetrating firms.[130] There may be a degree of interdependence among the firms, as in the case of consciously parallel pricing, or the firms may be acting completely independently, albeit in a parallel fashion.[131] Parallel exclusion is anticompetitive because it can be closely linked to price increases and can slow or block product innovation.[132] They identify six mechanisms of exclusion: (1) simple exclusion, (2) recruiting agents, (3) overbuying an input, (4) tying, (5) resale price maintenance, and (6) most favored nations clauses (MFN).[133]

Hemphill and Wu describe simple exclusion as where "the excluders act on their own, without enlisting assistance from other parties, to raise the costs of market entry. . . . Though the methods vary, their shared features are that the excluder does not need to contract with others to succeed and that the costs of exclusion are relatively low."[134] Recruiting agents refers to when the excluders enlist the help of third parties to help effectuate exclusion along the supply chain.[135] Overbuying an input excludes potential entrants by

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[126] David E. Weinstein & Yishay Yafeh, *Japan's Corporate Groups: Collusive or Competitive? An Empirical Investigation of Keiretsu Behavior*, 43 J. IND. ECON. 359, 359 (1995).

[127] Ginette Kurgan-Van Hentenryk, *Structure and Strategy of Belgian Business Groups (1920-1990)*, *in* BEYOND THE FIRM: BUSINESS GROUPS IN INTERNATIONAL AND HISTORICAL PERSPECTIVE 88 (T. Shiba & M. Shimotani eds., 1997).

[128] *See* C. Scott Hemphill & Tim Wu, *Parallel Exclusion*, 122 YALE L.J. 1182 (2013).

[129] *Id*. at 1189.

[130] *Id*. at 1190.

[131] *Id*. at 1196.

[132] *Id*. at 1210.

[133] *Id*. at 1201–09.

[134] *Id*. at 1201. An example they give is excluding rivals through the standard-setting process.

[135] *Id*. This second method of exclusion could be costly for the excluders because the agents will need to be compensated or threatened by the excluders for lost profit or opportunities forgone by virtue of taking part in the exclusionary scheme. However, such a scheme need not be costly if "there are multiple agents and no single agent bears the full cost of exclusion." *Id*. at 1203.

depriving them of access to a crucial input.[136] When parallel exclusion is undertaken through tying, the market at which the exclusion is aimed is usually the tied product market, and not the tying product market. Parallel resale price maintenance achieves exclusion by providing multiple downstream retailers an attractive profit margin, and hence a strong economic incentive to act in the interests of the upstream manufacturers, including to exclude potential entrants in the upstream market.[137] Finally, MFN clauses achieve exclusion by making it difficult for a new entrant buyer to secure cheaper sources of supply because extending a low price to one buyer would entail discounts to all downstream buyers, which an upstream seller may be reluctant to do.[138]

The existence of conglomerates is conducive to parallel exclusion in a number of ways. The first is the incentives of a prisoner's dilemma created by parallel exclusion. Hemphill and Wu highlight two reasons for deviation in a parallel exclusionary scheme: the impulse to accommodate an entrant and shirking.[139] One member of the exclusionary scheme may be tempted to defect if it is paid off by the entrant. Shirking will be an issue if the exclusionary conduct is costly and the benefit redounds to every other member of the scheme while the costs are borne by one member alone. As Hemphill and Wu note, under these circumstances the dominant strategy in a one-period game would be to defect.[140] But if this game is repeated, it will become a coordination game. For conglomerates, they may be playing this game in multiple markets at the same time. Therefore, not only is the game repeated over time, it is also repeated across markets. They will hence have extra incentives to cooperate with each other.

The second is by deterring powerful outsiders from disrupting the exclusionary scheme. A powerful outsider can undermine the stability of such a scheme by dictating terms that disrupt the existing parallel practice or by playing one oligopolist against another.[141] In an economy dominated by conglomerates, the source of such a powerful outsider would be limited if most of the large players in the economy belong to one of the corporate groups. Members of a conglomerate obviously have no incentives to serve as the powerful outsider to disrupt the parallel practice. Even if such a firm exists, it may be less willing to challenge the existing parallel practice if the firm is somehow dependent on members of some of the conglomerates in the supply of input, distribution, or other aspects of its operation. Or such a firm

[136] *Id*.
[137] *Id*. at 1206–07.
[138] *Id*. at 1209.
[139] *Id*. at 1220–21.
[140] *Id*. at 1221.
[141] *Id*. at 1225.

may simply be deterred by a desire not to mess with the powerful economic interests represented by the conglomerates, regardless of any actual commercial dependence. The minimization of challenge by a powerful outsider means that parallel exclusionary schemes among conglomerate companies are more likely to remain stable.

The third way in which the existence of conglomerates is conducive to parallel exclusion is by making what Hemphill and Wu call recidivist exclusion more likely. According to them, parallel exclusionary schemes often may not be the result of deliberate planning but instead follow from the maintenance of customary practice.[142] To the extent that the exclusionary pattern can be replicated across industries, the habit to follow it in one industry may spread to another industry. To the extent that parallel exclusion creates competitive harm, the prevalence of conglomerates would exacerbate the problem by rendering exclusionary schemes more likely to arise and to remain stable.

3. Interlocking Directorate

This third type of multifirm conduct is not anticompetitive in itself, but it gives rise to the potential for collusion or coordination by way of exchange of competitively sensitive information through the common director. The idea is that if the same person sits on the board of directors of two competitors, he or she may act as a conduit of information, deliberately or inadvertently, between the two firms, which will then use the information to coordinate their market behavior. Given that it would be incredibly onerous to monitor the flow of information through this common director on a daily basis, the more feasible alternative is to ban the same person from sitting on the boards of directors of two competitors altogether.

Interlocking directorate is by no means confined to conglomerates. Stand-alone companies can share common directors as well. Interlocking directorate, however, has greater potential for harm because of the wide range of business of a conglomerate. Especially if the common director sits on a high level of the ownership chain within two conglomerates, it is possible for this common director to have a coordinative effect over a vast number of markets. Competitive harm will be much more widespread than if interlocking directorate happens between two stand-alone firms.

B. Unilateral Conduct

Apart from conduct involving coordination or collusion among

[142] *Id*. at 1227.

conglomerates operating in multiple markets, conglomerates are also prone to distort competition through unilateral conduct. In particular, the financial resources at the disposal of conglomerates mean that conglomerates are better able to withstand the loss that occurs during the predation period of predatory pricing. Conglomerates also stand to gain from the reputational effect of predatory pricing. There is bound to be spillover effect to other markets once the conglomerate establishes its reputation as a fierce competitor. Its competitors in other markets may hesitate to compete too aggressively for fear of triggering retaliation by the conglomerate. Conglomerates stand to gain from tying and other forms of leveraging of market power due to their multimarket operation. There are also reasons to believe that conglomerates will be able to take advantage of its heft and perhaps the reliance of their transactional counterparties in multiple markets to exploit these counterparties. Such exploitative practices are regulated as unfair trade practices in some jurisdictions. Conglomerates may also deter entry by their sheer size and may cross-subsidize their subsidiaries, thereby distorting competition in a specific market. Lastly, conglomerates may also lead to a loss of potential competition.

1. Predatory Pricing

Conglomerates enjoy two advantages in pursuing predatory pricing. First, because conglomerates operate in multiple markets, they stand to benefit by establishing reputations as fierce competitors that will meet competitive entries with cut-throat price-cutting in multiple markets. Therefore, they have greater incentive to pursue predatory pricing. Second, because of their deeper pockets, conglomerates are better able to withstand losses incurred during the predation period and therefore have greater ability to execute a successful predatory pricing scheme. And when competitors appreciate that, they will deem predatory pricing by conglomerates a more likely response to competitor entry and will be more deterred from attempting such an entry. This feeds back to the reputational effect scenario such that conglomerates may not even need to undertake actual predation to build that reputation.[143]

The importance of reputational effect in predatory pricing has been widely noted.[144] Kreps and Wilson demonstrate that reputation effect helps a

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[143] Paul Milgrom & John Roberts, *Predation, Reputation, and Entry Deterrence*, 27 J. ECON. THEORY 280, 304 (1982).

[144] ORG. ECON. COOPERATION DEV., PREDATORY PRICING 7 (1989), http://www.oecd.org/competition/abuse/2375661.pdf; Patrick Bolton, Joseph F. Brodley & Michael H. Riordan, *Predatory Pricing: Strategy Theory and Legal Policy*, 75–80 (TILBURG MICROECONOMICS CENTER DISCUSSION PAPER VOL. 1999-82, 1999), https://pure.uvt.nl/portal/files/533021/82.pdf.

monopolist to deter a future stream of potential entrants once it has manifested its willingness to engage in predation strategy with an early entrant.[145] No less an authority than F.M. Scherer has alluded to the possibility that this reputation effect applies to a conglomerate across multiple markets. He refers to:

> the demonstration effect that sharp price cutting in one market can have on the behavior of actual or would-be rivals in other markets. If rivals come to fear from a multimarket seller's actions in Market A that entry or expansion in Markets B and C will be met by sharp price cuts or other rapacious responses, they may be deterred from taking aggressive actions there. Then the conglomerate's expected benefit from predation in Market A will be supplemented by the discounted present value of the competition-inhibiting effects its example has in Markets B and C.[146]

Milgrom and Robert show that in the presence of information asymmetry, it pays for the monopolist to pursue predation to deter an early entrant to acquire the reputation of being a fierce competitor.[147] Information asymmetry is important because when firms are not completely sure about each other's action, reputation, which may help to predict future behavior, matters.[148] This reputation not only deters entry in the market in which predation is pursued, it will do so in other markets as well. These markets need not be related.[149] Milgrom and Roberts note that "the value of a reputation and the extent of reputation building increase with the frequency of the opportunities for its use."[150] This is particularly relevant to conglomerates because it means that the more diversified a conglomerate is, the more valuable it would be for the conglomerate to build a predatory reputation. This makes intuitive sense because the more markets in which a conglomerate operates, the greater is the payoff to the predation strategy, and the more likely it is that the conglomerate will recoup its loss. Importantly, the reputational effect need not even be that strong to deter entry.[151] Therefore, conglomerates would have an overriding incentive to cultivate a fearsome reputation to deter potential rivals.

Conglomerates are also better able to undertake predation strategies.

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[145] David M. Kreps & Robert Wilson, *Reputation and Imperfect Information*, 27 J. ECON. THEORY 253 (1982).

[146] FREDERIC M. SCHERER, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE 338 (2d ed. 1980).

[147] Milgrom & Roberts, *supra* note 143, at 302.

[148] *Id*.

[149] *Id*. at 285.

[150] *Id*. at 304.

[151] Kreps & Wilson, *supra* note 145, at 262.

Conglomerates have access to greater financial resources than stand-alone firms to withstand the loss that is sustained during the predation period. This corresponds with the deep pocket theory of predation.[152] Moreover, as the benefit of predation is no longer limited to market in which it is practiced, the conglomerate will weigh the benefits across all markets against the loss to determine whether it would be rational to pursue predation.

The deep pocket argument has been criticized for ignoring the possibility that the entrant can turn to the capital markets to finance itself when it withstands the onslaught of predation.[153] Therefore, more sophisticated versions of the deep pocket model focus on the interaction between the entrant and the financial markets. For instance, Poitevin illustrates that because of capital market imperfections and a relative familiarity of the capital market with the incumbent but not the entrant, the entrant will be forced to take on debts to signal its quality to the capital market. Such action renders the entrant susceptible to predation.[154] Furthermore, Bolton, Brodley, and Riordan assert that five conditions need to be met for financial predation to succeed: (1) the target requires external financing, (2) the target's external financing depends on its initial performance, (3) predation will be harmful enough that it threatens the target's continual viability, (4) the predator understands the target's reliance on external financing, and (5) the predator can finance predation internally or has substantially better access to external credit than the target.[155] This extra gloss of financial market imperfection notwithstanding, ultimately what matters is that the predator has greater financial resources to withstand the loss. Conglomerates have greater availability of internal funding and better access to external domestic funding. Conglomerates also have better access to the international capital markets. Overall, the financial advantage of a conglomerate over a stand-alone firm would be substantial.

Three comments are in order. First, all this discussion about the relative strength of a conglomerate predator versus its target only holds true if the target is not a stand-alone firm of a substantial size. If the target was another conglomerate company, the financial advantage would depend on the relative financial strength of the two conglomerates. But the decisive financial advantage would be lost and one can no longer be as confident about the

[152] *See* Paul Milgrom & John Roberts, *New Theories of Predatory Pricing*, *in* INDUSTRIAL STRUCTURE IN NEW INDUSTRIAL ECONOMICS 112, 118–23 (Giacomo Bonanno and Dario Brandolini eds., 1990); Jean-Pierre Benoit, *Financially Constrained Entry in a Game with Incomplete Information*, 15 RAND J. ECON. 490 (1984).

[153] Bolton et al., *supra* note 144, at 53–54.

[154] Michel Poitevin, *Financial Signalling and the "Deep Pocket" Argument*, 20 RAND J. ECON. 26, 26 (1989).

[155] Bolton et al., *supra* note 144, at 60–62.

predator's likelihood of success. Even if the target was a stand-alone firm, it need not be small. The national telephone monopolist may operate in only one industry, but it is likely to dwarf many firms in the economy. Second, the deep pocket theory of predation is premised on imperfections in the capital markets. Given that capital markets in developing countries are often less sophisticated, market imperfections abound, which means predation strategies are more likely to succeed.[156] Finally, if predatory pricing is being used as a parallel exclusion strategy, it will need to be pursued.

2. Tying

Tying and other forms of leveraging of market power require the practicing firm to operate in multiple markets, often of related products, such as complements. Obviously, conglomerates are not the only ones that offer multiple products. A stand-alone firm can also offer complementary or related products. Yet it remains true that the wide scope of a conglomerate's operations means that it is bound to have a wider range of product offering than a stand-alone firm. The wide product range presents greater opportunities for tying or other forms of leveraging of market power.

Although the relationship between conglomerates and tying does not seem to have been deeply explored in the academic literature, the possibility for tying offered by conglomerate operation is well recognized under EU competition law. The *2008 EU Non-Horizontal Merger Guidelines* contain a detailed discussion of how a conglomerate merger will give rise to tying concerns.[157] In the *Guidelines*, the European Commission focuses on ability to foreclose, incentives to foreclose, and competitive impact. This relationship was further explored in detail in a number of cases, such as *Commission v. Tetra Laval*[158] and *General Electric v. Commission*.[159] Although the courts' focuses were on issues more specific to the merger review context, such as the likelihood of the alleged conduct postmerger and

[156] Finally, it should be noted that the above referenced theories of predatory pricing fall under the rubric of the Strategic Theory, which incorporates game theory in the analysis. Many of these Strategic Theory models manage to show competitive harm from predation strategies. However, their conclusion is highly sensitive to their assumptions (though to a lesser extent true for the reputational effect models) and would no longer be valid if the real-world situation deviates from the specifications in the model. For a critique of these game-theoretic models of predatory pricing, see Kenneth G. Elzinga & David E. Mills, *Predatory Pricing and Strategic Theory*, 89 GEO. L.J. 2475 (2001).

[157] *Guidelines on the assessment of non-horizontal mergers under the Council Regulation on the control of concentrations between undertakings*, 2008 O.J. (C 265) 6, paras. 93–118, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2008:265:0006:0025:en:PDF.

[158] Case C-12/03 P, Comm'n v. Tetra Laval, 2005 E.C.R. I-987.

[159] Case T-210/01, Gen. Elec. v. Comm'n, 2005 E.C.R. II-5575.

whether the fact that the alleged conduct can be prosecuted after the fact obviates the need for intervention at the merger review stage, the thrust of the cases was a recognition that expansion of a conglomerate's product scope will create more opportunities for tying.

In fact, some older U.S. cases have recognized another form of leveraging of market power, reciprocity, as a possible theory of harm in conglomerate mergers.[160] Reciprocity refers to a situation where Firm A is a buyer of Firm B which in turns sells to another division of Firm A. Reciprocity could be anticompetitive if the Firm A withholds purchases from Firm B unless Firm B also purchases from Firm A. Although it is not entirely clear whether reciprocity remains a viable theory of harm in conglomerate merger cases (in fact, it is not clear whether conglomerate mergers still attract any antitrust scrutiny in the U.S.), these old cases remain relevant in their recognition of the possibility of leveraging of market power in the conglomerate context.

3. *Exploitative Practices by Conglomerate Companies*

Conglomerate companies sometimes make use of their market power or bargaining power to exploit contractual counterparties.[161] If a contractual counterparty relies on businesses with a number of conglomerate companies, these companies can pool together their bargaining power to extract better bargaining terms from the counterparty. In fact, these companies may push the bargain so hard that the contractual terms become exploitative. Such exploitation of contractual counterparties could be a regulatory concern. U.S. antitrust law does not regulate exploitative practices. EU competition law does, but mostly only in the realm of excessive pricing.[162] Beyond that EU law has largely adopted a hands-off approach. The competition law or related laws of a number of jurisdictions, such as France, Germany, Italy, Japan, and Korea, however, do regulate such exploitative practices. In Germany and France, the area of law is known as abuse of economic dependence or dependency.[163] In Japan and Korea, it is called abuse of superior bargaining

[160] *E.g.*, Fed. Trade Comm'n v. Consol. Foods Corp., 380 U.S. 592 (1965).

[161] It has been recognized that bargaining power can ultimately come from market power. *See* Rochelle Cooper Dreyfuss & Lawrence S. Pope, *Dethroning Lear? Incentives to Innovate After MedImmune*, 24 BERKELEY TECH L.J. 971, 987 (2009).

[162] RICHARD WHISH & DAVID BAILEY, COMPETITION LAW 759–69 (8th ed. 2015).

[163] *See* Mor Bakhoum, Abuse without Dominance in Competition: Abuse of Economic Dependence and its Interface with Abuse of Dominance 8–9 (2015) (unpublished manuscript) (on file with the Academic Society for Competition Law), http://ascola-tokyo-conference-2015.meiji.jp/pdf/ConferencePapers/General%20Session%202/Bakhoum_abuse%20of%20economic%20dependence%20ASCOLA%202015%2013%205%202015.pdf; Florian Wagner-von Papp, *Comparative Antitrust Federalism and the Error-Cost Framework: Rhetoric and Reality: You Protect Competitors, We Protect*

position.[164] What follows is a brief exposition of the kind of exploitative practices that have been addressed in South Korea, which has one of the most severe problems with conglomerates, also known as *chaebols*.

Article 23 of the South Korean Monopoly Regulation and Fair Trade Act (MRFTA) prohibits "trading by unjustly using a superior bargaining position."[165] The law enumerates five instances of abuse of superior bargaining position, namely forced purchase, forced provision of benefit, imposition of sales target, imposition of disadvantage, and interference with business management and operations. Imposition of disadvantage is defined as an "[a]ct of causing a disadvantage in the process of carrying out the trade, setting or changing the trading condition to the disadvantage of the counterpart using methods other than . . . forced purchase, forced provision of benefit, and imposed sales target."[166]

In the *Seoul City Gas* case, the defendant forced the counterparty customer service centers to purchase specific gifts for their employees, and was found by the Korea Fair Trade Commission (KFTC) to have committed a forced purchase.[167] In the *LG Electronics* case, the defendant required its agent stores, which referred customers to the defendant, to be jointly liable for nonpayment by the customers. The KFTC ruled that the conduct was an unjust imposition of disadvantage because it unfairly passed on customer default risk to the agent stores against the will of the stores, and because the conduct deviated from the common practices in the industry.[168] The LG Group is one of the major conglomerates in South Korea.[169] In the *Hyundai Department Store* case, Hyundai compelled its suppliers to share the login information on an information portal that would allow Hyundai to check the sales records of its competitors in real-time. The KFTC ruled that the conduct

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Competition—Except When We Protect Competitors, *in* WILLIAM E. KOVACIC: AN ANTITRUST TRIBUTE LIBER AMICORUM—VOLUME II 23, 55 (Nicolas Charbit & Elisa Ramundo eds., 2014).

164 Thomas K. Cheng & Michal S. Gal, *Superior Bargaining Power: Dealing with Aggregate Concentration Concerns*, *in* ABUSE OF DOMINANCE IN COMPETITION LAW (Paul Nihoul & Iwakazu Takahashi eds., forthcoming) (on file with author).

165 Monopoly Regulation and Fair Trade Act, Act No. 3320,1980, art. 23(1)4, (S. Kor.), *translated in* Korea Fair Trade Commission online database, http://eng.ftc.go.kr/bbs.do?command=getList&type_cd=62&pageId=0401.

166 Enforcement Decree of The Monopoly Regulation and Fair Trade Act, Table 1–2, *translated in* Korea Fair Trade Commission online database, http://eng.ftc.go.kr/bbs.do?command=getList&type_cd=62&pageId=0401.

167 Seouldo sigaseu(ju)ui geolaesangjiwinam-yonghaeng-wie daehan geon [Abuse of Superior Bargaining Position by Seoul City Gas Co. Ltd.], Korea Fair Trade Commission, Case 2013-1622, Resolution 2014-105, at paras. 51–62 (May 8, 2014) (S. Kor.) (translation on file with author).

168 Eljijeonja(ju) geolaesangjiwinam-yonghaeng-wie daehan geon [Abuse of Superior Bargaining Position by LG Electronics Co. Ltd.], Korea Fair Trade Commission, Case 2011-2555, Resolution 2014-069, at § 2.C.2).B) (Apr. 3, 2014) (S. Kor.) (translation on file with author).

169 *See* LG Corp, http://www.lgcorp.com/about/affiliatesList.dev (last visited Sept. 17, 2016).

was an unfair interference with business operations because it would force the suppliers to divulge accurate sales information of competing department stores to Hyundai and would force suppliers to take part in costly and ineffective sales promotion events to the detriment of the suppliers.[170] Hyundai is another leading conglomerate in the country.

Not only have the *chaebols* been regularly found to have abused their superior bargaining position, the KFTC has also expressly linked the notion of superior bargaining position to conglomerate membership. In the *Lotte.com* case, the KFTC buttressed its conclusion of a superior bargaining position on the grounds that the defendant was part of a conglomerate. In finding that Lotte.com had a superior bargaining position, the KFTC emphasized that it was one of the seventy-seven companies affiliated with the Lotte Conglomerate.[171] The KFTC observed that "the suppliers' business activities, such as the expansion of their businesses and promotion of their products, would be inevitably subject to the influence of their trades with the defendant, who has connections with the powerful conglomerate."[172]

4. Entry Deterrence or Loss of Potential Competition

Conglomerates may deter entry into markets and cause loss of potential competition. A number of mechanisms through which conglomerates may do so have been delineated above, such as through parallel exclusion or building a predatory reputation. It has been noted that conglomerates may deter entry without any overt action, simply by virtue of its vastness. Ayal notes that "in order to challenge a business group with economic power, a competitor must not only enter the relevant product markets, but also create a network of contacts and input providers, well beyond the obvious production facilities and marketing venues."[173]

It is, however, important not to overstate this problem. Regardless of who one's competitors are, entering a new market always entails building new business connections, supplier networks, and distribution networks. It is unlikely that the obstacles become greater simply because one's competitors are conglomerate companies. Conglomerate companies do not always achieve greater entry deterrent effect. In fact, Cestone and Fumagalli show

[170] Jusighoesa hyeondaebaeghwajeom-ui geolaesangjiwinam-yonghaeng-wie daehan geon [Abuse of Superior Bargaining Position by Hyundai Department Store, Inc.], Korea Fair Trade Commission, Case 2008-1962, Resolution 2008-317, at § 2.C.(3)–(4) (Dec. 4, 2008) (S. Kor.) (translation on file with author).

[171] (ju)losdedaskeom-ui geolaesangjiwinam-yonghaeng-wie daehan geon [Abuse of Superior Bargaining Position by Lotte.com Co. Ltd.], Korea Fair Trade Commission, Case 2012-0591, Resolution 2014-037, at § 2.C.2).A) (Jan. 22, 2014) (S. Kor.) (translation on file with author).

[172] *Id.*

[173] Ayal, *supra* note 101, at 230.

that internal markets do not always help conglomerate companies to deter entry; under certain conditions, they may actually be *softer* than stand-alone firms.[174] However, it is possible that it is harder to build essential business connections when facing conglomerate competitors. This could be true if the economy is so controlled by conglomerates that most of the supplier network and distribution network are in the hands of conglomerates. There may be an understanding among them to restrict access to these resources only to fellow conglomerates. Or even if suppliers and distributors are independent, they can be so reliant on business from conglomerates that they are susceptible to conglomerate pressure to limit themselves to dealing with other conglomerates.

That conglomerates, or to put it more precisely conglomerate mergers, can result in loss of potential competition is undisputed. Loss of potential competition as a theory of harm in conglomerate mergers is widely accepted. Although conglomerate mergers have not been the enforcement focus of the Agencies for quite some time, there remain a slew of U.S. Supreme Court cases from decades ago that apply various potential competition theories to conglomerate mergers.[175] The *1984 Non-Horizontal Merger Guidelines* issued by the Department of Justice articulates the rationale for regulating conglomerate mergers on potential competition grounds as follows:

> In some circumstances, the non-horizontal merger of a firm already in a market (the "acquired firm") with a potential entrant to that market (the "acquiring firm") may adversely affect competition in the market. . . . By eliminating a significant present competitive threat that constrains the behavior of the firms already in the market, the merger could result in an immediate deterioration in market performance. . . . [Furthermore,] [b]y eliminating the possibility of entry by the acquiring firm in a more procompetitive manner, the merger could result in a lost opportunity for improvement in market performance resulting from the addition of a significant competitor.[176]

If loss of potential competition is a concern for conglomerate mergers, it can be tackled relatively easily through merger review. It does not require direct intervention on the structure or market behavior of conglomerates and merely requires us to restrict their growth by acquisition under some circumstances.

[174] Giacinta Cestone & Chiara Fumagalli, *The Strategic Impact of Resource Flexibility in Business Groups*, 36 RAND J. ECON. 193, 207 (2005).

[175] *See, e.g.*, United States v. Falstaff Brewing Corp., 410 U.S. 526 (1973); United States v. Marine Bancorporation, 418 U.S. 602 (1974).

[176] Dep't of Justice 1984 Merger Guidelines, § 4.1, 4 Trade Reg. Rep. (CCH) ¶ 13,103 [hereinafter 1984 Merger Guidelines].

5. *Cross-Subsidization*

Cross-subsidization refers to the subsidization of one line of business or subsidiary by another line of business or subsidiary within a conglomerate. Although it could be viewed in some sense as a strength in that conglomerate companies are well supported financially, cross-subsidization could lead to resource misallocation because one line of business within a conglomerate is no longer responsible for its own profit and loss. The cross-transfer of funds from one line of business to another allows an otherwise inefficient or loss-making business to survive, resulting in inefficient use of resources. It also results in distortion of competition because competitors within a market no longer compete with the resources and profit they generate within that market. Competition is distorted when a competitor that would have run out of cash and been forced out of the market under normal circumstances is artificially propped up by external funding. The market is saddled with an inefficient producer supplying substandard output, which the market would be better off without. Short of preventing the exit of an inefficient firm, cross-subsidization also gives conglomerate companies better ability to withstand a short-term competitive threat in a market.[177] However, cross-subsidization has also been said to be procompetitive by allowing a conglomerate company to be a more effective entrant into a new market.[178]

Cross-subsidization has often been studied from a corporate finance perspective. The question posed is usually whether conglomerates lose value by engaging in cross-subsidization.[179] Some commentators have found that conglomerates do lose value by engaging in inefficient cross-subsidization.[180] From a competition perspective, cross-subsidization most often arises as an issue in the regulated industries. For example, it has been featured in a few European cases in which the postal service allegedly subsidized its parcel delivery service, which is in competition with private providers, with other sources of revenue or direct subsidies.[181] In addition, cross-subsidization has been examined in the telecom sector[182] and electricity

[177] ERIC A. SCHUTZ, MARKETS AND POWER: THE 21ST CENTURY COMMAND ECONOMY 79 (2001).

[178] *Id*.

[179] *See* Berger & Ofek, *supra* note 23, at 58; Margaret Meyer, Paul Milgrom & John Roberts, *Organizational Prospects, Influence Costs, and Ownership Changes*, 1 J. ECON. MGMT. STRATEGY 9 (1992); Iman van Lelyveld & Klaas Knot, *Do financial conglomerates create or destroy value" Evidence from the EU* (DNB WORKING PAPER No. 174/2008, 2008), http://www.dnb.nl/binaries/Working%20paper%20174_tcm46-175062.pdf.

[180] Berger & Ofek, *supra* note 23 at 58; van Lelyveld & Knot, *supra* note 179, at 14.

[181] Case C-39/94, SFEI v. La Poste, 1996 E.C.R. I-3547; Case C-399/08, P Comm'n v. Deutsche Post AG, 2010 E.C.R. I-7862.

[182] Steve G. Parsons, *Cross-Subsidization in Telecommunications*, 13 J. REG. ECON. 157 (1998); Kenneth C. Baseman, *Open Entry and Cross-Subsidization in Regulated Markets*, *in* STUDIES IN PUBLIC

sector.[183] Within competition law, the discussion of cross-subsidization often arises in the context of predatory pricing.[184] It has been explored in the context of below-cost pricing practiced by multiproduct firms in competitive markets.[185] However, these multiproduct firms are not meant to refer to conglomerates, but stand-alone firms, such as supermarkets, that sell multiple products. Simple cross-subsidization of a line of business (within a conglomerate or not) absent predatory pricing outside of the regulated industry context has not been treated as a stand-alone violation of competition. Yet commentators have noted the distortionary effect of cross-subsidization in this context. Walter and Brock observe that cross-subsidization means that "the large conglomerate's market 'success' may be due primarily to its 'deep pocket' rather than superior efficiency or innovativeness."[186] South Korea is one of few jurisdictions that place restrictions on intragroup transactions in its competition law, which will be discussed in greater detail below.

V. POSSIBLE RESPONSES TO CONGLOMERATE DOMINANCE

A number of responses are possible to the problems described above. Some of these problems are inherent in the size and internal operations of conglomerates. It would be very difficult to alleviate these concerns through regulations of their market behavior. There will need to be direct restrictions on their growth and internal operations. Japan and Korea have been at the forefront of such direct regulation of conglomerates. The discussion below will borrow heavily from their experiences. In deciding whether to adopt such restrictions, there needs to be a careful holistic assessment of the net benefits of conglomerates to the local economy.[187] The effectiveness of these measures also needs to be considered. The consensus in Korea, which is the

REGULATION 329 (Gary Fromm, ed., 1981).

[183] SALLY HUNT, MAKING COMPETITION WORK IN ELECTRICITY 60 (2002).

[184] Cyril Ritter, *Does the Law of Predatory Pricing and Cross-Subsidization Need a Radical Rethink*?, 27 World Competition 613 (2004); John Temple Lang & Robert O'Donoghue, *Defining Legitimate Competition: How to Clarify Pricing Abuses Under Article 82 EC*, 26 Fordham Int'l L.J. 83 (2002); Thomas W. Gilligan & Michael L. Smirlock, *Predation and Cross-Subsidization in the Value Maximizing Multiproduct Firm*, 50 SOUTHERN ECON. J. 37 (1983).

[185] Zhijun Chen & Patrick Rey, *Competitive Cross-Subsidization* (Toulouse School of Econ., Working Paper No. IDEI-808, 2013), http://idei.fr/sites/default/files/medias/doc/wp/2013/wp_idei_808.pdf.

[186] WALTER ADAMS & JAMES W. BROCK, THE BIGNESS COMPLEX: INDUSTRY, LABOR, AND GOVERNMENT IN THE AMERICAN ECONOMY 176 (2d ed. 2004).

[187] In fact, one may argue that not all of the advantages of conglomerates should count toward the determination of their net social benefits. Many of these advantages, such as sharing of goodwill and economies of scale and scope, accrue to the firm, and do not necessarily benefit society in general. One may argue that these advantages should not be given credit unless there is evidence that they are passed onto consumers or otherwise shared with society at large.

jurisdiction that has most actively applied direct regulation of conglomerates in recent years, is that these measures have not been successful in reining in conglomerates in the country.[188] Although this does not mean that these measures may not work in other jurisdictions. Finally, even if it is decided that these restrictions should be adopted, one should make sure that there is sufficient political will to adopt and enforce them.

Some other problems delineated above concern the market behavior of conglomerates. Most of them fall within the usual ambit of conventional competition law. The only anomaly is abuse of superior bargaining position, which is regulated as unfair trade practices.

A. Direct Regulation of Conglomerates and Their Internal Operations

1. Direct Restrictions on the Growth of Conglomerates

Japan is rather unique in that it imposes direct restrictions on the size of conglomerates under its competition law. There are specific provisions that target what is known as excessive concentration of economic power. Article 9(1) of the Anti-Monopoly Act (AMA) states that "[n]o company may be established that would cause an excessive concentration of economic power due to share holding (including equity interest; the same applies hereinafter) in other companies in Japan . . . ."[189] Article 9(3) proceeds to define an excessive concentration of economic power as follows:

> the overall business scale of a company, its subsidiary companies, and other domestic companies whose business activities it controls through shareholding, is extremely large across a considerable number of business fields; that a company, its subsidiary companies, and other domestic companies it controls have a great amount of power to influence other enterprises through transactions with their funds; or that a company, its subsidiary companies, and other domestic companies it controls occupy influential positions in a considerable number of interrelated fields of business; and that any of these factors have a large effect on the national economy and impede fair and free competition from moving forward.[190]

The Japan Fair Trade Commission (JFTC) has issued the *Guidelines*

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[188] Jeong-Pyo Choi & Dennis Patterson, *Conglomerate Regulation and Aggregate Concentration in Korea: An Empirical Analysis*, 12 J. OF ASIA PACIFIC ECON. 250, 259–68 (2007) (arguing that the various measures adopted in the MRFTA have had minimal impact on aggregate concentration in South Korea).

[189] Antimonopoly Act, Act No. 54 of 1947, art. 9(1), http://www.jftc.go.jp/en/legislation_gls/amended_ama09 (Japan).

[190] *Id*. art. 9(3).

Concerning Companies which Constitute an Excessive Concentration of Economic Power to provide a more precise definition of excessive concentration of economic power. According to these *Guidelines*, excessive concentration of economic power refers to three scenarios: (1) a corporate group which has "business activities whose overall scale is exceptionally large and covers a substantial number of principle [sic] fields of business"[191]; (2) a corporate group which wields "a high degree of influence over other companies derived from trades involving funds"[192]; and (3) a corporate group which "occupies a substantial position in each of a substantial number of principle [sic] fields that are interrelated."[193] These three scenarios would only constitute excessive concentration of economic power if the corporate group exerts "big influence over the national economy"[194] and "obstructs enhancement of fair and free competition."[195]

The *Guidelines* further interpret these three scenarios as respectively referring to "[a] company group . . . of large scale and has large-scale enterprises in each of a substantial number of principal fields of business [headings omitted]"[196]; "[a] company which owns both a large-scale financial company and a large-scale company except a company engaged either in financial business or in a line of business closely related thereto [headings omitted]"[197]; and "[a] company which owns substantial number of companies each of which possesses a substantial position over a principal field of business, [and] the said fields of business being interrelated but different for each company [headings omitted]."[198] A company group is of large scale if it has total assets of over 15 trillion yen.[199] A large-scale financial company is one with total assets over 15 trillion yen. A large-scale enterprise or company is one with total assets of over 300 billion yen.[200] A company possesses a substantial position if it accounts for no less than 10% of the total sales in the field of business.[201] A substantial number refers to five or more.[202] A principal field of business is "a type of industry which is

[191] Guidelines Concerning Companies Which Constitute an Excessive Concentration of Economic Power, 2002, art. 2(1), http://www.jftc.go.jp/en/legislation_gls/imonopoly_guidelines.files/Company_Concentration.pdf (Japan).
[192] *Id*.
[193] *Id*.
[194] *Id*.
[195] *Id*.
[196] *Id*. art. 2(2).
[197] *Id*. art. 2(3).
[198] *Id*. art. 2(4).
[199] *Id*. art. 2(2).
[200] *Id*.
[201] *Id*. art. 2(4).
[202] *Id*. art. 2(2).

included in the three-digit classifications of Japan Standard Industrial Classification and in which shipment volume exceeds six hundred billion JPY."[203] Lastly, the degree of interrelatedness "shall be examined with reference to the degree of actual trade dependency among different fields of business and the circumstances of user choice."[204] In particular, fields of business are interrelated if they share trade relationships or complement or substitute relationships.[205] By way of example, the JFTC explains that electric power and oil refining are interrelated fields of business, as are banking, securities, life insurance, and the credit card industry.[206]

The *Guidelines* seem to adopt a prescriptive, mechanical approach to the prohibition. If a corporate group falls within any of the three enumerated scenarios, it violates Article 9 of the AMA. The *Guidelines* do not mandate a separate consideration of whether the group wields big influence over the national economy and whether the group obstructs the enhancement of fair and free competition. Under these *Guidelines*, the JFTC has little discretion over the designation of excessive concentration of economic power.[207] It is not clear how strictly enforced these highly prescriptive rules on excessive concentration of economic power are today.

2. *Direct Restrictions on Intragroup Transactions*

Most competition laws do not directly regulate cross-subsidization within conglomerates as such. The MRFTA in South Korea, however, does impose limitations on the ability of conglomerate companies to give assistance to each other, such as in the form of debt guarantees. This was believed to be a serious issue as it allowed *chaebol* companies to be excessively leveraged. The first version of the restriction came about in the 1992 amendment, which restricted affiliate debt "guarantees to 200% of the [guaranteeing] subsidiaries' net assets . . . ."[208] In the 1996 amendment, the cap was lowered to 100% of the guaranteeing subsidiary's net assets.[209]

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[203] *Id*. art. 2(4).

[204] *Id*.

[205] *Id*.

[206] *Id*. List 2.

[207] Toshiaki Takigawa, *Competition law and policy of Japan*, 54 ANTITRUST BULLETIN 435, 497 (2009). The provisions regulating economic concentration were introduced in the original AMA to prevent the reemergence of zaibatsu after Japan's defeat in the Second World War. *Id*. at 496. However, the issue of economic concentration has gradually lost its urgency during the post-War years and the Japanese parliament, known as the Diet, and the Japan Fair Trade Commission gradually loosened the scope of regulation of economic concentration. For example, the prohibition of pure holding companies, which had formed the bedrock of regulation of economic concentration was lifted in the 1997 AMA amendment. *Id*.

[208] Kyu Uck Lee, *Economic Development and Competition Policy in Korea*, 1 WASH. U. GLOBAL STUD. L. REV. 67, 70 (2002).

[209] *Id*.

Finally, in the 1998 amendment, which remains effective to this day in the form of Article 10-2, all kinds of intragroup debt guarantees by affiliated companies are prohibited altogether.[210] It was said that prior to the introduction of this restriction, "*chaebols* had easy access to banks because the *chaebol* subsidiaries would have other affiliates guarantee the *chaebols'* debts under the collateral-based loan system—it is very difficult in Korea to obtain credit without collateral—thus disproportionately favoring the *chaebols* and fueling their rapid expansion."[211] Therefore, aside from preventing cross-subsidization within conglomerates, this provision also helps to correct the distortions in the domestic financial markets resulting from the oversized presence of conglomerates.

Somewhat related to the issue of intragroup assistance within a conglomerate is cross-shareholding among conglomerate companies. Although it is mainly seen as a corporate governance issue, by injecting equity capital into an affiliate, a conglomerate company is indirectly subsidizing the affiliate's operations. Article 9 of the MRFTA provides that a "company belonging to [a designated business] group . . . shall not acquire or own stocks of an affiliated company which . . . owns [that first company's] stock."[212] Affiliated companies are defined in Article 2 as companies belonging to the same designated business group.[213]

B. Regulation of Market Behavior

1. Mutual Interdependence

Mutual interdependence essentially results in or facilitates three types of harmful situations: express collusion, tacit collusion, and mutual forbearance in competitive effort. For express collusion, the solution is relatively straightforward. Cartels are uniformly condemned under competition laws across the globe. What needs to be done is that competition authorities need to be vigilant in markets in which the likelihood of collusion is augmented by mutual interdependence. For tacit collusion, given that it is generally legal, there is probably not much that competition law can do to directly tackle the problem. The same applies to mutual forbearance. If the leverage comes from a sales relationship or supply of important input, presumably, the competition authority can attempt to remove the leverage by

[210] Monopoly Regulation and Fair Trade Act, Act No. 3320,1980, arts. 10–2, (S. Kor.), *translated in* Korea Fair Trade Commission online database, http://eng.ftc.go.kr/bbs.do?command=getList&type_cd=62&pageId=0401.

[211] Lee, *supra* note 208, at 70.

[212] Monopoly Regulation and Fair Trade Act, art. 9.

[213] *Id*. art. 2.

ordering the severance of the sales or supply relationship. This, however, would amount to an excessive intrusion of commercial freedom as a currently beneficial business relationship is being sacrificed for possible reduction in competitive effort. Unless the competition authority can prove actual and palpable reduction in competitive effort, such a prohibition would be ill-justified. And if the leverage comes from relative weakness in particular markets, there would be nothing that the competition authority can do to remedy that. It would seem that for cases of tacit collusion and mutual forbearance, the greatest hope is to rely on merger review to prevent the emergence of situations of mutual interdependence in the first place. This will be discussed in greater detail in the merger review part.

2. Parallel Exclusion

As mentioned earlier, parallel exclusion has not been expressly recognized as conduct actionable under competition law in the United States or elsewhere. However, as Hemphill and Wu suggest, it is possible to accommodate it under existing U.S. antitrust doctrines such as shared monopoly or conspiracy to monopolize under § 2 of the Sherman Act, or the aggregation doctrine under § 1.[214] They also suggest invoking § 5 of the Federal Trade Commission and prosecuting parallel exclusion as an unfair method of competition.[215] Likewise, under EU competition law, it may be possible to fit parallel exclusion under the doctrine of collective dominance under Article 102 of the Treaty on the Functioning of the European Union (TFEU).[216] An alternative would be to pursue it under Article 101 of the TFEU, which, unlike § 1 of the Sherman Act, does not require an agreement.[217] A concerted practice will also sustain an infringement of Article 101. The notion of concerted practice has been used to tackle parallel conduct in oligopolistic markets in the past,[218] and it is possible it can be used to cover parallel exclusion. Therefore, on both sides of the Atlantic, there are possibilities to use competition law to tackle parallel exclusion.

3. Predatory Pricing

Competition law, of course, regulates predatory pricing. Under U.S. antitrust law, a plaintiff, in order to prevail in a predatory pricing claim, must show that the defendant monopolist has priced its product below a certain

[214] Hemphill & Wu, *supra* note 128, at 1236–43, 1245–48.
[215] *Id*. at 1243–45.
[216] *Id*. at 1239 n.237.
[217] WHISH & BAILEY, *supra* note 162, at 103–120.
[218] *Id*. at 603–05.

measure of cost and there is a dangerous probability of recoupment of the loss sustained during the predation period.[219] Under EU competition law, there is no need to prove recoupment. Instead, the applicable rule changes according to the level of the price. If the price is above average total cost, then the price cutting is presumptively legal.[220] If the price is below average variable cost, there is a rebuttable presumption that it has committed predatory pricing.[221] If the price is between average total cost and average variable cost, the defendant would be guilty of predation if the price cutting is part of a plan to eliminate a competitor.[222] While the consensus in the United States seems to be that the requirement of a showing of probable recoupment is sound, Leslie has recently argued against this requirement, more in line with EU law.[223] This article will not attempt to resolve this highly intricate debate. Suffice it to say for now that if below-cost price cutting by conglomerate companies seems frequent enough in a particular jurisdiction, there may be a good argument for abolishing the recoupment requirement, which is widely believed to have rendered the predatory pricing claim unwinnable under U.S. law.[224] This is especially true when there is evidence that the target has impaired access to the capital market, which means it has reduced ability to withstand predation, which in turn means that there is a smaller loss for the predator to recoup.

If the requirement is to be kept, then it needs to be adjusted to allow for a showing of multimarket recoupment. Not allowing for this would overstate the difficulty of recoupment for conglomerate companies and result in false negatives. However, one needs to be mindful of the complexity of this proof of multimarket recoupment. The recoupment that takes place in other markets will not be in the form of a price increase after a rival has exited the market. It will be the premium that the conglomerate can charge in light of deterred market entry. This would require the courts to identify who the likely entrants are and estimate how far the price would have dropped if they had entered. And this would have to be done for multiple markets. This would probably be beyond the capability of most courts.

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[219] Brooke Group Ltd. v. Brown & Williamson Tobacco Corp., 509 U.S. 209, 210 (1993).

[220] *See* Case C-62/86, AKZO Chemie BV v. Comm'n of the European Cmtys., 1991 E.C.R. I-3359, ¶ 91.

[221] *See id.* ¶ 72.

[222] *Id*. ¶ 71.

[223] Christopher R. Leslie, *Predatory Pricing and Recoupment,* 113 COLUM. L. REV. 1695, 1698–1700 (2013).

[224] Daniel A. Crane, *The Paradox of Predatory Pricing,* 91 CORNELL L. REV. 1, 6 (2005).

4. Tying

Competition law is fully equipped to handle tying, which is within the purview of both U.S. antitrust law and EU competition law. In fact, tying is one of the few nonhorizontal conduct towards which both sides of the Atlantic share a similarly hostile attitude.[225] The leading case under U.S. antitrust law is *Jefferson Parish Hospital District No. 2 v. Hyde*.[226] In this case, the Supreme Court reaffirmed the qualified per se rule for tying, under which the plaintiff, in order to prevail, must prove: (1) there are two distinct products, (2) customers are coerced to purchase the two products together, (3) the defendant possesses market power in the tying product market, and (4) a not insubstantial amount of commerce in the tied product is affected.[227] In Europe, the case law by and large imposes the same requirements on a tying or bundling claim.[228] One extra twist under EU law is that the defendant is allowed to offer an objective justification for the tie, which, if accepted, would exonerate the defendant.[229] Under the qualified per se rule in the United States, no procompetitive justifications will be accepted.

5. Abuse of Superior Bargaining Position

As mentioned earlier, abuse of superior bargaining position is not within the purview of conventional competition law. In both Japan and Korea it is regulated as an unfair trade practice. In both jurisdictions, there is a set of detailed guidelines and a body of decisional practice and case law that explain the application of the provision. The *KFTC Guidelines* provide very detailed guidance on how the provision is applied.[230] A full explanation of the complex analytical framework is beyond the scope of this article. Suffice it to note that under the provision, it is necessary both to prove a superior bargaining position and the existence of an abuse, which should fall within one of the five categories stipulated in the MRFTA.

The MRFTA provides that a superior bargaining position is to be established in light of factors such as the "ease of securing a substitute party for trade, level of income dependency in the relationship, control or

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[225] Perhaps one minor difference is that tying is almost exclusively treated as an abuse of dominance under EU law, whereas it could be prosecuted under both Section 1 and Section 2 of the Sherman Act, which usually means that Section 1 is invoked by virtue of its lower market power requirement.

[226] 466 U.S. 2 (1984).

[227] *Id*.

[228] WHISH & BAILEY, *supra* note 162, at 732–36.

[229] *Id*. at 736.

[230] Korea Fair Trade Commission, Guidelines for Assessment of Unfair Trade Practices, *translated in* Korea Fair Trade Commission online database, http://eng.ftc.go.kr/bbs.do?command=getList&type_cd=62&pageId=0401 [hereinafter KFTC Guidelines].

supervision involved, and characteristics of goods or services traded."[231] The *Guidelines* further state that the fact that the counterparty had no choice but to accept the abusive conduct, such as forced purchase demand, shows that the undertaking has a superior bargaining position. Ease of securing a substitute party for trade refers to "whether or not it is possible to find another undertaking to trade with at a low transaction cost."[232] The reference to low transaction cost suggests that the standard is not high. What needs to be proved is not absolute impossibility, but only that a replacement cannot be found without incurring high transaction costs. The replacement will only be deemed to be adequate if it does not result in reduction in trading volume or does not present difficulties for the counterparty to recover its investments.[233] In other words, the *Guidelines* make it quite easy to demonstrate a lack of choice.[234] In KFTC's decisional practices, it seems that the KFTC emphasizes the following factors: the market in which the parties operate, the gap between the parties' business capacities and their scope of business activities, and the characteristics of the product or service.[235] Lastly, the KFTC's decisional practice suggests that the KFTC pays much attention to the defendant's market power in the market to which the contract pertains. The KFTC usually begins each decision with a very detailed analysis of the relevant market and proceeds to enumerate the party's market share.

Given the number of different conduct enumerated in the MRFTA, this article will not examine the legal treatment of each type of abuses. Forced purchase will be used as an example for illustration. The *KFTC Guidelines* defines forced purchase as "an undertaking forcing its trading counter[party] to purchase goods or services even though the counterparty has no intention of doing so."[236] The purchase must be made under coercion, which can be proved by the existence of penalty for failure to purchase and other objective facts suggesting that the counterparty was forced to make the purchase. The *Guidelines* emphasize that the primary consideration in determining the legality of forced purchase, like other prohibited abuses, is whether it

[231] *Id*. § II.6.A.(2)(B). Similar criteria are used in other jurisdictions such as France. Bakhoum, *supra* note 163, at 5–6.

[232] KFTC Guidelines, *supra* note 230, § II.6.A.(2)(B).

[233] *Id.*

[234] This is similar to the situation in Italy where an undertaking is required to demonstrate that it is unable to substitute its production or its contractual counterparty without incurring unreasonable costs. *See* Valeria Falce, *The Italian Regulation against the abuse of economic dependence*, *in* ABUSE OF DOMINANCE IN COMPETITION LAW (Paul Nihoul & Iwakazu Takahashi eds., forthcoming) (on file with author). However, this is already a more stringent standard than France, where an economic dependent situation can be said to exist if a contractual party cannot replace its counterparty on identical terms. Bakhoum, *supra* note 163, at 10.

[235] Cheng & Gal, *supra* note 164, at 305.

[236] KFTC Guidelines, *supra* note 230, § II.6.A.(1)(A).

"violates principles of fairness in trade." Unfairness of the forced purchase can be established in light of factors such as "the objective of the conduct, likelihood of anticipation by the counterparty, . . . ordinary course of trade in the industry, damage [] caused to the counterparty as a result of the forced purchase, and relevant laws."[237] On the likelihood of anticipation, the *Guidelines* explain that if the forced purchase was "clearly predictable or if the purchase is specified in the contract from the beginning, such forced purchase shall not be considered unfair."[238] This suggests that at least with respect to forced purchase, the abuse of superior bargaining position only applies to ex post contractual revisions, which substantially narrows its scope.

Before concluding this discussion about abuse of superior bargaining position, it should be noted that regulating unilateral exploitative practices by a nondominant firm is highly controversial within competition law. Wagner-von Papp argues that these provisions upset the careful balance that has been struck to avoid false positives in the abuse of dominance provisions.[239] Another recurrent problem in this area is the difficulty in coming up with a rigorous definition of superior bargaining position. Therefore, while it may be justified to extend the provisions to conglomerates if a particular jurisdiction already has these provisions in place, it may not be wise to adopt them solely for the purpose of regulating exploitative practices by conglomerate companies. These provisions will be applied to many scenarios beyond conglomerates that a jurisdiction may not want to regulate.

6. Entry Deterrence/Loss of Potential Competition

Entry deterrence on its own is not a competition law violation. It is only the outcome or effect of particular conduct. How it is treated under competition law depends on how it is achieved. If it is achieved by means of parallel exclusion or the reputational effect of predation, it would be evidence that the alleged conduct is exclusionary and therefore illegal. However, if the entry deterrent effect is the result of the vastness of a conglomerate and the need to replicate its business connections, as argued by Ayal, there would be no remedy under competition law short of making being a conglomerate itself a violation, which no jurisdiction does. An alternative would be measures to limit the growth and size of conglomerates, which Korea and Japan have adopted. This stops short of making being a conglomerate itself a violation, but restricts conglomerates from becoming too big, hence reducing the

[237] *Id*. § II.6.A.(2)(B).
[238] *Id.*
[239] Wagner-von Papp, *supra* note 163, at 60.

probability that they would exert the undesired entry deterrent effect.

Meanwhile, regulating conglomerate mergers for potential competition concerns is widely accepted in U.S. antitrust law.[240] A detailed discussion about this will be reserved for the merger review part.

7. Interlocking Directorate

Interlocking directorate is regulating by § 8 of the Clayton Act. It provides that "[n]o person shall, at the same time, serve as a director or officer of any two corporations . . . that are . . . by virtue of their business and location of operation, competitors, so that the elimination of competition by agreements between them would constitute a violation of any of the antitrust laws."[241] The statute then provides a number of minor exemptions for small corporations and insignificant competitive overlap. Section 8 expects the worst of an interlocking directorate in that it assumes the common director to bring about the most anticompetitive consequence. The test for legality is whether a competition-eliminating agreement between the two competitors would be illegal under any of the antitrust laws. Given that price fixing cartel is the most harmful conduct between two competitors, § 8 essentially means that if a price fixing agreement between two firms would be illegal, the interlocking directorate would be illegal even though an exclusive dealing agreement or a joint venture between the two firms would be upheld.[242] Interlocking directorate between two vertically related firms is generally legal under the statute since the firms are not competitors.[243] It is fair to say that interlocking directorate has not been an enforcement priority of the two U.S. Agencies. However, in 2009, the Federal Trade Commission did launch a high-profile investigation of interlocking directorate between Google and Apple.[244] The investigation caused the resignation of Eric Schmidt, the then-chief executive officer of Google, from Apple's board.[245]

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[240] On the contrary, the EU does not seem to put much focus on potential competition as a competitive concern for conglomerate mergers. There is no mention of loss of potential competition in the conglomerate merger section of the EU Non-Horizontal Merger Guidelines.

[241] Clayton Act § 8, 15 U.S.C. § 19 (2012).

[242] HERBERT HOVENKAMP, FEDERAL ANTITRUST POLICY: THE LAW AND COMPETITION AND ITS PRACTICE § 12.11 (4th ed. 2011).

[243] *Id*. Common remedies of interlocking directorate include elimination of the interlock and prohibitions of future interlock. Damages are theoretically available, but have yet to be awarded to private parties. ABA SECTION OF ANTITRUST LAW, ANTITRUST LAW DEVELOPMENTS 430 (6th ed. 2007).

[244] Miguel Helft & Brad Stone, *Board Ties at Apple and Google Are Scrutinized*, N.Y. TIMES (May 4, 2009), http://www.nytimes.com/2009/05/05/technology/companies/05apple.html?_r=0.

[245] David Goldman, *Google CEO Schmidt leaves Apple board*, CNN MONEY (Aug. 3, 2009, 9:39 AM), http://money.cnn.com/2009/08/03/technology/schmidt_google_apple_board/.

8. Merger Review

Merger review can be an effective means to control the conglomerate problem by preventing their emergence in the first place or by preventing them from continuing to grow (at least for growth by acquisition). Both the United States and the EU regulate conglomerate mergers (in the case of the United States, it at least used to). However, the way these mergers are regulated in these two jurisdictions would not address the concerns about conglomerates highlighted in this article. In the United States, regulation of conglomerate mergers was focused on either the loss of potential competition or increased risks of exclusionary practices, such as reciprocity, tying, or predatory pricing.[246] Likewise, in the EU, the main focus in regulating conglomerate mergers is on potential foreclosure effects through tying practices. The regulatory focus is not on sheer size as such, but on potential risks of impairment of competition or anticompetitive conduct. Therefore, while merger review will help to tackle some of the specific concerns about conglomerates, such as elimination of potential competition, tying, or predatory pricing, it will not address the root of the problem itself.

Merger review can be used to ensure that effective potential competition is preserved. According to the 1984 *Guidelines*, there are two potential competition theories: perceived potential competition and actual potential competition. Under the perceived potential competition theory,

> [b]y eliminating a significant present competitive threat that constrains the behavior of the firms already in the market, the merger could result in an immediate deterioration in market performance. . . . If the acquiring firm had unique advantages in entering the market, the firms in the market might be able to set a new and higher price after the threat of entry by the acquiring firm was eliminated by the merger.[247]

Under the actual potential competition theory,

> [b]y eliminating the possibility of entry by the acquiring firm in a more procompetitive manner, the merger could result in a lost opportunity for improvement in market performance resulting from the addition of a significant competitor. The more procompetitive alternatives include both new entry and entry through a 'toehold' acquisition of a present small competitor.[248]

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[246] HOVENKAMP, *supra* note 242, § 13.3. Professor Hovenkamp, however, notes that these risks are more often imagined than real.

[247] 1984 Merger Guidelines, *supra* note 176, § 4.111.

[248] *Id*. § 4.112.

According to the *Guidelines*, when evaluating potential competition concerns, the Department of Justice will focus on a number of factors, including: (1) market concentration, (2) conditions of entry, (3) the acquiring firm's entry advantage, and (4) the market share of the acquired firm.[249]

In the *Marine Bancorporation* case, the Supreme Court defined the perceived potential competition doctrine as consisting of the following three elements:

> if the target market is substantially concentrated, if the acquiring firm has the characteristics, capabilities, and economic incentive to render it a perceived potential de novo entrant, and if the acquiring firm's premerger presence on the fringe of the target market in fact tempered oligopolistic behavior on the part of existing participants in that market.[250]

The Court in that case expressly reserved the issue of whether actual potential competition is a recognized doctrine under U.S. merger review law.[251]

Merger review can also be used to prevent situations of mutual forbearance from arising in the first place. While the idea is simple in theory, the difficulty lies in determining when mutual interdependence is likely to arise. It cannot be the rule that mergers are prohibited whenever a conglomerate enters by acquisition a market in which other conglomerates operate, when these conglomerates also compete in another market. Cases in which the leverage for mutual forbearance is an important sales or supply relationship are relatively easier. The competition authority can simply prohibit a conglomerate from acquiring a firm that is an important supplier or customer of another conglomerate. Cases in which the leverage for mutual forbearance is relative weakness in a market present more difficulties. The authority cannot prohibit a merger simply because the target is weak and would become a source of leverage for rivals. However, Areeda and Turner have noted that this kind of acquisition is highly unlikely.[252]

Areeda and Turner have proposed an analytical framework to determine when intervention is justified in cases in which mutual interdependence increases the likelihood of express or tacit collusion. They stipulate three

[249] *Id*. §§ 4.131–4.134.

[250] 418 U.S. at 624–25.

[251] *Id*. at 625.

[252] Phillip Areeda & Donald Turner, *Conglomerate Mergers: Extended Interdependence and Effects on Interindustry Competition as Grounds for Condemnation*, 127 U. PENN L. REV. 1082, 1089 (1979) ("A firm with a strong position in one market would have no incentive to acquire a vulnerable firm in a second market if the principal effect of that acquisition were to reduce its perceived ability to make profit-maximizing moves in the first market. Nor is there any reason for a firm vulnerable in one market to acquire a strong firm in a second market if the vulnerability reduced its felt ability to exploit the strong firm's position.").

necessary conditions for intervention: (1) "[t]he merged firm and at least one rival must confront each other in two markets, each of which is somewhat oligopolistic in performance but not rigidly so,"[253] (2) "[t]he merged firm and at least one other two-market firm must both be significant in both markets, and both markets must be relatively important to both firms,"[254] and (3) "[t]o be deterred from a price cut in one market a firm must be subject to sanctions in the second market."[255] The condition for a somewhat but not rigidly oligopolistic market is due to the fact that if the market is already rigidly oligopolistic, competition probably cannot get much worse.[256] There is not much to worry about. Significance is relevant because if the two firms are not significant forces in the market, their actions will not affect overall market performance.[257] Importance is relevant because if the market is not important to the two firms, they will not be affected by losses in it.[258] Following Bernheim and Whinston's theory about transfer of surplus enforcement power, the competition authority would also want to pay attention to whether (1) one market is rapidly growing and the other is slow-growing, (2) one market is one in which actions are directly observable and immediately punishable and the other one in which there are substantial detection and punishment lags, or (3) one market has high demand and the other has low demand. These pairings of markets would raise the likelihood and severity of sanction.

Despite the limited effectiveness of merger review in tackling the conglomerate problem, it is correct after all that it is only used to target specific competitive concerns or conduct that may arise from a merger, such as mutual interdependence, loss of potential competition, or increased risks for exclusionary conduct, as opposed to being used to regulate size. Any attempt to use merger review to prevent conglomerates from emerging in the first place or growing would be inevitably arbitrary. Questions such as what qualifies as a conglomerate, what should be the limit of size, how should size be measured, etc. will necessitate some arbitrary line drawing. Any rules that can be formulated will also be highly complex and prescriptive, as is evidenced by the Japanese rules on excessive concentration of economic power. Finally, to the extent that a conglomerate is family-owned, which many conglomerates in emerging economies are, restrictions on the growth of conglomerates can be circumvented through some family shareholding trusts or other mechanisms. They are unlikely to be effective.

[253] *Id*. at 1084.
[254] *Id*. at 1085.
[255] *Id*. at 1086.
[256] *Id*. at 1085.
[257] *Id*. at 1086.
[258] *Id*.

VI. THE CASE OF HONG KONG

A. Overview of Competition Law in Hong Kong

Hong Kong was one of the last developed economies to adopt a cross-sector competition law. Prior to 2012, the government had espoused a sectoral approach to competition law, having in place competition law provisions in the sector-specific regulations for the telecom and broadcasting sectors. This is despite the fact that there had been vocal public demand for a cross-sector competition law since the 1990s, when the Consumer Council, a statutory consumer advocacy body, recommended that Hong Kong adopt one. One of the main reasons for the public demand for competition law, contrary to the conventional conception of the objective of competition law, is not to obtain greater protection for consumer welfare. It is the long held perception that the local economy is dominated by conglomerates, most of which are family-owned and heavily involved in property development.[259] One study concludes that the corporate assets held by the fifteen largest families in Hong Kong accounted for 84.2% of GDP, and that the five largest corporate groups controlled 32.1% of the market capitalization in Hong Kong in 1996.[260]

The conglomerates have been accused of a variety of conduct, such as collusion, tying, refusal to deal, predatory pricing, and exploitative practices against suppliers. They have also been accused of squeezing out SMEs and excessive pricing, especially in the property management sector. There are high public expectations that the newly enacted Competition Ordinance will address the dominance of conglomerates in Hong Kong. While some of the alleged conduct clearly falls within the purview of competition law, others can present difficulty. For instance, the exploitative practices against suppliers are generally tackled under the rubric of unfair trade practices, which the Hong Kong Competition Ordinance does not regulate, in other jurisdictions. Even though tying is clearly one of the prohibited business practices under competition law, it is mostly regulated as an abuse of dominance. The problem is that in Hong Kong, the alleged perpetrators of tying usually do not command a dominant position in their relevant markets.

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[259] Due to the lack of inhabitable land in the city, property development is one of the most important sectors of the economy. *See* Hong Kong Monetary Authority, *The Property Market and the Macro-Economy*, QUARTERLY BULLETIN 05/2001, 1 (2001), http://www.hkma.gov.hk/media/eng/publication-and-research/quarterly-bulletin/qb200105/fa02.pdf.

[260] Stijn Claessens, Simeon Djankov & Larry H.P. Lang, *The Separation of Ownership and Control in East Asian Corporations*, 58 J. FIN. ECON. 81, 108 (2000).

B. An Overview of Conglomerate Dominance in Hong Kong

As mentioned earlier, some commentators have drawn a distinction between conglomerates and corporate groups. In Hong Kong, no such distinction is drawn. A conglomerate refers to a business group which operates in multiple sectors of the economy through its subsidiaries. Most of the conglomerates in Hong Kong are family-owned, especially those that were established by a local founder and not descended from the British trading houses from the colonial times. Some of the more prominent conglomerates in Hong Kong include the Cheung Kong Group, Sun Hung Kai, Henderson Land, the New World Group, Swire Pacific, and Jardine Matheson. In particular, the owner of the Cheung Kong Group, Li Ka Shing, is the richest man in Asia and the seventeenth richest man in the world, according to Forbes.[261] Lee Shau Kee, the owner of Henderson Land, is the twenty-seventh richest man in the world.[262] The fact that two men from a place as small as Hong Kong can be ranked among the top thirty richest men in the world underscores the degree of concentration of wealth in the city.

Studies have produced a range of results on aggregate concentration in Hong Kong. Claessens and his coauthors find that the ten largest families in Hong Kong controlled about a third of the corporate sector and that the five largest family groups controlled 32.1% of the market capitalization in Hong Kong.[263] Masulis and his coauthors find slightly lower figures. They report that 15.63% of the listed firms in Hong Kong belonged to family groups and 26.29% of the market capitalization was accounted for by such groups.[264] According to Poon, listed companies controlled by the six leading conglomerates accounted for 14.7% of the total market capitalization of the Hong Kong Stock Exchange in 2010.[265] This is after significant dilution of the Hong Kong stock market by Mainland companies. Eight years earlier, the same companies were responsible for 23.5% of the market capitalization in Hong Kong.[266] It has also been estimated that the six biggest conglomerates in Hong Kong take in at least 23 cents of every dollar spent by the city's residents.[267]

The Economist has come up with a slightly different way of measuring

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[261] Chase Peterson-Withorn, *Forbes Billionaires: Full List of The 500 Richest People in the World 2015*, FORBES (Mar. 2, 2015, 7:00AM), http://www.forbes.com/sites/chasewithorn/2015/03/02/forbes-billionaires-full-list-of-the-500-richest-people-in-the-world-2015/.

[262] *Id*.

[263] Claessens, Djankov & Lang, *supra* note 260, at 83, 108.

[264] Masulis et al., *supra* note 22, at 3569.

[265] ALICE POON, LAND AND THE RULING CLASS IN HONG KONG 23 (2011).

[266] *Id*.

[267] Te-ping Chen, *Hong Kong's Tycoons Under Attack*, WALL ST. J. (Aug. 31, 2012, 2:59AM), http://www.wsj.com/articles/SB10000872396390444230504577615212739865968.

the concentration of aggregate concentration. It publishes what is known as the Crony Capitalism Index, which calculates "the total wealth of those of the world's billionaires who are active mainly in rent-heavy industries," which refer to industries that are more susceptible to rent-seeking, such as (1) casinos; (2) coal, palm oil, and timber; (3) defense; (4) commercial and investment banking; (5) infrastructure and pipelines; (6) oil, gas, chemicals, and other energy; (7) ports and airports; (8) real estate and construction; (9) steel, other metals, mining, and commodities; and (10) utilities and telecom services.[268] Unsurprisingly, Hong Kong came out on top in the Index, with close to 80% of the city's GDP accounted for by billionaires in the so-called "crony sectors." Hong Kong's percentage is almost four times as high as Russia's, which came out number two in the Index.[269] Hong Kong's preponderance in these crony sectors is all the more remarkable because it is basically entirely absent in six of the ten enumerated sectors, including casinos, coal, defense, infrastructure, oil and gas, and steel and mining. Hong Kong is a major financial center. Therefore, it is not surprising that finance accounts for a significant proportion of the GDP. However, it is important to bear in mind that the Index does not calculate the percentage of GDP accounted for by a particular sector, but by the total wealth of billionaires operating in that sector. Most of the major financial institutions in Hong Kong are multinational corporations. The owners of these institutions are not local billionaires, and hence would not be counted towards the Index. What then accounts for the extraordinary high percentage of local GDP attributed to the crony sectors? The answer lies in the real estate sector.

The real estate or the property sector has always been one of the most important sectors in the local economy, especially since the departure of manufacturing for Mainland China in the 1980s. The local economy has been inextricably linked to the swings of the property market ever since the 1980s. The economy expanded rapidly during the prehandover rally in the real estate market from the late-1980s all the way to the Asian Financial Crisis. And the economy was in doldrums for years when the property market collapsed dramatically during the Asian Financial Crisis. It is no coincidence that practically all the major conglomerates in Hong Kong are involved in the property sector. Cheung Kong, Sun Hung Kai, and Henderson Land are three of the largest property development companies in Hong Kong.[270] The other

[268] *Planet Plutocrat: Our crony-capitalism index*, THE ECONOMIST (Mar. 15, 2014), http://www.economist.com/news/international/21599041-countries-where-politically-connected-businessmen-are-most-likely-prosper-planet.

[269] *Id*.

[270] Jackie Connor, *Hong Kong: Economic Freedom Belies Crony Capitalism*, SEVEN PILLARS INSTITUTE (Oct. 1, 2014), http://sevenpillarsinstitute.org/news/economics/hong-kong-economic-freedom-belies-crony-capitalism.

conglomerates such as New World, Jardine Matheson, Swire Pacific, and Hong Kong Land also have significant presence in the real estate sector. The property sector is especially crucial in Hong Kong as compared to other economies largely because of the scarcity of land in the city. The city has an area of barely over 1,100 square kilometers, 24% of which consisted of built-up areas as of 2013.[271] 76% of the total land area is nonbuilt-up land that is scattered across the city in the form of woodland, grassland, wetland, and agricultural land.[272] According to the government, over 500 square kilometers of the city's land is unsuitable for development as it consists of country parks, remote areas, small islands, and steep slopes.[273]

What compounds the land scarcity problem is the fact that the government is practically the sole supplier of undeveloped land and has long adopted a high land price policy.[274] Land sales account for a significant part of the government's revenue and therefore the government has had every incentive to keep land, and by extension, property prices high. According to government data, land sales accounted for between 15% and 20% of the total government revenue from 2012 to 2015.[275] During the heyday of the property market boom, land sales contributed to as much as 30% of the total government revenue.[276] Stamp duties, which are collected from property transactions, contributed another 10% of revenue to the government coffers.[277] In fact, from April to September 2014, stamp duties accounted for more than a quarter of the overall government revenue.[278] Therefore, property-related revenue sources altogether contribute to more than 30% of the government revenue. It is no coincidence that property prices in Hong Kong have been some of the highest in the world. According to the Telegraph, Hong Kong is the second most expensive place in the world to buy residential property, more expensive than New York, London, and Tokyo, and just after Monaco, a tiny principality in the south of France.[279] Hong Kong also has the second highest commercial property rental in the

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[271] Hong Kong Government Central Policy Unit, *Commission on Strategic Development: Land Utilisation and Land Supply to Support Economic Development of Hong Kong* 1 (Nov. 2013), http://www.cpu.gov.hk/doc/en/commission_strategic_development/csd_3_2013e.pdf.

[272] *Id*.

[273] *Id*.

[274] POON, *supra* note 265, at 44.

[275] Legislative Council Secretariat Research Office, *Fact Sheet: Major sources of government revenue* 1 (2015), http://www.legco.gov.hk/research-publications/english/1415fs03-major-sources-of-government-revenue-20141215-e.pdf.

[276] POON, *supra* note 265, at 113.

[277] Legislative Council Secretariat, *supra* note 275, at 1.

[278] *Id*.

[279] *The world's 10 most expensive cities to buy property*, THE TELEGRAPH (Sept. 5, 2015), http://www.telegraph.co.uk/finance/property/international/10675352/The-worlds-10-most-expensive-cities-to-buy-property.html?frame=2440091.

world after London.[280]

The property development market in Hong Kong is highly concentrated. By all accounts, the market has become more concentrated over the last two decades. According to a Consumer Council study, 70% of total new private housing was supplied by seven developers and 46% by three developers.[281] Moreover, two of the major developers, Sun Hung Kai Properties and Henderson Land, allegedly held an enormous land bank.[282] By 2010, the top four developers accounted for 74% of all new apartments sold and the top two developers held 60% of the market.[283] By 2014, the top three developers supplied 72% of the new apartments sold in Hong Kong.[284] In fact, one report suggests that the private residential market is as concentrated as the top two developers holding 70% of the market.[285] It is important to note that market share in residential property carries significance beyond the residential property market to the market for retail rentals or shopping malls. This is because in Hong Kong, residential property development has tended to come in large-scale property developments that consist of tens of buildings sitting on top of a large shopping mall. Needless to say, the shopping malls thus built stay in the hands of the developer. Therefore, a high market share in residential property also indirectly gives a developer significant presence in the retail rental market, which they use to leverage into the retail sector.

High market shares on their own of course do not give the top property developers market power. What gives these developers substantial market power is the high entry barriers to the private residential market. First, the market suffers from low contestability. No new player has managed to grab a market share of over 5% since 1981.[286] It does not help that a number of medium-sized developers failed following the Asian Financial Crisis, further shielding the top developers from competitive pressure.[287] Second, as mentioned earlier, a number of the leading developers hold an enormous land bank through years of acquisition. Others have acquired substantial land

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[280] Miho Favela, *Top 10 Most Expensive Office Markets in the World Revealed*, WORLD PROPERTY J. (Mar. 4, 2015, 9:45AM), http://www.worldpropertyjournal.com/real-estate-news/united-kingdom/london-real-estate-news/london-office-rental-rates-2015-most-expensive-office-markets-cushman-wakefield-annual-office-space-across-the-world-global-rankings-george-roberts-james-young-john-siu-8910.php.

[281] POON, *supra* note 265, at 24, 66.

[282] *Id*. at 25.

[283] Vivian Kwok, *Two developers tower over market*, SOUTH CHINA MORNING POST (Aug. 12, 2010), http://www.scmp.com/article/721930/two-developers-tower-over-market.

[284] Sophia Yan, *Hong Kong has a tycoon problem*, CNN MONEY (Nov. 2, 2014), http://money.cnn.com/2014/11/02/news/economy/hong-kong-tycoons/.

[285] *See* Connor, *supra* note 270.

[286] POON, *supra* note 265, at 66.

[287] *Id*. at 57.

holding through acquisition of utilities companies, whose former plants can be converted for residential development.[288]

So what is the relevance of the substantial market power of the large conglomerate developers in the property development market for the wider economy? In Hong Kong, the large conglomerate developers have fulfilled the prophecy of Winston Churchill when he declared that land monopoly is the mother of all other forms of monopoly,[289] and have successfully leveraged their market power in the property development market into other related markets, such as property management, residential broadband services, groceries, pharmacy, and even mobile telephony. As will be explained subsequently, such leveraging of market power is particularly effective because of the enormous price differential between residential property and all these other markets such as groceries and broadband services. The large price differential means that consumers pay scant attention to these other products or services that are often directly or indirectly tied to the purchase of an apartment when making the property purchase. Such lack of consumer attention has magnified the market power of the conglomerate property developers and has in some sense rendered the coercion requirement in a standard tying claim superfluous. The conglomerates have thus been able to strengthen their positions in the markets for these other products and services through their market power in the property development market.

C. Assessment of Advantages and Disadvantages of Conglomerates in Hong Kong

An assessment of the net benefits of conglomerates in Hong Kong is important because it informs the policy decision as to what should be done about them. If conglomerates redound net benefits to the city, then they probably should be tolerated and efforts should be made to contain their competition-distorting effects by way of competition law enforcement. If conglomerates on balance cause net harm to the economy, as seems to be the conclusion in South Korea, then more drastic measures may be needed.

1. How relevant are conglomerate advantages in Hong Kong?

There is no denying that group membership redounds significant benefits to conglomerate companies. Such efficiency benefits may provide

[288] *Id*. at 115. The land holdings of the large developers took on added significance after the nine-point plan adopted by the government in 2002, which was enacted in response to the collapse of the property market and severely curtailed land supply. *Id*. at 122.

[289] STEVEN B. CORD, SOCIETY AT THE CROSSROADS: CHOOSING THE RIGHT ROAD 245 (2003).

strong justifications for the continual existence of conglomerates. However, one should note that many of these advantages, such as the provision of internal capital and factor markets, overcoming missing institutions, and improving access to the international capital markets, are peculiar, or at least especially relevant, to emerging economies where legal and financial institutions are developing. As noted earlier, many of these advantages fade in significance as economies mature and institutions develop. Thus these advantages will be of little relevance to conglomerates in Hong Kong, which is an advanced economy with high-quality institutions and well-developed capital markets.[290] According to the World Bank Governance Indicators, Hong Kong had a percentile rank of 89.81 for political stability and no violence, 98.08 for government effectiveness, 99.52 for regulatory quality, 93.75 for Rule of Law, and 92.31 for control of corruption in 2014.[291] Overcoming missing institutions thus should be irrelevant for Hong Kong companies. Meanwhile, according to the World Bank, Hong Kong's stock market ranked number four in the world behind the United States, China, and Japan as measured by market capitalization of domestic listed companies. Access to international capital markets and provision of internal capital markets are hence not an important concern for Hong Kong companies, at least for those big enough to raise capital through public share offerings.[292]

The most relevant advantages for conglomerates in Hong Kong, therefore, would be economies of scale and scope, risk sharing, and sharing of group goodwill. However, it is not entirely clear how relevant the last advantage is to conglomerates in Hong Kong. Unlike conglomerates in other countries such as South Korea and India, where group companies often explicitly incorporate the group name in their corporate identity, it is not often easy in Hong Kong to discern that a company belongs to a certain conglomerate. Hong Kong conglomerate companies do not seem keen to flaunt their group identity. Therefore, the main justifications for conglomerates in Hong Kong would be economies of scale and scope and risk sharing. In light of the doubts cast by empirical evidence on the ability of a conglomerate to reap economies of scale, the efficiency justifications for conglomerates in Hong Kong are rather thin.

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[290] According to World Bank data, Hong Kong was the 26th richest economy in the world in 2014 as measured by GDP per capita. *See* The World Bank, *GDP per capita (current US$)*, http://data.worldbank.org/indicator/NY.GDP.PCAP.CD.

[291] The World Bank, *Worldwide Governance Indicators Project*, http://info.worldbank.org/governance/wgi/index.aspx#home.

[292] The World Bank, *Data: Market capitalization of listed domestic companies (current US$)*, http://data.worldbank.org/indicator/CM.MKT.LCAP.CD.

2. *What is the extent of conglomerate harm in Hong Kong?*

Agency costs are a corporate governance problem and not a competition law problem, even though poor corporate governance may have implications on the competitive behavior of firms. Therefore, if agency costs are deemed to be a serious problem in Hong Kong, the solution should be found in corporate law and not competition law. In any case, empirical evidence seems to suggest that agency costs are not a serious issue.

Crowding out of SMEs and entrepreneurs has been observed in Hong Kong. It is widely acknowledged that the conglomerates have squeezed out SMEs in some sectors, such as groceries, as mom-and-pop stores have met their demise one after another.[293] While it may not be entirely attributable to the presence of the conglomerates, studies have suggested that Hong Kong has lost much of its entrepreneurship over the years and now has a much lower level of entrepreneurship than the global average.[294] A related reason for the increasing difficulty of entrepreneurship is the high rental costs. The high rental costs are partly attributable to the high land price policy of the government and partly attributable to the market power of the conglomerate property developers. Many small businesses are priced out of the market by the high rental costs.[295]

The Author is unable to locate studies that attempt to measure the overall welfare effects of conglomerates on the Hong Kong economy or the impact of conglomerates on SME access to financial markets. However, it has been noted that a lack of financing is the main impediment to potential growth and internationalization for SMEs in Hong Kong.[296] Most founders of SMEs in Hong Kong "start with very limited equity capital and rely more on seed capital for new businesses from the founders' personal savings, contributions from family and sometimes friends, and from mortgaging their properties."[297] There seem to be no studies on SMEs access to bank

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[293] Razeen Sally, *Capitalism's Halting Progress in Asia*, QUADRANT ONLINE (Jan 2, 2016), https://quadrant.org.au/magazine/2015/12/capitalisms-halting-progress-asia (last visited Sept. 4, 2016).

[294] CHINESE UNIV. OF H.K. CTR. FOR ENTREPRENEURSHIP, GLOB. ENTREPRENEURSHIP MONITOR H.K. & SHENZHEN 3 (2009) ("Both Hong Kong and Shenzhen have experienced dramatic drops in entrepreneurial prevalence since our last studies in 2007 and 2004 respectively."); *id.* at 4 ("Hong Kong has a relatively low level of entrepreneurship"). The 2004 Study already showed that the level of entrepreneurship in Hong Kong was lower than what one would expect given its level of income. *Id*. at 5.

[295] Katie Hunt, *Small businesses are priced off Hong Kong's streets*, BBC NEWS (July 22, 2013), http://www.bbc.com/news/business-23366025; Ilaina Jonas, *Hong Kong has world's most expensive retail space—report*, REUTERS (May 12, 2013, 12:06 AM), http://www.reuters.com/article/us-property-retail-idUSBRE94C03F20130513.

[296] Benjamin Fung, *Integrating Financial and Non-Financial Support Measures for Hong Kong Small and Medium Enterprises*, THE H.K. MANAGER, (4th Qtr. 2008), http://www.hkma.org.hk/hkmanager/hkmgr2008v4/eng/archive/gz.asp (last visited Sept. 4, 2016).

[297] *Id*.

financing, which is probably the most important of financing for SMEs, in Hong Kong. Meanwhile, according to an IOSCO 2015 report, SMEs in Hong Kong have not been successful in raising capital in the capital markets. The equity market is marred by asymmetric regulation that disadvantages SMEs in getting listed on the Hong Kong Stock Exchange.[298] And no Hong Kong SMEs have successfully issued debt securities.[299] More rigorous studies would provide more conclusive evidence. But one can surmise that SMEs in Hong Kong do face limited access to capital.[300]

Both the design of the political system and anecdotal evidence suggest that conglomerates in Hong Kong wield significant political influence. The political system in Hong Kong is such that the business sector generally, and the conglomerates in particular, are given substantial direct influence. The city's mayor, called the chief executive, is selected by a 1200-member-strong Election Committee, which is stacked with representatives from the business sector. In fact, one of the most peculiar features of this committee is the existence of the corporate vote, whereby certain corporations, including the major conglomerates, are entitled to their own votes.[301] Corporate entities, many of which are conglomerates, were wholly or partly responsible for electing 570 of the 1200 seats on the Election Committee in 2011.[302] This selection system gives the conglomerates considerable leverage over the chief executive in a government which is very much executive-led. Legislation that pertains to public expenditure, political structure or the operation of the Government must be introduced by the administration.[303] The Legislative Council ("LegCo"), Hong Kong's parliament, is also stacked in favor of business interest. There are functional constituencies in LegCo, which represent a particular profession, such as lawyers or doctors, or a particular industry, such as logistics or finance.[304] In other words, there is a parliament member for the logistics industry or tourism industry. Many of the representatives of the functional constituencies have a business

[298] THE GROWTH AND EMERGING MKTS. COMM. OF THE INT'L ORG. OF SEC. COMM'NS, SME FIN. THROUGH CAPITAL MKTS.—FINAL REPORT, 44–45, 49–50 (2015), https://www.iosco.org/library/pubdocs/pdf/IOSCOPD493.pdf.

[299] *Id*. at 29.

[300] Of course the fact that SMEs face limited access to capital does not mean that it is because they are squeezed out by conglomerates. The extent to which competition by conglomerates deprives SMEs of access to capital will have to be determined by more rigorous empirical studies by economists.

[301] HONG KONG SPECIAL ADMINISTRATIVE REGION GOVERNMENT, METHODS FOR SELECTING THE CHIEF EXECUTIVE IN 2017 AND FOR FORMING THE LEGISLATIVE COUNCIL IN 2016 24 (2013), http://www.2017.gov.hk/filemanager/template/en/doc/Con_Doc_e_(FINAL)_with_cover.pdf.

[302] Carine Lai, *Abolish corporate voting to make Hong Kong elections fairer*, SOUTH CHINA MORNING POST (Nov. 13, 2014, 5:42 PM), http://www.scmp.com/comment/insight-opinion/article/1638964/abolish-corporate-voting-make-hong-kong-elections-fairer.

[303] XIANGGANG JIBEN FA art. 74 (H.K.).

[304] HONG KONG GOV'T, *supra* note 301, at 31–33.

background and are beholden to business interests. Together with its leverage over the chief executive, the business community in Hong Kong is very well-positioned to exercise political influence over government policies.

There also have been cases of nepotism between government officials and the conglomerates that suggest that the latter hold significant influence over public policy. Chin-Man Leung, the Secretary for Buildings and Lands in 2004, authorized the decision to sell below market price the government's stake in a public-private partnership known as the Hunghom Peninsula Project to two conglomerate developers, the New World Group and Sun Hung Kai Properties.[305] After his retirement, Leung was offered a lucrative position in the New World Group.[306] Amid public uproar, Leung eventually gave up the position.[307] An even more high-profile case was the Rafael Hui case. Hui was a former Chief Secretary for Administration, which is the equivalent of a prime minister in the Hong Kong government. In December 2014, Hui was found guilty of receiving bribes from one of the owners of Sun Hung Kai Properties, Thomas Kwok.[308] In fact, conglomerate influence on the government goes all the way to the very top. The first Chief Executive of Hong Kong after the handover, Chee-Hwa Tung, himself hailed from a tycoon shipping family. During his administration, Ka-Shing Li of the Cheung Kong Group held a stake in Tung's company.[309] Even if Li did not in fact leverage his stake in Tung's company to influence public policy, the appearance of potential influence is enough to cause the public to cast doubt on the impartiality of Tung's administration, especially given his own close connections to the conglomerate families. And there are well-documented instances of the conglomerate developers exerting direct and public influence over government policies. The conglomerate developers, through their trade association—the Real Estate Developers' Association—successfully torpedoed the Town Planning Bill, which would have introduced greater transparency and accountability in the town planning process through direct and public lobbying efforts.[310]

D. Possible Responses to Conglomerate Dominance in Hong Kong

The foregoing discussion shows that conglomerate dominance is a

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[305] POON, *supra* note 265, at 14.
[306] *Id*.
[307] *Id*.
[308] Stuart Lau, *Rafael Hui and Thomas Kwok found guilty of bribery in Hong Kong's biggest graft trial*, SOUTH CHINA MORNING POST (Dec. 19, 2014, 4:42 PM), http://www.scmp.com/news/hong-kong/article/1665519/rafael-hui-and-thomas-kwok-found-guilty-bribery-hong-kongs-biggest.
[309] Morck et al., *supra* note 4, at 696.
[310] POON, *supra* note 265, at 158–59.

serious problem in Hong Kong. What should be done about it? How should Hong Kong deploy the twin tools of direct regulation of conglomerate size and internal operations and competition law enforcement? Applying competition law to competition-distorting conduct would be uncontroversial. Conglomerates are not being singled out. They are subject to the same regulation as everyone else. What is more controversial is whether direct regulation should be applied. Answering this question entails a three-step inquiry. The first step is whether the particular economy enjoys net benefits from the existence and continual growth of conglomerates. If the answer is yes, conglomerates should be left alone. If the answer is no, then we may ponder what can be done about them. The second step is to come up with appropriate measures to tackle conglomerates. An appropriate measure would be one that is effective without being unduly intrusive. Third, there remains the question of whether any measures that are proposed to be adopted would be feasible given the local political climate. Given the powerful political influence of conglomerates, there needs to be very strong political will to push through these measures and enforce them.

With respect to Hong Kong, the answer to the last two steps clearly point to the negative. Regarding the net benefits of conglomerates, while it seems that none of the advantages of conglomerates have particular salience to Hong Kong anymore, and therefore probably only a modicum of harm would tip the net benefits in the negative, a more rigorous and systematic study would be necessary to draw definitive conclusions. Regarding the appropriateness of the available regulatory tools, the experiences of Japan and South Korea have not been encouraging. The measures that have been adopted in these two jurisdictions are highly prescriptive and hence intrusive, and yet the consensus seems to be that the *chaebols* continue to dominate the South Korean economy. Unless and until better measures can be crafted effectively to restrict the growth of conglomerates, any regulatory decision must be made with caution. Lastly, there is an evident lack of political will to adopt any measures to directly tackle conglomerates in Hong Kong. Despite the widespread dissatisfaction within the public about conglomerate dominance, the ethos of positive non-interventionism is so deeply ingrained in the governance approach in Hong Kong, and the business community has such a stranglehold over the Hong Kong political system, that there is little hope that any of these more intrusive measures would ever be adopted. It took Hong Kong close to twenty years to adopt something as uncontroversial as a general competition law. It would take a major political upheaval for any legislative measures to be taken against the conglomerates.

Having established that Hong Kong should eschew direct regulation of the conglomerates, it remains to be seen what can be done under the recently adopted Competition Ordinance. The fact that options are available under the competition law in other jurisdictions does not mean that they are suitable for or available in Hong Kong. One glaring omission from the Ordinance is merger review. Under Section 4 of Schedule 7 of the Ordinance, merger review is only applicable to the telecom sector.[311] The rest of the economy is not subject to merger review, which means companies in those sectors can merge to monopoly free from regulatory oversight. What makes matters worse is that it is not even possible to challenge a consummated merger under the equivalent of Section 1 and Section 2 of the Sherman Act. Section 4 of Schedule 1 of the Ordinance expressly excludes mergers from the purview of what are known as the first conduct rule (the equivalent of Section 1) and the second conduct rule (the equivalent of Section 2).[312] Therefore, concerns about the loss of potential competition and facilitation of mutual interdependence as a result of a merger cannot be addressed under the Ordinance.

The situation is the same for abuse of a superior bargaining position. The Hong Kong Ordinance does not include any provision on unfair trade practices, which is the basis for regulating the abuse of a superior bargaining position in Japan and South Korea. To the extent the abusive conduct can be said to restrict competition and is perpetrated by a firm with a substantial degree of market power, it may be possible to pursue it under the second conduct rule.[313] However, most of these abuses do not directly harm competition and therefore probably would not meet the requirements of the second conduct rule. In any case, the second conduct rule only applies to firms with a substantial degree of market power, which would greatly limit the reach of the rule in dealing with abuses of superior bargaining position, as a superior bargaining position need not, and in many cases does not, equate market power.

Interlocking directorates seems to be a common problem in Hong Kong. The degree of overlap between the boards of the leading conglomerates seems to be significant.[314] Whether the Competition Ordinance can be applied to interlocking directorates is a different matter. Unlike the Clayton Act, the Ordinance does not contain a section that directly targets interlocking directorates. Therefore, prosecuting interlocking directorates would need to be done under the general provisions. The first conduct rule applies to agreements that restrict competition.[315] The employment contracts

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[311] Competition Ordinance, (2012) Cap. 619, Sch. 7, § 4 (H.K.).

[312] *Id*. at Sch. 1, § 4.

[313] *Id*. at § 21.

[314] Bryane Michael & Say Goo, *Last of the Tai-Pans: Improving the Sustainability of Long-Term Financial Flows by Improving Hong Kong's Corporate Governance*, 16 AIIFL WORKING PAPER 31 (2013).

[315] Competition Ordinance, *supra* note 311, at § 21.

between the director at issue and his or her two companies would certainly count as agreements. Whether these agreements restrict competition would depend on whether potential effect would suffice for the purpose of the rule or whether actual effect must be proven. If actual restrictive effect is required, it is unlikely that the first conduct rule can be successfully applied to interlocking directorates. It would essentially require direct proof that the director at issue passes on competitively sensitive information between the two companies which results in a change of competitive behavior. This would be a rather difficult burden to meet.

As far as mutual interdependence is concerned, if it is expressed in the form of express collusion, the first conduct rule will readily apply to it. Even though there is currently no case law under the Ordinance, there are no signs that the first conduct rule will deviate from the international consensus and apply to tacit collusion, and it certainly would not apply to mutual forbearance. As mentioned in Part 0, entry deterrence from the sheer size of the conglomerate would not be a violation. To the extent deterrence is achieved through other anticompetitive conduct such as predatory pricing or parallel exclusion, the authority can pursue such conduct directly.

Parallel exclusion would be a very helpful enforcement tool against conglomerates in Hong Kong. There has been anecdotal evidence of conduct that is suggestive of parallel exclusion, such as the overbuying of land by some of the conglomerate property developers to deprive smaller developers of supply and the pursuit of predatory pricing by two leading supermarket chains, both of which are conglomerate companies, in response to market entry in 1999.[316] The question is whether it is possible to fit the theory of parallel exclusion into the strictures of the Ordinance. Hemphill and Wu suggest a number of possibilities under U.S. antitrust law, such as shared monopoly, conspiracy to monopolize, Section 5 of the FTC Act, and the aggregation doctrine under Section 1. Unfortunately, none of these would be possible under Hong Kong law. There is no doctrine of conspiracy to monopolize and shared monopoly under the second conduct rule, which explicitly refers to substantial degree of market power by *an* undertaking. Nor is there, at least not yet, an aggregation doctrine under the first conduct rule. There is also no equivalent of the unfair methods of competition prong under Section 5 of the FTC Act. However, all hope is not lost. One saving grace under the second conduct rule is that its market power threshold is much lower than the monopoly power required under Section 2. Although the precise amount of market power required remains to be determined by

[316] Mark Williams, *The Supermarket Sector in China and Hong Kong: A Tale of Two Systems*, 3 COMPETITION L. REV. 251, 265 (2007).

the courts, the expectation is that 30% to 40% would suffice.[317] Therefore, it would be possible for the authority to go after conglomerate companies for parallel exclusion one by one under the second conduct rule.

As discussed earlier, one of the major problems with prosecuting conglomerates for predatory pricing is the difficulty in taking into consideration the possibility of multimarket recoupment. In reality, it would be very difficult to ascertain the quantum of recoupment in markets in which the conglomerate company did not raise price, but merely avoided the prospect of price cutting by an aggressive but now deterred entrant. Thankfully, the Competition Ordinance, as currently interpreted by the Hong Kong Competition Commission (HKCC), allows for some flexibility regarding recoupment. According to Section 5.7 of the *Guidelines* issued by the HKCC on the second conduct rule, the Commission "may, at its discretion, consider the extent to which the predating undertaking is in the longer term able to 'recoup' its short term losses stemming from the below cost pricing."[318] Therefore, at least as interpreted by the HKCC, prospect of recoupment is not a necessary component in a predatory pricing claim, unlike under U.S. antitrust law. This flexibility would allow the HKCC to consider evidence of multimarket recoupment when such evidence is available, but would not require the HKCC to reject a predatory pricing claim simply because successful recoupment cannot be proved. Whether the Competition Tribunal, which adjudicates competition cases brought by the HKCC, will adopt the same position remains to be seen.

There have been many instances of tying reported in the media and in regulatory decisions over the years involving the conglomerates. In particular, most of the ties have involved the sale of property tied with the sale of other ancillary services such as property management services,[319] household broadband services,[320] or even retail services such as supermarkets and pharmacies.[321] With property management services, the modus operandi is usually that the property developer would reserve the right to appoint the

[317] Thomas K. Cheng, *Ready for Action: Looking Ahead to the Implementation of Hong Kong's Competition Ordinance*, 5 J. EUR. COMPETITION L. & PRACTICE 88, 93 (2014).

[318] H.K. COMPETITION COMM'N, GUIDELINE ON THE SECOND CONDUCT RULE 30 (2015), https://www.compcomm.hk/en/legislation_guidance/guidance/second_conduct_rule/files/Guideline_The_Second_Conduct_Rule_Eng.pdf.

[319] Ngai Ming Yip, *Management Rights in Multi-owned Properties in Hong Kong*, *in* Multi-owned Housing: Law, Power and Practice 121 (eds. Sarah Blandy, Ann Depuis & Jennifer Dixon, 2010); Hong Kong Legislative Council, Amendments to Motion on "Improving Property Management and Operation of Owners' Corporations" 2 (March 21, 2013), http://www.legco.gov.hk/yr12-13/english/counmtg/motion/m_papers/cm0327cb3-452-e.pdf.

[320] T 261/03, OFFICE OF TELECOMMS. AUTH., COMPLAINTS ABOUT ARRANGEMENTS FOR THE PROVISION OF TEL. & INTERNET ACCESS SERVS. AT BANYAN GARDEN ESTATE (2003).

[321] Williams, *supra* note 316, at 264.

property management company before the property is sold. Most of the conglomerate property developers in Hong Kong also own a property management company as a subsidiary, and the property manager appointed would almost invariably be the affiliate. In other words, the sale of the property management service would be tied to the sale of residential property. With household broadband services, the famous case was the *Banyan Garden* case, in which the Office of Telecommunications Authority, the previous telecom regulator, received a complaint that residents of Banyan Garden had no choice but to use the broadband service provided by an affiliate of the property developer.[322] In this instance, the sale of household broadband service was tied to the sale of residential property. With retail services, this is particular to one of the conglomerate property developers. It has long been observed that the shopping malls of its residential properties would only have its own affiliate supermarket, pharmacy, and electronics retailer. All of these three markets in Hong Kong are essentially duopolies with a number of small fringe competitors. The chief rivals of the supermarket, pharmacy, and electronics retailer of this conglomerate are almost never seen in its shopping malls. Viewed from a tying perspective, retail services in supermarket, pharmacy, and electronics are tied to the sale of residential property.

The HKCC, in its *Guidelines on the Second Conduct Rule*, essentially follows the prevailing U.S. and EU approaches of requiring: (1) two distinct products, (2) existence of a tie, meaning consumers are coerced to buy the two products together, (3) market power in the tying product market, and (4) anticompetitive foreclosure in the tied product market.[323] There are, however, problems with applying this four-part framework to the tying cases described above. First, it is not entirely clear that the property developer at issue has sufficient market power in the relevant market. It was mentioned earlier that, by some measures, the two leading property developers in Hong Kong have around 30% market share each in the firsthand residential property market. This may turn out to be insufficient for the market share threshold of the second conduct rule. Even if that were sufficient, it is not clear that the relevant market should be confined to firsthand residential property or should be residential property in general. If the relevant market is the latter, the developer's market share is surely much lower than 30%. And there are good arguments that residential property in general should be the relevant market as firsthand and secondhand residential properties seem to be reasonable substitutes in the eyes of the buyers. Therefore, there is likely to be

[322] Thomas K. Cheng, *A Tale of Two Competition Law Regimes—the Telecom-Sector Competition Regulation in Hong Kong and Singapore*, 30 WORLD COMPETITION 501, 522–524 (2007).

[323] GUIDELINE ON THE SECOND CONDUCT RULE, *supra* note 318, at 31–32.

insufficient market power for the purpose of the second conduct rule. Second, at least in the context of retail services, it is not clear that the coercion element is present. Consumers are not forced to purchase property and those retail services from the same conglomerate. They are free to go elsewhere for their grocery shopping, personal care products, or electronics. Consumers tend to visit those stores in their estate's shopping mall because of proximity.

All this may mean that the instances of tying enumerated above may be beyond the reach of the second conduct rule. However, this Author believes that when the value of the tying product and the value of the tied product differ so drastically—USD $2 million for a residential property versus USD $30 a month for household broadband service or USD $50 for groceries—the requirement for market power in the tying product and the coercion requirement become meaningless. The reason for requiring that the seller have market power in the tying product market is to ensure that consumers are truly forced by a lack of reasonable substitutes in the tying product market to purchase the tied product. Otherwise, the tie would inflict no harm as consumers are free to go elsewhere. When the value of tying product dwarves that of the tied product, consumers are simply not going to take the tied product into account when purchasing the tying product, and they are simply not going to switch to another tying product in reaction to the tie even though alternatives are available. In the eyes of the consumers, the tied product is simply too insignificant in the purchase decision for the tying product.

This does not, however, mean that consumers do not care about the lack of choice in household broadband service or property management service once they have purchased the residential property, as evidenced by the consumer complaints that arise after the fact. The fact that consumers were not mindful of the deprivation of choice when they purchased the residential property does not mean that they do not value the choice. It also does not mean that there is no foreclosure effect on competing household broadband service or property management service providers. The main reason that competition law prohibits tying is not because it limits consumer choice, but because it forecloses the tied product market.[324] Given the substantial market share of this property developer (even though it falls short of what it required for the second conduct rule), there is going to be significant foreclosure effect. Competing grocers are effectively foreclosed from 20% to 30% of the market because they are not allowed to rent in shopping malls owned by that developer.[325] The foreclosure effect is particularly significant for property

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[324] HOVENKAMP, *supra* note 242, at §§ 10.6a–b.

[325] And in Hong Kong, geographical proximity to the residences of the shoppers is very important for supermarkets because most residents do not drive to do their grocery shopping. Most of them walk to the nearby supermarkets. And it has been found that most of them would not walk more than 500 meters for groceries. *See* H.K. CONSUMER COUNCIL, GROCERY MKT. STUDY: MKT. POWER OF SUPERMARKET

management services, as it seems that many of the property developers in Hong Kong have the same practice. There is a serious concern of parallel exclusion of rival unaffiliated property management service companies. Therefore, the proposed rule is when there is a huge discrepancy between the value of the tying product and that of the tied product, the market power requirement for the tying product and the coercion requirement should be relaxed.

Against the high public expectations for the recently enacted Competition Ordinance, it seems that it would not be able to tackle the root of the problem, which is the domination of the local economy by conglomerates. In order to do that, Hong Kong may need to consider some more drastic measures, such as what Japan and Korea have in place in their competition laws, which have largely proven to be ineffective and highly intrusive. There is also an absence of the requisite political will to enact such measures. In the end, the citizenry of Hong Kong may have to accept that conglomerate dominance is here to stay and the most that competition law can do is to limit the extent of the damage wrought by the conglomerate's anticompetitive conduct. This is not to say that improvements cannot be made to the current Competition Ordinance. The most obvious one would be to extent merger review beyond the telecom sector to the rest of the economy. That would allow the HKCC to safeguard against the loss of potential competition or the creation of mutual interdependence in conglomerate merger cases. One can also consider the introduction of a provision directly regulating interlocking directorate and the expansion of the second conduct rule to cover parallel exclusion scenarios. And if there is a desire to tackle of exploitative practices, the second conduct rule can be revised to apply to exploitative practices as well as exclusionary practices.

VII. CONCLUSION

The goal of this article is to highlight a competition problem that has been long overlooked by the two leading competition law jurisdictions in the world, the United States and the EU. It presents a two-step framework for determining the correct response to conglomerate dominance in an economy. Given the size of these two continental-scale economies, it is no surprise that no conglomerates dominate these economies. The same cannot be said about small economies and emerging economies, which tend to be less dynamic and more prone to conglomeration. Once conglomerates have emerged and solidified their positions, there are two options available: direct regulation of

CHAINS UNDER SCRUTINY 36 (2013), https://www.consumer.org.hk/ws_en/competition_issues/reports/20131219.html.

their size and internal operations or competition law enforcement against their anticompetitive conduct. The former, which requires an assessment of net benefits of conglomerates, can be said to be a direct challenge to the notion of conglomerates. It is often clumsy and ineffective, not to mention highly intrusive. It is of questionable merit. Therefore, if it is believed that mere regulation of their anticompetitive conduct is insufficient, the first line of defense against conglomerates would seem to be to prevent them from emerging in the first place, i.e., through merger review. However, the kind of conglomerate merger review existing under U.S. and EU law, which focuses on elimination of potential competition and foreclosure effects through tying and reciprocity, would not serve this purpose. To prevent conglomerates from becoming too big that they acquire excessive economic power and political influence, regulation based on size would be necessary. Merger review based on size alone, however, would be fraught with difficulty.

The alternative would be to accept that, just like with abuse of dominance or monopolization—competition law does not regulate dominance or monopoly power, but only the abuse of it—it should equally leave conglomerates and their economic power alone and only regulate instances where there is anticompetitive conduct. Yet there is an important difference between monopoly power and conglomerate economic power. One reason that we do not directly regulate monopoly power is the belief that if left to market forces, monopoly power will eventually be eroded away by new entrants or new products. Monopoly power does not last. In contrast, experience tends to show that conglomerates endure and they are not eroded away by new entrants or new products. Short of catastrophic investment decisions like the ones made by the Daewoo Group in South Korea, conglomerates are unlikely to disappear. Even if one does, many others remain. By virtue of their vastness and multimarket operations, there would need to be simultaneous new entrants or new products in many markets to threaten a conglomerate, which is highly unlikely. Given the durable nature of conglomerates, intervention against their economic power is more justified than intervention against monopoly power. The problem is finding the right approach. Drawing a line based on size would be arbitrary and susceptible to circumvention. Yet there seems to be no better way to prevent the concentration of economic power in small and emerging economies. This is a conundrum that would require further serious thinking.