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2012 Modularization of Korea's Development Experience:

Chaebol Policy for Suppression of Economic Power Concentration

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MINISTRY OF STRATEGY AND FINANCE

INHA UNIVERSITY

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Chaebol Policy for Suppression of Economic Power Concentration

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Prepared by	Inha University
Author	Jinbang Kim, Inha University, Professor
Advisory	JeongPyo Choi, Konkook University, Professor
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Preface

The study of Korea's economic and social transformation offers a unique opportunity to better understand the factors that drive development. Within one generation, Korea has transformed itself from a poor agrarian society to a modern industrial nation, a feat never seen before. What makes Korea's experience so unique is that its rapid economic development was relatively broad-based, meaning that the fruits of Korea's rapid growth were shared by many. The challenge of course is unlocking the secrets behind Korea's rapid and broad-based development, which can offer invaluable insights and lessons and knowledge that can be shared with the rest of the international community.

Recognizing this, the Korean Ministry of Strategy and Finance (MOSF) and the Korea Development Institute (KDI) launched the Knowledge Sharing Program (KSP) in 2004 to share Korea's development experience and to assist its developing country partners. The body of work presented in this volume is part of a greater initiative launched in 2010 to systematically research and document Korea's development experience and to deliver standardized content as case studies. The goal of this undertaking is to offer a deeper and wider understanding of Korea's development experience with the hope that Korea's past can offer lessons for developing countries in search of sustainable and broad-based development. This is a continuation of a multi-year undertaking to study and document Korea's development experience, and it builds on the 40 case studies completed in 2011. Here, we present 41 new studies that explore various development-oriented themes such as industrialization, energy, human resource development, government administration, Information and Communication Technology (ICT), agricultural development, land development, and environment.

In presenting these new studies, I would like to take this opportunity to express my gratitude to all those involved in this great undertaking. It was through their hard work and commitment that made this possible. Foremost, I would like to thank the Ministry of Strategy and Finance for their encouragement and full support of this project. I especially would like to thank the KSP Executive Committee, composed of related ministries/departments, and the various Korean research institutes, for their involvement and the invaluable role they played in bringing this project together. I would also like to thank all the former public officials and senior practitioners for lending their time, keen insights and expertise in preparation of the case studies.

Indeed, the successful completion of the case studies was made possible by the dedication of the researchers from the public sector and academia involved in conducting the studies, which I believe will go a long way in advancing knowledge on not only Korea's own development but also development in general. Lastly, I would like to express my gratitude to Professor Joon-Kyung Kim and Professor Dong-Young Kim for his stewardship of this enterprise, and to the Development Research Team for their hard work and dedication in successfully managing and completing this project.

As always, the views and opinions expressed by the authors in the body of work presented here do not necessary represent those of the KDI School of Public Policy and Management.

May 2013

Joohoon Kim

Acting President

KDI School of Public Policy and Management

Contents | LIST OF CHAPTERS

Summary 12

Chapter 1

Introduction 19

Chapter 2

Early Perceptions, Measurements, and Policy Measures 23

1. Chaebol and the Concentration of Economic Power 24
2. Measurements of Economic Power Concentration 27
    2.1. Aggregate Concentration 27
    2.2. Ownership Concentration 32
3. Policy Measures against Economic Power Concentration 35
    3.1. Promotion of Ownership Dispersion 35
    3.2. Credit Management System 37

Chapter 3

Five Measures Put in the Fair Trade Act 43

1. Background 44
2. Designation of Big Business Groups 48
   2.1. Scope of Business Groups 48
   2.2. Criterion for Bigness of Business Groups 49
3. Ceiling on the Total Amount of Shareholding: Phase One, 1987-1995 52
   3.1. Details of the Regulation 52
   3.2. Accomplishments in the First Five Years 55
4. Ceiling on the Total Amount of Shareholding: Phase Two, 1995-2009 58
   4.1. Twists and Turns 58
   4.2. Ups and Downs 62
   4.3. Spurious Impacts and Counterfactual Conjectures 66
   4.4. Implication for Policymakers 71
5. Prohibition of Reciprocal Shareholding 72
   5.1. Earlier Enactments 72
   5.2. Details and Variations 74
   5.3. Accomplishments in the First Three Years 76
   5.4. Not Reciprocal but Circular 77
   5.5. Implication for Policy Makers 78

6. Restrictions on the Voting Rights of Financial Companies 79
6.1. Financial Companies and Economic Power Concentration 79
6.2. Significance of the Restriction 82
6.3. Partial Restoration after Elimination 83
6.4. Implication for Policy Makers 84
7. Ban on Holding Companies 86
7.1. Holding Companies Defined and Banned 86
7.2. Intentions and Actualities 88
7.3. From Ban to Regulations 91
7.4. Rising Number of Holding Companies and the Significance 93
7.5. Implication for Policy Makers 95
8. Limitation on Debt Guarantees 96
8.1. Introduction and Reinforcement 96
8.2. Range of Application 97
8.3. Mission to Accomplish 97
8.4. Implication for Policy Makers 98

Chapter 4

Concluding Remarks 101

References 104

Appendix 106

Contents | LIST OF TABLES

Chapter 2

Table 2-1 Sales of Chaebol Groups as percent of GNP, 1974-1985 28
Table 2-2 Added Value of Chaebol Groups as percent of GDP, 1973-1978 29
Table 2-3 Added Value and Share of Chaebol Groups in Manufacturing, 1973-1978 30
Table 2-4 Share of Chaebol Groups in Manufacturing, 1977-1982 30
Table 2-5 Share of Chaebol Groups in Non-financial Sector, 1983-1989 31
Table 2-6 Herfindahl Index for Chaebol Groups in Non-financial Sector, 1983-1989 32
Table 2-7 Inside Shareholding of Listed Companies, 1976-1983 34
Table 2-8 Inside Shareholding of Thirty Largest Chaebol Groups, 1983-1991 34

Chapter 3

Table 3-1 Scope of Big Business Groups, 1987-1992 50
Table 3-2 Inside Shareholding of Top Business Groups, 1987-1995 55
Table 3-3 Major Changes in the Ceiling on the Total Amount of Equity Investment, 1987-2007 61
Table 3-4 Inside Shareholding of Top Business Groups, 1995-2005 68
Table 3-5 Business Groups Subject to the Equity Investment Regulation, 1995-2004 68
Table 3-6 Reciprocal Shareholding of Big Business Groups, 1987-2002 76
Table 3-7 Chaebol Groups Transformed to Holding Company System 94
Table 3-8 Voting Rights Before and After Conversion to Holding Company 94
Table 3-9 Debt Guarantees of Business Groups Subject to Limitation, 1993-2000 99

Contents | LIST OF FIGURES

Chapter 2

Figure 2-1 Number of Listed Companies and Distribution of Shares 37
Figure 2-2 External Sources of Corporate Funds 38
Figure 2-3 Ratio of Loans to Equity for Large, Medium, and Small Companies 40

Chapter 3

Figure 3-1 Pyramiding of Samsung as of 1997 89
Figure 3-2 Pyramiding of Hanwha as of 1997 90

Contents | LIST OF BOXES

Chapter 2

Box 2-1 Herfindahl Index ········ 32

Chapter 3

Box 3-1 The Fair Trade Act and Economic Power Concentration ········ 45
Box 3-2 The Falling Ratio of Equity Investment ········ 54
Box 3-3 Mandatory Tender System ········ 64
Box 3-4 Equity Investment of Holding Companies and their Subsidiaries ········ 67
Box 3-5 Cross Shareholding or Reciprocal Shareholding ········ 74

Summary

The Korean word ‘chaebol’ literally means a group of individuals related by blood, who have accumulated massive wealth. Yet the word is commonly used to refer to a business group consisting of numerous big companies, owned and controlled by a person or family.

A chaebol family typically owns a large portion of shares in only one or two core companies, but its control power can reach a large number of companies. One of the means for chaebols to achieve this is to acquire a so-called equity investment in affiliated companies. Given a high ratio of inside shareholding in affiliated companies, the chaebol owner exercises exclusive control rights over them.

The number of chaebols grew rapidly in the 1960s and 1970s. Their rapid growth resulted largely from the government’s policy for economic growth. Chaebols were taken as partners by the government in implementing the Five Year Economic Development Plans. The government designated a few industries to develop, and a few companies to enter each of the industries. In addition to the protection from domestic and foreign competition, the designated companies were provided with loans at preferential interest rates through state-owned banks. The designated companies could also borrow from foreign investors, thanks to the state-owned banks’ guarantees of repayment. A company was more likely to be designated and reap the benefit of privilege, if it belonged to one of the top chaebols.

The top chaebols kept growing much faster than the national economy in the 1980s, further raising their share in the national economy. People were ambivalent to the fast growth of chaebols. Their growth led the growth of the national economy, which was praised. Their growth also resulted in unprivileged and retarded sectors, which was deplored. The voice of discontent had gotten louder since the late 1970s, and the government took measures against the disproportionate growth between the chaebol sector and others.

“Prevention of excessive concentration of economic power” had been an aim of the government before the phrase was put in the first article of the Fair Trade Act in December 1980. Induced or enforced public offerings were one of the earlier anti-concentration measures. The Credit Management System was another, and continued to be used in the 1980s.

When the Fair Trade Act was promulgated in December 1980, the Act included no particular measures against economic power concentration. Four such measures were enacted through amendments in December 1986, with another measure coming in December 1996. The five anti-concentration measures were called Ban on Holding Companies, Prohibition of Reciprocal Shareholding, Ceiling on the Total Amount of Shareholding, Restriction on the Voting Rights of Financial or Insurance Companies, and Limitation on Debt Guarantees. In order to implement these measures, the Fair Trade Committee designated Big Business Groups according to the Presidential Decree.

Not all the anti-concentration measures have accomplished their objectives. First, the ceiling on the total amount of equity investment was reinforced only to be lifted before the reinforcement became enforced in 1998. Although the equity investment regulation was recalled in less than two years, it was relaxed with a long list of exceptions and exclusions. Second, the prohibition of reciprocal shareholding was inapplicable to its nearly perfect substitute, namely, circular shareholding. The amount of circular shareholding increased in a few chaebols around 2000. Third, holding companies had not been a favorite of chaebols when the ban on holding companies was enacted. The ban, however, could have been significant when it was lifted in 1999. A number of chaebol groups transformed themselves to a holding company system, significantly increasing the voting rights of chaebol owners. Fourth, the restriction on the voting rights of financial or insurance companies was practically removed in 2002, although the restriction was partially restored later. Only the limitation on debt guarantees has accomplished its mission. Chaebol companies stopped giving debt guarantees to their affiliated companies before 2001.

In sum, four of the five anti-concentration measures were abolished, relaxed, or evaded after the economic crisis of 1997. It was not that the concentration of economic power had been prevented or suppressed, but rather the contrary. The share of top chaebol groups in the national economy rose again a few years after the economic crisis. In fact, the government abolished or relaxed the anti-concentration measures to attain other aims, and never seemed all that interested in the suppression of economic power concentration.

Although the suppression of economic power concentration was still in the list of its goals, the government had to prioritize. Any anti-concentration measure was relaxed or abolished, if it was seemingly or arguably obstructive to such aims as “facilitation of corporate

restructuring," "promotion of corporate investment," and "protection of incumbent control rights." Of these three aims, the last one was particularly incompatible with the aim of the anti-concentration measures. Nonetheless, the government attempted to attain both aims by adjusting the details of the anti-concentration measures, a truly challenging effort.

Ambivalence is inevitable in policymaking. It is easier said than done that no policy should be designed to attain two or more conflicting aims by one measure. The chaebol policy of Korea makes an excellent case in this regard.

The main body of this report consists of two chapters, one being much longer than the other. Chapter 2 briefly reviews two anti-concentration measures, after looking into the people's perception on chaebols and various measurements of economic concentration before the mid-1980s. Chapter 3 explicates and evaluates the five anti-concentration measures enacted through the amendment of the Fair Trade Act in December 1986.

Earlier Anti-Concentration Measures

In May 1973, the President issued "Five Special Orders on Firms' Public Offerings and Corporate Culture." The President's Special Order was preceded by two pieces of legislation, which yielded the Capital Market Promotion Act in November 1968 and the Initial Public Offering Inducement Act in December 1972. They were intended to promote the ownership dispersion of chaebol companies through which the people at large would share the benefits of economic growth with chaebol owners. Various incentives were offered for the objective, including tax benefits for listed companies and their shareholders. In addition, the Minister of Finance was given the power to review target firms and select qualified firms to go public. The Minister of Finance could ask financial institutions to limit their lending and other assistance measures to non-complying firms.

Although some firms refused to go public, the government's effort was deemed a success. The number of listed firms and the amount of paid-in capital increased significantly in the late 1970s. The shares owned by those with less than one thousand shares, however, rarely exceeded 5 percent until 1986. In comparison, the shares owned by those with more than one hundred thousand shares never fell below 50 percent. Given this distribution of shares, one can hardly state that there had been a big advance in ownership dispersion.

Possibly more significant was the measure called the Credit Management System. When it was devised in July 1974, it took the form of agreement by which all the financial intermediaries should abide. Yet the Bank Supervisory Board determined both the direction and the details. Its unit of application was not an individual company but a group of companies under control of a same person, and its target of application included those

chaebol groups with the combined amount of loans exceeding 5 billion won. All the target groups were sorted into two categories, according to their consolidated ratio of loans to equity. A target group was detrimentally labeled "A" if its ratio turned out to be higher than 400 percent. Further credit offering was disallowed to any company belonging to a group labeled "A." In addition, it had to work out a three-year plan for financial structure improvement, which could include requirement to sell affiliated companies or non-business purpose properties.

The Credit Management System attained legal ground when the Agreement on Credit Management of Main Banks was replaced with the Detailed Rules for Credit Management of Financial Institutions in July 1984. More importantly, the Detailed Rules focused more on "suppression of disproportionate loans and credit," one of its two declared objectives.

Various data could be collected to illustrate accomplishments of the Credit Management System. For instance, the ratio of bank loans to sales has fallen rather rapidly in large companies since 1976. One can thus conclude that the Credit Management System had the intended effect, insofar as the allocation of bank loans is concerned. However, in Korea, a disproportionate allocation of bank loans stopped being a necessary condition for the concentration of economic power. Despite the reduced share of chaebol groups in bank loans, they have succeeded in increasing their share in the national economy, while sustaining substantial ownership.

Anti-Concentration Measures Put in the Fair Trade Act

In December 1986, the Fair Trade Act was amended to enact four measures for "suppression of economic power concentration." The phrase became a part of the title for Chapter 3 of the Act. Another measure was put in the Act in December 1992.

Among the five anti-concentration measures, Ceiling on the Total Amount of Shareholding could have been the most significant. It prohibited any company belonging to a Big Business Group from acquiring or owning stocks of other domestic companies in excess of its Ceiling Amount. A company's Ceiling Amount depended on its Net Assets Amount, the former's ratio to the latter being 40 percent. The ratio was lowered to 25 percent as of April 1995 with a three-year grace period. A chaebol group has only two ways of lowering its ratio of equity investment. It has either to lower its ratio of inside shareholding, or to reduce its amount of equity capital. Either way, the chaebol owner's economic power will shrink as a result. If the equity investment regulation had yielded a poor result, it would have been due to the long list of exceptions and exclusions. In fact, the list continued to grow after the regulation was recalled in December 1999.

While the *amount* of inter-company shareholding was regulated by the Ceiling, the *structure* of inter-company shareholding was regulated by the Prohibition of Reciprocal Shareholding. The latter, however, had a loophole. The prohibition was not extended to a nearly perfect substitute of reciprocal shareholding, namely, circular shareholding. The difference between them exists only in the number of companies involved. Both of them help to make up the "fictional capital," and to enhance the control power of chaebol owners. The amount of circular shareholding increased in a few chaebol groups by around 2000.

Financial or insurance companies raise a huge amount of funds in various forms. They could thus be an ideal means for chaebol owners to enhance their economic power. Nonetheless, financial companies and insurance companies were excluded from application of the Ceiling on the Total Amount of Shareholding. The government opted for the Restriction on the Voting Rights instead. A financial or insurance company might still acquire and own stocks of affiliated companies, but it was prohibited from exercising its voting rights in those stocks. The restriction, however, was practically removed in 2002; a financial or insurance company might exercise up to 30 percent of the voting rights on any of the critical matters in the general meeting. The reason cited for this removal was the threat of hostile takeovers from foreigner investors. The restriction then was partially restored; the upper limit of voting rights was lowered to 15 percent as of April 2008. The reason cited for this restoration was the excessive expansion of chaebol groups via financial or insurance companies.

Holding companies could also be a convenient means for chaebol owners to strengthen their economic power. The Ban on Holding Companies was another anti-concentration measure enacted in December 1986. The ban, however, was lifted as of April 1999. The ban was replaced with some regulations on their shareholding and financing, but the regulations were relaxed further at a later time. The argument was that a holding company should facilitate "corporate restructuring." Compared to the current ownership structure of chaebol groups, a simpler structure of inter-company shareholding was cited as another merit of the holding company system. Quite a few chaebol groups transformed themselves to adopt a holding company system in the 2000s, and the chaebol owners' control power grew significantly stronger.

The member companies of a chaebol group could borrow more with better terms from banks and non-bank financial institutions, by giving debt guarantees to each other. That is what happened in the 1970s and 1980s in Korea, and what the Limitation on Debt Guarantees was intended to change. Enacted in 1996 through the amendment of the Fair Trade Act, the regulation has been reinforced twice thereafter. Before the last reinforcement in 1998, any company belonging to a Big Business Group was prohibited from giving debt guarantees to its affiliated companies in excess of a certain amount. Currently, the prohibition applies to

any amount of debt guarantees, with a few exceptions. This regulation was relatively better accepted by chaebol companies, and achieved visible results.

Chapter 1

Introduction

Introduction

The word 'chaebol' is a romanization of the Korean word '재벌,' or the Chinese characters '財閥'. The same characters are pronounced 'zaibatsu' (ざいばつ) in Japanese. Read as chaebol or zaibatsu, the pair of Chinese characters literally means a group of blood-related persons who have accumulated massive wealth. Yet the word is commonly used to refer to a business group, consisting of numerous companies owned and controlled by a person or family. Such a business group is likely to be highly diversified; each constituent company engages in quite a different sort of business from the others. The word chaebol or zaibatsu, therefore, may be said to connote a large size and diversification of business groups, as well as concentrated ownership and family control. Collusion between business and politics is another connotation of the word, since it was a key factor for emergence of such business groups in both Korea and Japan.

There had existed a number of business groups called zaibatsu in Japan, but the bigger ones were broken up by decision of the Allied Forces after World War II. In particular, those stocks owned by holding companies and controlling families were confiscated, and sold in pieces to the general public. This led to the so-called zaibatsu resolution, since a zaibatsu group had normally consisted of a family-owned holding company and its subsidiaries. The Allied Forces then had the Japanese government enact a few measures to prevent "excessive concentration of economic power." The ban on holding companies was one such measure. Apparently, the Allied Forces suspected that the resurrection of zaibatsu groups should bring back the excessive concentration of economic power in Japan.

In Korea, chaebols have been prominent for a half-century or so. Relating them to "economic power concentration," however, is a relatively recent view. Other aspects of chaebols seem to have drawn more attention of the public and press in the earlier years. One such aspect is the irregularities in relation between chaebols and political power. In August

1958, for instance, a Korean newspaper carried an article titled “Collusion of Emerging Chaebols and Political Power.”

The number of chaebols grew rapidly in the 1960s and 1970s. Their rapid growth resulted largely from the government’s policy for economic growth. Chaebols were taken as partners by the government in implementing the Five Year Economic Development Plans. The government designated a few industries to develop, and a few companies to enter each of the industries. In addition to protection from domestic and foreign competition, the designated companies were provided with loans at preferential interest rates through state-owned banks. The designated companies could also borrow from foreign investors, thanks to the state-owned banks’ guarantees of repayment. A company was more likely to be designated and reap the benefit of various privileges if it belonged to one of the top chaebols.

People were ambivalent to the rapid growth of chaebols. Their growth led the growth of the national economy, which was praised. Their growth also accompanied unprivileged and retarded sectors, which was deplored. The voice of discontent got louder, and the government took measures against the disproportionate relationship between the chaebol sector and others.

Four measures for “suppression of economic power concentration” were put in the Fair Trade Act in December 1986, with another initiative introduced a few years later. The present survey shall explicate the details and ensuing variations of the five measures, before evaluating them for implications (Chapter 3). The five measures were preceded and paralleled by other anti-concentration measures. The present survey shall briefly deal with two such measures, after looking into the people’s perception of chaebols and various measurements of economic concentration (Chapter 2). The two chapters are followed by final chapter, which concludes with abbreviated remarks (Chapter 4).

Here are a few words of explanation about the terms to be used below. It has been noted above that the term chaebol may refer to either of two distinguishable entities. This disambiguation is convenient in some cases, but when it is not, ‘chaebol group’ or ‘chaebol owner’ will be used instead. The former refers to a group of companies under control of a same person or family, and the latter refers to the controlling person or family. ‘Chaebol company’ is also used if necessary. Of course, it refers to a constituent company of a chaebol group. ‘Business group,’ ‘controlling shareholder’ and ‘affiliated company’ may be more appropriate terms to use in some cases. As explained below, ‘business group’ and ‘group of affiliated companies’ are the translation of two official terms.

Chapter 2

Early Perceptions, Measurements, and Policy Measures

1. Chaebol and the Concentration of Economic Power

2. Measurements of Economic Power Concentration

3. Policy Measures against Economic Power Concentration

Early Perceptions, Measurements, and Policy Measures

1. Chaebol and the Concentration of Economic Power

In Korea, a large number of big companies are under exclusive control of a few individuals called chaebol, who own a major portion of shares in a small number of core companies. Two issues are to be raised about this system. One concerns the disparity between ownership and control; many a company is under exclusive control of a person or family who owns few or no shares in it. This disparity leads to the so-called agency problem. The controlling minority shareholder is likely to pursue his or her private interest at the cost of the company and other shareholders. It is said that the agency problem of this kind can be resolved through good corporate governance. The government-led "chaebol reform" thus focused on the accountability and transparency of management after the economic crisis of 1997. The Commercial Act, for instance, was amended to make it easier for small shareholders to file suits against directors. The Securities and Exchange Act was amended to ensure that outside directors represent at least a quarter of the board of directors. The corporate disclosure rules were upgraded and the penalties for violation were strengthened. The government also proceeded to introduce such institutions as cumulative vote and class action suit.

Prior to the 1980s, the agency problem due to the ownership-control disparity was not quite the major issue raised by the people pertaining to chaebols. People were more concerned with the economic power concentration. A large number of big companies had been under exclusive control of a few individuals. The economic power concentrated in their hands was exerted in other areas of society as well. The concentration of economic power was seen a serious problem for the nation. It is this problem that the chaebol policy of Korea was primarily designated to resolve in the 1980s.

The issue of economic power concentration, however, had not been seriously raised in Korea until the mid-1970s. Other issues had attracted more attention of the public and press. The inappropriate relation between business and politics was one such issue. In Korea, the collusion between business and politics had been a key factor for the emergence of chaebols. They took advantage of the privatization of state-reverted properties after liberation from Japan's colonial rule in 1945, and the establishment of the Korean government headed by Syngman Rhee in 1948. Foreign aid materials were another source of 'primitive accumulation' for chaebols during this period. Chaebols then seized opportunities for rapid growth in government contracts for reconstruction, after the Korean War between 1950 and 1953. Those opportunities were usually accompanied by import licenses and allotments of scarce foreign exchange. Preferential access to bank loans was another privilege they enjoyed. It is, therefore, reasonable to suspect that the chaebol owners and political leaders colluded to exchange favors and kickbacks between them. This suspicion evolved towards a movement to punish "illicit fortune amassers" after Rhee's government was overthrown by a student revolution in 1960. Established through a military coup in 1961, Park's interim government took over the tasks of punishment and arrested a dozen chaebol leaders. In some cases, they had to give up a few companies and banks, to be released and condoned.

It has been implied above that chaebols were seldom viewed in relation to economic power concentration in the early period of liberated Korea. In other words, neither the size of chaebol groups nor their ownership structure was quite an issue in the 1950s. This seems to have been the case in the 1960s as well. Although the phrase 'economic power concentration' appeared in various newspaper articles printed in the 1960s, few of those articles used the phrase jointly with the term chaebol.[1] In fact, the phrase was not the right one for their subject matter. More appropriately and frequently used was the phrase 'monopoly and oligopoly,' which were blamed for high prices. This issue was raised particularly in reaction to the price-fixing by monopolistic producers, which a lawmaker from the opposition party exposed in 1964.[2] This incident led the government to consider an enactment for fair trade and competitive market,[3] which was not realized for more than a decade. Instead, the government opted for direct price control.[4]

1. An exceptional example is an article in KyunghyangShinmun of March 5, 1963. The author alternately used the two terms, 'economic power concentration' and 'chaebol,' relating them to the protection and favor of political power.
2. Their price-fixing was called the Three Powder Scandal. Three Powder referred to sugar, flour, and cement.
3. A draft of Fair Trade Act was prepared in 1964, and a revised draft was submitted to the National Assembly in 1966.
4. The Price Stabilization and Fair Trade Act passed the National Assembly in December 1975 and the Price Stabilization Committee was founded in accordance to the Act.

It is around the mid-1970s that the issue of economic power concentration began to draw the attention of the public and press. In 1974, for instance, a college professor reportedly referred to the "evils of the Japanese zaibatsu," while expressing his concern with the "excessive concentration of economic power into big business groups under family control" in Korea (DongAIlbo, May 29, 1974). He also argued for the necessity of further policy measures to promote public offering and dispersed ownership of big companies. The size of chaebol groups, however, was not quite an issue at the time. It was the ownership concentration that people primarily protested, and that the government wanted to ease. 'Selection and concentration' had been the government's strategy for economic growth in 1970s, and a few selected companies had grown rapidly with national support and protection at the expense of people. People then demanded the government to divide up the benefits as well as the cost. The government responded to this demand by promoting the dispersion of ownership in big companies through public offerings.[5]

The size of chaebol groups seems to have once been a major issue in the early 1980s. When the Korea Development Institute (KDI) released a researcher's report on the issue in April 1980,[6] many a newspaper article cited it in length. Covering the years from 1973 to 1978, the report estimated the total value added of top chaebol groups, and compared the amount with the GNP to compute an index of "macro-concentration" as a measurement of economic power concentration.[7] The report then evaluated the degree and trend of economic power concentration, before proposing a few policy measures, including regulations for fair trade and competition. The proposal, however, did not refer to any measures that would help directly to suppress the macro-concentration or economic power concentration by business groups. This was equally the case for those newspaper articles citing the report. Nonetheless, it is noteworthy that the report differentiated between market concentration and "macro-concentration," before taking the latter to be a proper measurement of economic power concentration. The same measurement is more often called an aggregate concentration.

The phrase 'economic power concentration' got an official status as the Monopoly Regulation and Fair Trade Act (MRFTA) passed through the National Assembly in December 1980. It was declared in the first article that the Act purports to "prevent excessive economic power concentration" among others. Yet the Act of December 1980 did not contain any articles concerning business groups. It is through the amendment of December 1986 that a few anti-concentration measures were enacted, and the title of Chapter 3 was extended to

5. The government had been urging big companies to go public before the Initial Public Offering Promotion Act was enacted in 1973. Nonetheless, many a big company opted to remain unlisted, and the President issued a 'special direction' for public offering in May 1974.

6. The Korea Development Institute had been established and funded by the government.

7. Sa Kong (1980) is a published version of the report.

include the phrase "Suppression of Economic Power Concentration."[8] This amendment was preceded by renewed recognition as to the problem of aggregate concentration in 1983 and later. We can find a number of newspaper articles and columns dealing with the problem, in terms of the bigness of business groups and their concentrated ownership. To quote from one of them (Maeil Kyungje Shinmun, September 7, 1984), "the chaebol are criticized not just because a few of them are oversized, but because they are owned and controlled by a few persons."

'Octopus tentacle' expansion was another issue that attracted attention of the public and press in the 1980s. In Korea, the term had been used to refer to the chaebols groups' reckless advance into diverse segments of industry, through the establishment of new companies or acquisition of other companies.[9] One may thus consider specialization as the opposite of an octopus tentacle expansion in this sense, and propose the former for the sake of economic efficiency and stability. The term had another connotation, which has more to do with economic power concentration than the one above had. That is, the term also referred to the chaebol groups' ruthless invasion into those scopes of business in which small and medium enterprises (SMEs) had been engaged. One may thus argue for protection or promotion of SMEs, while citing the chaebol groups' octopus tentacle expansion. It is hard to tell which was more relevant in the 1980s. Yet it is a fact that the term appeared a lot more often in newspapers around 1984, than before.

To sum, economic power concentration has been a matter of big business groups under control of a person or family in Korea. It has thus comprised of two sorts of concentration, namely, ownership concentration and aggregate concentration. The latter has usually accompanied a diversified business structure with numerous affiliates. It is these three aspects of economic power concentration that has led the government to design various measures to be applied to the chaebol groups.

2. Measurements of Economic Power Concentration

2.1. Aggregate Concentration

There exist few official statistics regarding the aggregate concentration in Korea before 1987. Currently available are scant statistics on the shares of top companies in a few industries. As for the shares of top chaebol groups during the early years, statistics ought to be constructed from scattered data. The situation was worse in the 1980s and prior. In his

8. The official translation of the phrase is "Repression of Economic Power Concentration."

9. One of the earliest uses of the term is to be found in the Dong-A Ilbo of November 25, 1975.

study on the issue of aggregate concentration relative to top chaebol groups, Cho (1982) accounted for his failure to obtain data on sales or profits of many an affiliated company.[10] His study, therefore, had only to rely on data including total assets, fixed liabilities, equity capital, and employment. In comparison, Kim (1987) computed the combined sales of top chaebol groups, based on "sales figures individually collected from each group and its affiliated companies by the author."<Table 2-1> reproduces part of the constructed statistics. Comparing the combined sales of top ten chaebol groups to the GNP in the table, we can see that their ratio had already doubled during the five year period between 1975 and 1980, before increasing more rapidly in the next six years until 1985. One does not have to trouble constructing these statistics for 1987 or later, because the Fair Trade Commission (FTC) has been releasing them.

Table 2-1 | Sales of Chaebol Groups as percent of GNP, 1974-1985

(Unit: %)

	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985
Top 5	11.6	12.8	14.5	19.8	22.9	24.6	35.0	41.3	42.2	46.7	52.4	65.6
Top 10	15.1	17.1	19.8	26.0	30.1	32.8	48.1	55.7	57.6	62.4	67.4	79.9
Top 20	-	26.1	-	-	-	-	61.0	-	-	76.9	81.8	93.0
Top 30	-	31.0	-	-	-	-	67.8	-	-	85.3	89.1	100.0
Top 40	-	34.0	-	-	-	-	72.3	-	-	90.3	94.1	104.7

Source: Kim, Seok Ki (1987)

As we shall see it in the following chapter, the MRFTA obligated a certain number of top chaebol groups to submit a detailed report on their financial status and inside shareholding to the FTC, when the Act was amended in December 1986. This reporting obligation was part of enforcement measures for "suppression of economic power concentration," a phrase added to the title of Chapter 3 through the amendment in December 1986. Given the reports of chaebol groups, the FTC has been releasing a few aggregate statistics such as combined sales, total asset amount, number of affiliates, and inside shareholding ratios for each chaebol group.

Again, it was not until 1987 that top chaebol groups were legally identified and obligated to report on their affiliates. Nonetheless, one would find it strange if no statistics had been produced on the aggregate concentration, in terms of top chaebol groups before 1987, which

10. Cho (1982) obtained the list of affiliated companies and other data for each of top thirty-four chaebol groups in publications of the Korea Chamber of Commerce and Industry and the Korea Listed Companies Association.

is not the case. In fact, measurements had preceded enactment of the anti-concentration measures by several years. Measurements seem to have preceded public perceptions as well, insofar as the issue of aggregate concentration is concerned.

One of the earliest reports on the issue of aggregate concentration via chaebol groups was released and briefed to the press in April 1980. Its author was a researcher at the Korea Development Institute, an institute established and sponsored by the government. Covering the six years from 1973 to 1978, the author primarily measured the aggregate concentration by estimating the total amount of added value of top chaebol groups, and comparing the estimates to the GDP for each year.[11] <Table 2-2> is a partial reconstruction of one of his tables. As the table shows, the top-ten chaebol groups accounted for 5.1 percent of GDP in 1973.[12] The ratio then rose to 10.9 percent in 1978, more than doubling in five years.[13] In other words, the top-ten chaebol groups had grown 2.8 times as fast as the national economy during this time period. Perhaps a more appropriate measurement could be obtained by delimiting it to the manufacturing sector; <Table 2-3> shows that the top ten chaebol groups accounted for as much as 23.4 percent of the manufacturing sector in 1978. This share is 1.68 times as large as that of 1973.

Table 2-2 | Added Value of Chaebol Groups as percent of GDP, 1973-1978

(Unit: %)

	1973(A)	1974	1975	1976	1977	1978(B)	B/A
Top 5	3.5	3.8	4.7	5.1	8.2	8.1	2.31
Top 10	5.1	5.6	7.1	7.2	10.6	10.9	2.14
Top 20	7.1	7.8	9.7	9.4	13.3	14.0	1.97
Top 46	9.8	10.3	12.3	12.3	16.3	17.1	1.74

Source: SaKong, Il (1980)

11. The author applied a formula to compute a company's added value based on its net income and total sales. See Sa Kong (1980).
12. The ratio underestimates the share of top chaebol groups since the author failed to include a number of smaller affiliates. A firm's 'value added' includes its labor costs and depreciation costs, as well as profits and interests. The GNP is measured by adding up all the firms' and other agents' value added.
13. The author seems to have selected the top chaebol groups based on their added value as of 1973 although he failed to explicate it. This being the case, a sort of self-selection problem arises in measurement and the ratio of increase in those chaebol groups' share is likely to be an overestimation.

Table 2-3 | Added Value and Share of Chaebol Groups in Manufacturing, 1973-1978

(Unit: billion won, %)

	1973(A)	1975	1978(B)	B/A
Top 5	98 (8.8)	262 (12.6)	895 (18.4)	9.15 (2.09)
Top 10	154 (13.9)	391 (18.9)	1,141 (23.4)	7.38 (1.68)
Top 20	242 (21.8)	600 (28.9)	1,619 (33.2)	6.69 (1.52)
Top 46	354 (31.8)	757 (36.5)	2,093 (43.0)	5.92 (1.35)
Whole Sector	1,591	2,075	3,511	2.21

1) Figures in parentheses denote the shares as percent for each year and their ratio of increase
Source: Sa Kong, Il (1980)

Table 2-4 | Share of Chaebol Groups in Manufacturing, 1977-1982

(Unit: %)

	Sales					Employment				
	1977(A)	1980	1981	1982(B)	B/A	1977(A)	1980	1981	1982(B)	B/A
Top 5	15.7	16.9	21.5	22.6	1.44	9.1	9.1	8.9	8.4	0.92
Top 10	21.2	23.8	28.4	30.2	1.42	12.5	12.8	12.8	12.2	0.98
Top 20	29.3	31.4	35.3	36.0	1.23	17.4	17.9	17.0	16.0	0.92
Top 30	34.1	36.0	39.7	40.7	1.19	20.5	22.4	20.8	18.6	0.91

Source: Lee, KyuUck and Lee, Sung-Soon (1985)

The degree and trend of aggregate concentration seems to have been a subject of continued research at the KDI, and relevant statistics were provided at the request of any member from the National Assembly. Then a new report was presented with more recent statistics in April 1983 (DongAIlbo, April 15, 1983). In addition to the share of top chaebol groups in manufacturing in terms of added value, it measured those shares in terms of sales and employment as well. These share statistics were included with more recent ones in another report released in June 1984 (Maeil Kyungje Shinmun, June 7, 1984; DongAIlbo, June 8, 1984).[14] Covering the years from 1977 to 1982, the author added up the sales of top chaebol groups to compute their share in the manufacturing sector for each year. The author computed their share in terms of employment as well. <Table 2-4> is a partial reconstruction of the author's table, which was reproduced in a joint work. Focusing on its columns for

14. The report was submitted without the author's name on it (interview with the author named KyuUck Lee).

sales, we find that the top ten chaebol groups had accounted for as much as 30.2 percent of the manufacturing sector in 1982. This share is 1.42 times as large as that of 1977. We can compare this ratio of increase to that which has been computed in <Table 2-3> for added values in 1973 and 1978.

In 1985 the government proceeded to enact several measures for "suppression of economic power concentration" through amendment of the MRFTA. Before the final bill of amendment was submitted to the National Assembly in December 1986, the shares of top chaebol groups was measured for 1983 as well. These share statistics were cited in those newspaper articles and columns favoring enactment. To quote from one of them (Dong-AIlbo, March 28, 1986): "Further concentration of economic power into a few business groups would hinder the sound development of the national economy. The shipment share of top thirty chaebol groups in manufacturing rose sharply from 32 percent in 1977 to 40.4 percent in 1983, while their contribution to employment decreased."

It was a few years after the amendment of the MRFTA that the KDI commissioned a more comprehensive research on various issues relative to chaebol groups, including the issue of aggregate concentration. The research was completed and published in 1992. Covering the years from 1983 to 1989, it not only measured the cumulative share of top chaebol groups in manufacturing or non-financial sector in terms of added value (see <Table 2-5>); it also measured the unevenness of share distribution among top chaebol groups by the Herfindahl index (see <Table 2-6>). In addition, the authors computed another index, which could be taken as a combination of the cumulative share and the Herfindahl index.[15] Measured by this combined index, the aggregate concentration via chaebol groups turned out to have increased sharply between 1983 and 1984. Part of this increase was attributed to increased disparity among top chaebol groups.

Table 2-5 | Share of Chaebol Groups in Non-financial Sector, 1983-1989

(Unit: %)

	1983	1984	1985	1986	1987	1988	1989
Top 5	4.81	8.24	8.62	8.81	9.03	9.61	11.06
Top 10	7.07	11.29	11.75	11.60	11.67	12.67	14.28
Top 20	9.09	14.64	14.89	14.53	14.72	15.63	17.51
Top 30	9.88	16.04	16.12	15.91	15.81	16.92	19.04

1) Cumulative share measured in terms of added value

Source: Jeong and Yang (1992)

15. The formula of this combined index is $\sum_{i=1}^{N}(Y_i/X)^2$ for N chaebol groups where Y_i/X denotes the share of the ith chaebol group in manufacturing or non-financial sector.

Table 2-6 | Herfindahl Index for Chaebol Groups in Non-financial Sector, 1983-1989

	1983	1984	1985	1986	1987	1988	1989
Top 5	0.21291	0.22662	0.22654	0.22416	0.22103	0.22098	0.22476
Top 10	0.11927	0.13599	0.13655	0.14114	0.14294	0.13930	0.14519
Top 20	0.07765	0.08636	0.08974	0.09422	0.09440	0.09524	0.10025
Top 30	0.06646	0.07276	0.07716	0.07945	0.08231	0.08194	0.08548

1) Index computed from each chaebol group's share in terms of added value
Source: Jeong and Yang (1992)

Box 2-1 | Herfindahl Index

Any Herfindahl index is computed by the formula $\sum_{i=1}^{N}(Y_i/X)^2$ for a group of N constituents where Y_i/Y denotes the ith constituent's share. This index shall vary between $1/N$ and 1, measuring unevenness of the share distribution. Note that this index shall be $1/N$ if the share distribution is perfectly even in the sense that $Y_i/Y = 1/N$ for any i. The other extreme is the case that one constituent takes it all and the others none.

2.2. Ownership Concentration

In the above mentioned work by Lee and Lee (1985) on economic power concentration,[16] the authors put as much stress on ownership concentration as on aggregate concentration (p. 99). "In Korea economic power concentration is rooted in the bigness of business groups and the concentration of ownership and control rights." The authors then added an observation (p. 99). "Controlling power has been based on ownership, and the former can be fully concentrated even if the latter is not fully concentrated." Given these statements, a reader might expect as long a section on ownership concentration as on aggregate concentration. Surprisingly (or maybe not), that is not the case. Only one and half pages were assigned to the section on ownership concentration. Perhaps less surprisingly, the section did not contain any table of figures. All the quantitative information that a reader can get in the section is the following. "A simple average being taken for the ten largest business groups, ownership concentration reaches 60.7 percent since affiliates and persons respectively own 49.0 percent and 11.7 percent of the outstanding stocks." No further explications were provided.

16. See also Lee, KyuUck (1986, 1990).

Although Lee and Lee (1985) did not reveal the source of ownership data, KDI had previously obtained a set of data on inside shareholding of chaebol groups in September 1983. The KDI reportedly constructed a table of figures relative to that matter, which a newspaper partly reproduced (Dong-A Ilbo, June 8, 1984). The reproduced table listed the combined ratio of inside shareholding, along with the number of affiliated companies and three financial figures for each of the thirty largest chaebol groups. KDI could not have constructed any table like this, if it had to rely only on public data. Not many companies were listed on the Korea Stock Exchange at the time, and even less companies fully disclosed the distribution of shares or the list of shareholders. A government agency, however, was capable of collecting such data. In early 1984, the Fair Trade Office reportedly directed the thirty largest chaebol groups to report on their ownership structure as of September 1983 (MaeilKyunjeShinmun, September 29, 1984). Their report should have included details regarding reciprocal shareholding, since it was a target of the then-current criticism of chaebol groups.[17] Data on cross shareholding among affiliates and controlling family's shareholding seem to have been included as well. The Fair Trade Office would have sent these data to the KDI for analysis and policy proposals,[18] and Lee and Lee (1985) would have had access to them.[19]

To be sure, it was no secret in the 1980s that ownership had been highly concentrated in most Korean companies. Given those data which had been disclosed and published, one could have constructed a table of figures like <Table 2-7> to confirm the highly concentrated ownership for listed companies; on average, the controlling family owned more than 25 percent of outstanding stocks before 1979, and no less than 19 percent until 1983. One could also have found it from the row of "affiliated companies" in <Table 2-7> that intra-group shareholding increased, preventing inside shareholding from falling below 25 percent.

17. Prohibition of reciprocal shareholding was one of the intentions behind the amendment of Commercial Act in April 1984.

18. The Fair Trade Office had originally been established in the Economic Planning Board. It is not until April 1990 that the Fair Trade Commission became an independent administrative organization and the Fair Trade Office was integrated into the Secretariat of the Fair Trade Commission.

19. This has been confirmed in an interview with KyuUck Lee.

Table 2-7 | Inside Shareholding of Listed Companies, 1976-1983

(Unit: %)

	1976	1977	1978	1979	1980	1981	1982	1983
Number of companies	273	322	356	355	352	344	344	328
Inside shareholding	34.28	32.60	32.54	30.02	27.89	27.36	26.53	27.82
Controlling family	27.51	26.52	27.30	24.19	21.91	20.19	19.14	19.07
Affiliated companies	5.90	5.50	4.89	5.32	5.44	6.57	6.70	7.95
Non-profit org.	0.87	0.58	0.35	0.51	0.54	0.60	0.69	0.80

1) A few list companies are excluded for lack of data

2) The share ratios are simple averages

3) 'Controlling family' includes the five largest of individual shareholders

Source: Lee, Keun et al. (2007)

Table 2-8 | Inside Shareholding of Thirty Largest Chaebol Groups, 1983-1991

(Unit: billion won, %)

	1983	1987	1989	1990	1991
Number of companies	441	493	535	557	570
Paid-in capital in par value	4,095	6,887	10,525	13,649	16,090
Inside shareholding	57.2	56.2	46.2	45.4	46.9
Controlling family	17.2	15.8	14.7	13.7	13.9
Affiliated companies	40.0	40.4	31.5	31.7	33.0

1) The figures are as of September 1st for 1983, and are as of April 1st for other years

2) Except for 1983, the share ratios are weighted averages, the weight being each company's paid-in capital in par value

3) The share ratios for 1983 and 1987 are taken from Yoo and Lim (1999) who refer to the FTC as the source of data

Source: Fair Trade Commission

The figures above, however, fail to include all the inside shareholding of listed companies. When the amended MRFTA obliged chaebol groups to report the details of inside shareholding in 1987 and thereafter, their ratio of inside shareholding turned out to be a lot higher than 25 percent, as we can see it in <Table 2-8>. To be exact, the weighted average ratio of inside shareholding was as high as 56.2 percent for the thirty largest chaebol groups

as of April 1987.[20] The gap is even larger between the two average ratios of intra-group shareholding; the (simple) average ratio was 19.1 percent for listed companies in December 1983 according to <Table 2-7>, whereas the weighted average ratio turned out to be 40.4 percent for companies belonging to the thirty largest chaebol groups as of April 1987. Part of this gap can be attributed to two facts; the ratio of intra-group shareholding was usually higher in unlisted companies, which were not included in the figures of <Table 2-7>, and the ratio of intra-group shareholding was usually lower in non-chaebol companies, which were not included in the figures of <Table 2-8>.[21] Yet it is no less likely that the figures in <Table 2-7> fail to include all the shares owned by affiliates. In other words, many of listed companies did not fully disclose the list of affiliates or their ratio of shares. Nonetheless, the FTC and KDI got a quite exact measurement of intra-group shareholding of the thirty largest chaebol groups as of September 1983. This measurement was required to design the regulations on intra-group shareholding, which would be enacted in December 1986.

3. Policy Measures against Economic Power Concentration

3.1. Promotion of Ownership Dispersion[22]

In Korea, ownership concentration has attracted the public attention for different reasons, and in different periods. In the early periods, ownership concentration primarily implied concentration of wealth through the big companies, and was criticized especially because of the understanding that the big companies owed much of their rapid growth to public support and sacrifice. This view was behind the special orders President Park issued to the cabinet in May 1973. Issuing "Five Special Orders on Firms' Public Offerings and Corporate Culture," President Park stated that "it is now time [for chaebols] to offer company stocks to the general public." He called it "their social responsibility as the people's firm." This order was preceded by two pieces of legislation, which had yielded the Capital Market Promotion Act in November 1968 and the Initial Public Offering Inducement Act in December 1972, respectively.[23] The former's declared objectives included "promotion of initial public

20. This figure was cited in a conference paper of a KDI researcher (Yoo, Seong Min 1995). It is not until 1991 that the FTC released the weighted average ratios of intra-group shareholding and controlling family's shareholding of each chaebol group. The weighted averages for 1989 and later are currently available from a disclosed document of the FTC.

21. According to the computation of Hattori (1984) based on data available in the annual reports of listed companies as of 1982, the average ratio of intra-group shareholding was 15.0 percent for those companies belonging to the ten largest chaebol groups, whereas it was 3.0 percent for other companies.

22. This subsection relies substantially on Kim, Woochan (2012), an earlier issue of this series.

23. The Initial Public Offering Inducement Act was repealed in November 1987. The Capital Market Promotion Act was repealed in January 1997, part of it being moved to the Security Exchange Act.

offering, dispersion of share ownership and people's participation in firms" among others, and the latter aimed to "enhance people's participation in firms … by promoting initial public offering."

Of course, it was not the only objective of these two Acts for the people at large to share the benefits of economic growth through dispersed ownership of companies. The Acts were also intended to improve the capital structure of companies by facilitating their equity financing. Various measures were designed for the objectives, including tax benefits for listed companies and their shareholders. The IPO Inducement Act of 1972 employed stronger measures. The Minister of Finance was given the power to review target firms and select qualified firms to go public. In addition, the Minister of Finance could ask financial institutions to limit their lending and other assistances to non-complying firms.

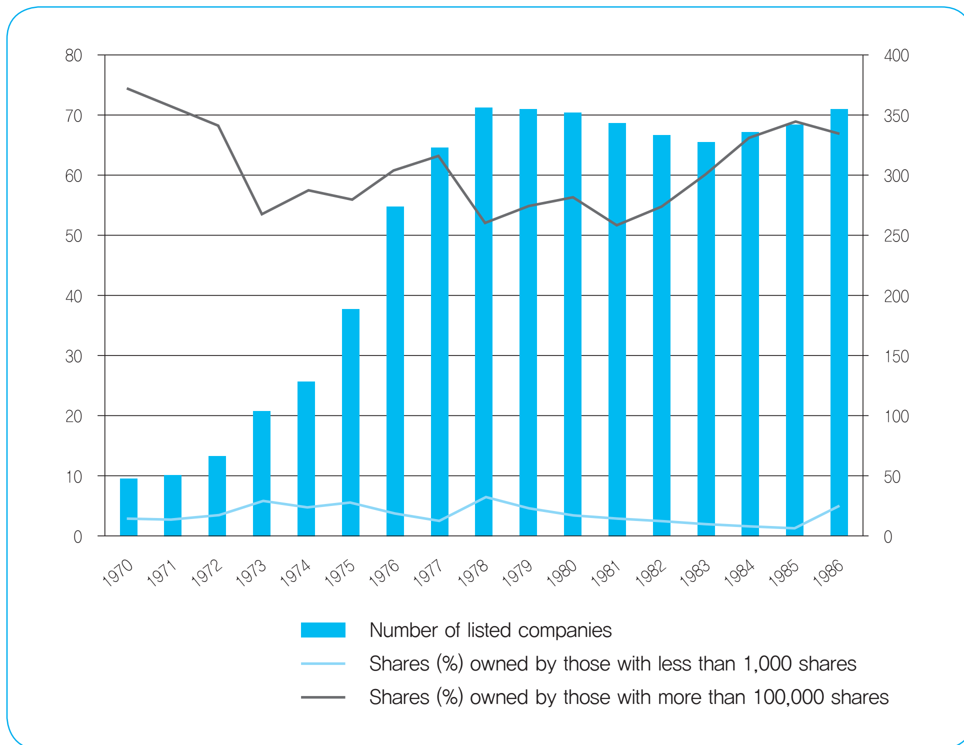
Despite all these measures and the President's special orders, chaebol owners rarely agreed to have key blue-chip firms to go public. Only a few secondary firms went public. To address this situation, the government announced the IPO Supplementary Measures in August 1975. The measures came up with a new set of target firms, which included primary firms within each chaebol group. In addition, the Securities and Exchange Act (SEA) was revised to enact the so-called ten percent rule in December 1976. According to Article 200 of the revised SEA, no shareholder was allowed to own more than ten percent of outstanding shares in a listed firm. Shareholders owning more than ten percent of shares at the time of listing, however, were not subject to this rule.[24] It was intended to relieve the chaebol owners' concern of losing control over their businesses.

Although some firms still refused to go public, the government's effort was deemed a success. [Figure 2-1] shows that the number of listed firms and the amount of paid-in capital increased significantly in the late 1970s. The government's effort, however, might not have brought this increase, had it not been for the low interest rates and high economic growth rates during this period. More importantly, the shares owned by those with less than one thousand shares rarely exceeded 5 percent until 1986.[25] In comparison, the shares owned by those with more than one hundred thousand shares never fell below 50 percent. Given this distribution of shares, one can hardly state that there had been a big advance in ownership dispersion.

24. This rule was discontinued in April 1997.

25. One should be careful with the recorded number of shares because the Korea Stock Exchange had the listed companies to consolidate their shares in 1987. In most cases, ten shares were consolidated to one at the time.

Figure 2-1 | Number of Listed Companies and Distribution of Shares



Source: Korea Stock Exchange, Securities Statistics Yearbook for 1987

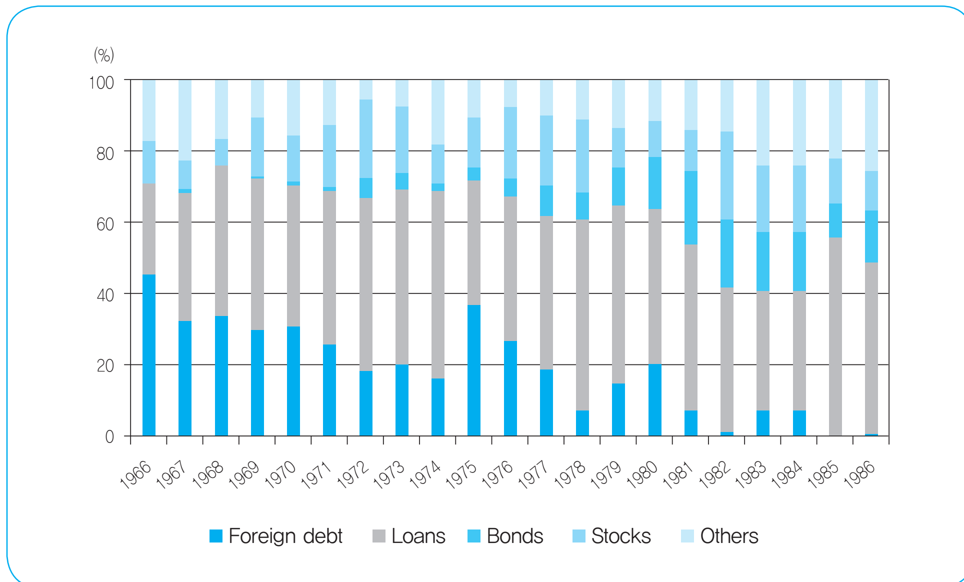
3.2. Credit Management System

Ownership concentration and rapid growth are hardly compatible for a company in traditional circumstances. Since a company's internal funds are scarcely sufficient to finance the investments required for rapid growth, it has to raise funds from other sources. Equity and debt are two alternatives. If a company opts for equity financing of a sufficiently large scale for rapid growth, the incumbent owners' ratio of shares shall unavoidably fall, and the ownership concentration can no longer be sustained. This outcome is avoidable only if the company opts for debt financing. Loans and bonds are two major forms of debt. That is, ownership concentration and rapid growth are compatible for a company that finances the required investments mostly by loans and bonds.

In Korea, top chaebol groups achieved surprisingly fast growth in the 1970s, occupying an increasingly larger portion of the national economy, as seen in <Table 2-2> and <Table 2-3>. Perhaps no less surprisingly, this growth accompanied no significant de-concentration of ownership as <Table 2-7> suggests it. We should therefore not be surprised to find out that

top chaebol groups relied heavily on debt financing for their growth in the 1970s. [Figure 2-2] can help us to confirm this conjecture though it does not exclude those companies not belonging to any of top chaebol groups. We shall find out that the issue of new equity accounted for a lot less than one fifth of external financing of Korean companies in the 1970s and later, if we roughly estimate the ratio from [Figure 2-2]. To be exact, the portion of new equity in external financing was 15.2 percent on average for the years 1966-86.[26] Most external financing took the form of loans or foreign debt, of which the latter normally required a domestic bank's guarantee of payment. Bonds were also mostly issued with a bank's guarantee of payment. To sum, Korean companies relied on banks for about two-thirds of their external financing in this period.

Figure 2-2 | External Sources of Corporate Funds



Note: Loans = Bank loans + Non-bank loans, Bonds = Corporate bonds+ CP
Source: Lee, Yoon-Ho (2005)

It is in this background that the Korean government devised the so-called Credit Management System in July 1974. It took the form of agreement by which all the financial intermediaries should abide, but the Bank Supervisory Board determined both the direction and details of the Agreement on Credit Management. Although its declared objective was

26. This ratio must be taken with a consideration. Equity financing would merely mean transference of capital from one or more affiliated companies to another, if affiliated companies acquired the newly issued stocks. In other words, it would increase nothing but the 'fictional' capital; no fresh funds would be brought into the group of affiliated companies.

"to promote equity capital replenishment and financial structure improvement of companies through integrated credit management," suppression of economic power concentration was another apparent objective. In particular, its unit of application was not an individual company but a group of companies under control of a same person,[27] and its target of application included those chaebol groups with combined amount of loans exceeding 5 billion won.

Given the Agreement of Credit Management, the Bank Supervisory Board proceeded to sort all the target groups into two categories according to their consolidated ratio of loans to equity.[28] A target group was beneficially labeled "B," if its ratio turned out to be lower than 400 percent. Otherwise, a target group was detrimentally labeled "A," and further credit offering was disallowed to any company belonging to it.[29] In addition, a target group labeled "A" had to work out a three-year plan for financial structure improvement, which had to be submitted to the group's main bank for evaluation and approved by the Director of the Bank Supervisory Board. The plan was required to include the sales of affiliated companies and non-business purpose properties, as well as initial public offerings and recapitalizations. A pledge to stop adding up affiliated companies by acquisition or establishment was another requirement.

In July 1976, the Credit Management System was supplemented by another agreement that concerned the main bank system. In particular, the Agreement on Operations of the Main Bank System prohibited any target company from making transactions with more than three banks. A target company was allowed only to transact with its main bank and two auxiliary banks of its choice. In addition, the Agreement obligated every target company to get the annual diagnosis of management from its main bank. This and the earlier Agreement were combined into the Agreement on Credit Management of Main Banks in June 1978.

The Agreement on Credit Management of Main Banks went through a number of reinforcing revisions before it was replaced with the Detailed Rules for Credit Management of Financial Institutions in July 1984. The Detailed Rules drew legitimacy from Article 30.2

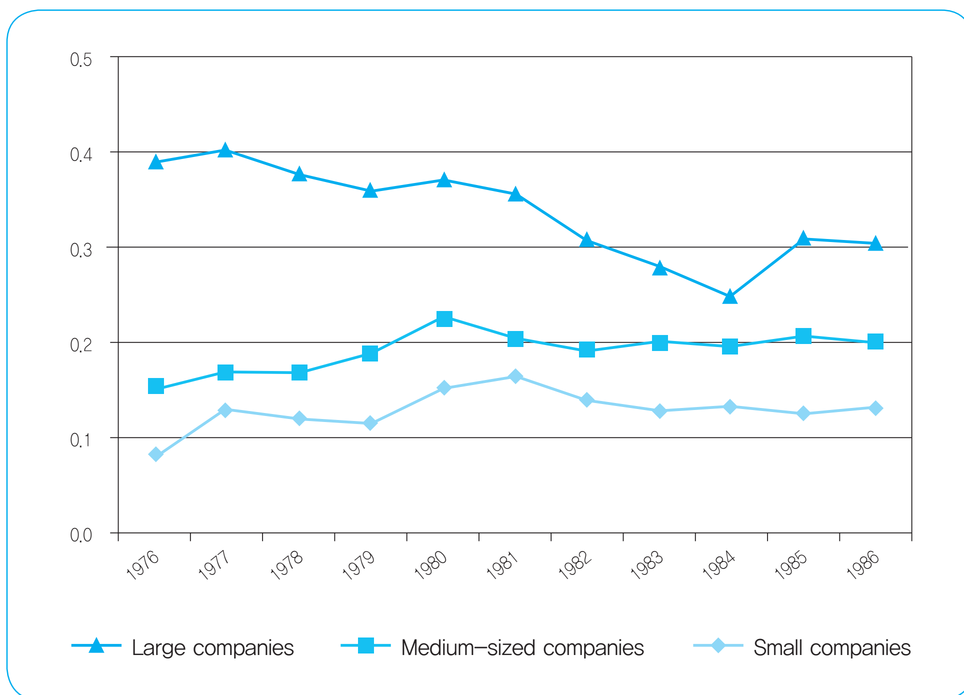
27. The Agreement on Credit Management contained a set of criteria for determining a "group of affiliated companies" under control of the same person. A key criterion was the ratio of inside shareholding; a company was considered affiliated if insiders owned 30 percent or more of its outstanding stock, where insiders included the same person's blood relatives and other affiliated companies. *De facto* control was another criterion.

28. The amount of cross shareholding among affiliates was subtracted from the total amount of equity capital when the consolidated ratio of loans to equity was computed.

29. Thirty or so of seventy target groups were reportedly labeled "A" in 1974 (MaeilKyungjeShinmun, May 27, 1975). The Bank Supervisory Board did not disclose the list.

of the Banking Act that had been amended in December 1982.[30] The Credit Management System thus had legal ground that the earlier ones had lacked. More importantly, the Detailed Rules focused more on "suppression of disproportionate loans and credit," one of its two declared objectives. In particular, Article 9 of the Detailed Rules read as follows: "Provided that the Director of the Bank Supervisory Board sees it necessary for correction of disproportionate loans and credit, he or she shall set an upper limit on increase in loans and credit of each financial institution for each group of affiliated companies."

Figure 2-3 | Ratio of Loans to Equity for Large, Medium, and Small Companies



Source: Lee, Yoon-Ho (2005)

Various data could be collected to illustrate the accomplishments of the Credit Management System. For instance, target groups disposed of forty affiliates in the three and half years after the Agreement on Credit Management was set out in 1974 (DongAIlbo,

30. The first clause of Article 30.2 read as follows: "The Monetary Policy and Operation Committee may set and enforce an upper limit on the total amount of loans and debt guarantees or underwriting for each group of affiliated companies." This power of the Committee was delegated to the Director of the Bank Supervisory Board in accordance with Article 12 of the Code of Credit Management of Financial Institutions. Article 30.2 of the Banking Act was revised and renumbered before its key provisions were deleted in February 1999.

May 23, 1974). More affiliates were sold out or closed down in the years 1981-83 (Min 1991, p. 269). The increased number of listed companies could also be attributed to it in part (see [Figure 2-1]). Direct impact, however, should be confirmed through the decreased share of top chaebol groups or large companies in bank and non-bank loans. According to Y. Lee (2005), who examined the ratio of bank loans to sales since 1976, the ratio fell rather rapidly for large companies until 1984 (see [Figure 2-3]). In comparison, the ratio rose in small and medium sized companies in the 1970s, before it fell slightly in the early 1980s. We could thus conclude that the Credit Management System had the intended effect, insofar as the allocation of bank loans is concerned.

However, in Korea, disproportionate allocation of bank loans was not a necessary condition for the concentration of economic power, or the aggregate concentration combined with the ownership concentration. Despite the reduced shares of chaebol groups in bank loans, they succeeded in increasing their share in the national economy, while sustaining the ownership concentration. Few could deny that further measures were required if economic power concentration were to be restrained.

Chapter 3

Five Measures Put in the Fair Trade Act

1. Background
2. Designation of Big Business Groups
3. Ceiling on the Total Amount of Shareholding: Phase One, 1987-1995
4. Ceiling on the Total Amount of Shareholding: Phase Two, 1995-2009
5. Prohibition of Reciprocal Shareholding
6. Restrictions on the Voting Rights of Financial Companies
7. Ban on Holding Companies
8. Limitation on Debt Guarantees

Five Measures Put in the Fair Trade Act

1. Background

It has been noted above that the issue of economic power concentration became an object of public attention in the mid-1970s, and that the term economic power concentration got a legal status for the first time when the Monopoly Regulation and Fair Trade Act (MRFTA) was promulgated in December 31, 1980. Article 1 of the MRFTA declared that its purpose should be served "by preventing…any excessive concentration of economic power." Strange as it may sound, however, the MRFTA included no particular measures to curb the concentration of economic power. It is through the first amendment in December 1986 that four such measures were included in Chapter 3, of which the title was changed to add the phrase "Suppression of Economic Power Concentration." The original title was "Restriction on Combination of Enterprises." This chapter was to include another anti-concentration measure in December 1992. The five measures were respectively named as Prohibition of Establishment of Holding Companies, Prohibition of Reciprocal Equity Investment, Ceiling on the Total Amount of Equity Investment, Restriction on Voting Rights of Financial or Insurance Companies, and Limitation on Debt Guarantees for Affiliated Companies. These names became the titles of the five newly added articles in Chapter 3 of the MRFTA. In addition, three more articles and a few new clauses were inserted in support of the five articles.

Box 3-1 | The Fair Trade Act and Economic Power Concentration

Professor KyuUck Lee was a leading figure in drafting the Fair Trade Act. He recollected in an interview how the Act got the phrase 'excessive power concentration.' "I was convinced that transition to a free-market economy was hard to expect of Korea as long as the chaebols remained intact. Senior officials opined, however, that it would make the legislation impossible due to objections from chaebols if the proposed regulations on chaebols were put in the Act. I had to retreat. Yet I insisted on laying a ground on which the regulations could be put in the Act through an amendment at an opportune time. The Act thus proclaimed it as an aim 'preventing any excessive concentration of economic power.'"

It was not an obvious choice for the government to have the MRFTA include those measures against economic power concentration. The government had reportedly considered having a special act deal with the task.[31] "Special Act for Prevention of Economic Power Concentration" could have been the name (MaeilKyungjeIlbo, July 21, 1984). A government official was quoted as saying, "the authorities concerned have agreed to set up measures against economic power concentration in the form of a special act, although it was proposed to supplement the Fair Trade Act for the purpose" (DongAIlbo, October 9, 1984). The final decision, however, was different according to another newspaper report relying on an official of the Economic Planning Board, in which the Fair Trade Office had been established (MaeilKyungjeIlbo, October 16, 1984). The government indeed decided to enact a few anti-concentration measures through amendments in the MRFTA, and the Economic Planning Board briefed to the press about the direction and contents of amendment in May 1985. A bill of amendment was finally made public in September 1986. It then went through a few conciliatory revisions before the final bill of amendment was submitted to the National Assembly in October 1986, and passed two months later.[32]

One may cite various elements that led to the enactment of anti-concentration measures in 1986. An apparent element was the rapid and disproportionate growth of top chaebol groups in the 1970s and the early 1980s, which has been noted in the previous chapter. As a matter of fact, the press repeatedly reported that the shipment share of top thirty chaebol

31. Another special act was under discussion relative to economic power concentration as the time. A suggested name was "Industrial Rationalization Promotion Act." It was not materialized partly due to disagreement between the Economic Planning Board and the Treasury Department (MaeilKyungje, October 19, 1984; DongAIlbo, October 24, 1984).

32. For instance, financial companies and insurance companies were excluded from application of two of the four anti-concentration measures, namely, prohibition of reciprocal shareholding and ceiling on the total amount of shareholding.

groups in mining and manufacturing industries had increased from 32.0 percent in 1977 to 39.7 percent in 1981 (KyunghyanShinmun March 17, 1984; DongAIlbo, April 28, 1984; MaeilKyungjeIlbo, July 21, 1984).[33] Compared to the GNP, the disproportionate increase of top chaebol groups' added value was another statistical fact that the press repeatedly reported. (MaeilKyungjeIlbo, March 17, 1984; DongAIlbo, October 18, 1984). This trend of economic concentration was nothing new according to a newspaper editorial, which hurried to add that "the direction of [the government's] economic management must be reconsidered, since the concentration of economic power has certainly reached a worrisome level and is to be further accelerated" (MaeilKyungjeIlbo, September 7, 1984).

The sustained concentration of ownership may be cited as well, in relation to the anti-concentration measures enacted in 1986. Notwithstanding the Initial Public Offering Inducement Act of 1972 and the President's Special Orders of May 1973, ownership of chaebol companies had scarcely been dispersed. The ratio of inside shareholding turned out to be as high as 57.2 percent on average for the thirty largest chaebol groups as of September 1983 (see <Table 2-8>). That is, outside investors owned no more than 42.8 percent of outstanding stocks of chaebol companies. To quote from the same newspaper editorial as above, "people do not criticize chaebol groups so much for their bigness as for their being owned and controlled by a few persons" (MaeilKyungjeIlbo, September 7, 1984).

One more point should be made as to the inside shareholding of chaebol groups. Of those 57.2 percent of shares which were kept inside of chaebol groups, 17.2 percent belonged to controlling families whereas 40.0 percent belonged to affiliated companies. To repeat, the ratio of intra-group shareholding was 40.0 percent on average for the thirty largest chaebol groups in September 1983. This high ratio of intra-group shareholding seems to have been something causing new concerns, if not something new for itself. "Reciprocal equity investment" and "equity investment in affiliated companies" were the two terms adopted to refer to intra-group shareholding, and the former was the primary target of criticism in which "fictional capital" and "irregular expansion" were frequently cited as its undesirable intentions (DongAIlbo, April 14, 1984). Capital was called as fictional in the sense that it existed merely in the accounting books, with no corresponding funds brought into a group of companies. For instance, if funds were transferred through acquisition of new stocks between companies belonging to a same chaebol group, its total amount of equity capital would increase with no real funding from outside at all. Fictional capital would also be

33. The data were reportedly provided by The Fair Trade Office.

made up if a chaebol group expanded itself by having a member company acquire stocks of a member-to-be company.[34] This was a point of the criticism on intra-group shareholding.

Article 342.2 of the Commercial Act was an answer that the government offered to the criticism on reciprocal shareholding in April 1984.[35] The article's range of application, however, was limited. It only prohibited "Acquisition of a Parent Company's Stocks by its Subsidiary Company," which still is the title of Article 342.2. In particular, the prohibition applied only to a pair of companies of which one owned 40 percent or more of the other's stocks. A company might still own up to 40 percent of another company's stocks if the latter owned less than 40 percent of the former's stocks. More significantly, Article 342.2 did not apply to any one-directional shareholding among companies. It only applied to bi-directional shareholding between a pair of companies, which constituted a tiny portion of intra-group shareholding of chaebol groups at the time. It is, therefore, not surprising at all that the ratio of intra-group shareholding did not fall in 1984, or in the subsequent years.

"Reciprocal equity investment" is one of those terms that have long been confusingly used in Korea. Even informed people have used the term to refer to any form of inter-company shareholding, not just bi-directional shareholding between a pair of companies (MaeilKyungjeShinmun, March 17, 1984). Their criticism on reciprocal equity investment, therefore, should be taken with care. More often than not, it would actually be directed towards intra-group shareholding, of which a small portion reciprocal shareholding accounted for in most chaebol groups. Those critics seem to have understood that the so-called fictional capital would not be made up only by reciprocal shareholding between a pair of affiliated companies, but by any intra-group shareholding. Those critics seem to have been aware that chaebol groups would rather rely on intra-group shareholding than on reciprocal shareholding for their "expansion through fictional capital" (DongAIlbo, April 14, 1984). Article 342.2 of the Commercial Act then could not have been a genuine answer to the criticism on "reciprocal equity investment." Further measures were thus called for.

As it has been explained above, the high ratio of intra-group shareholding was not just a matter of ownership concentration. It had as much to do with aggregate concentration, or "irregular expansion," of chaebol groups. Concerned more with the latter, one could obtain a clue in the increasing number of affiliated companies in combination with the high

34. Funds should flow out of a company in order for it to purchase another company's old stocks. Nonetheless, no company's equity capital would decrease according to its accounting books. Fictional capital would be made up. This fictional capital would then be erased from the accounting books if the two companies are merged to one.

35. Along with Article 342.2, a new clause of Article 369 was put in the Commercial Act in April 1984. This clause was to deny voting rights of some stocks involved in reciprocal shareholding, and its range of application was wider than that of Article 342.2: "Provided that a company ... owns more than 10 percent of another company's stocks, the former's stocks owned by the latter shall have no voting rights."

ratio of intra-group shareholding. As for the thirty largest chaebol groups, Lee and Lee (1985b) reported that the average number of member companies had jumped from 4.2 in 1970 to 14.3 in 1979, though it slightly fell to 13.4 in 1982.[36] Part of this increase was due to acquisitions, but incorporation was more common.[37] In either case, it was not unusual for one or more of the existing member companies to acquire and own a large portion of the stocks issued by a member-to-be company, bringing out a complex structure of shareholding among member companies. The structure was so complex that the term pyramiding does not properly describe it. It is this sort of group expansion that the government tried to restrain, by enacting a set of anti-concentration measures through the first amendment of the MRFTA in 1986.

2. Designation of Big Business Groups

2.1. Scope of Business Groups

The MRFTA got seven new articles in Chapter 3 through the amendment of December 31, 1986. Put below Article 7, four of them were numbered as 7.2 through 7.5. These four articles were alike insofar as they all concerned inter-company shareholding. In particular, they respectively involved holding companies, the total amount of shareholding of a company, reciprocal shareholding between a pair of companies, and shareholding of financial or insurance companies. Yet there was a difference in the scope of application between the first one and the others; Article 7.2 applied to any domestic company while Articles 7.3 through 7.5 exclusively applied to those companies belonging to a Big Business Group as the MRFTA called it.[38] Accordingly, the MRFTA needed to have the scope of Big Business Groups determined one way or another. In particular, it had to specify how to determine the constituents of a business group before setting the criterion for its bigness.

Logically speaking, the scope of Big Business Groups shall be determined as soon as the scope of Business Groups is determined and the criterion for their bigness is given. It also goes without saying that the scope of any group is determined by its constituents. It is, however, quite legally complex to specify what constitutes a Business Group. Deferring much of it to the Presidential Decree, Article 2 of the MRFTA got a new clause adopting *de*

36. Lee and Lee (1985) may have failed in counting a few small companies into these numbers. According to the earliest data available from the FTC, which should have had a complete list of member companies, the average number is 16.4 for the thirty largest Business Groups as of April 1987.

37. During the years of 1971 through 1979, the net increase in the number of member companies of the thirty largest business groups amounts to 303, of which 202 companies were newly incorporated while 135 companies were taken over (Lee and Lee 1985b, p. 93; Lee 1986, p. 5).

38. 'Large-scale Enterprise Groups' may be a more direct translation of the term appearing in Article 7.3 of the MRFTA. The FTC has translated it as 'Large Business Groups.'

facto control as the yardstick for determination: "The term 'business group' herein refers to a group of companies the business activities of which a same person in fact controls … according to the criteria as specified in the Presidential Decree."

Titled "Scope of Business Groups," Article 2.2 of the Presidential Decree of April 1987 specified the criteria as *de facto* control.[39] Two criteria were set, one being much less concrete than the other. The former being applied, a person shall be considered to 'control' the concerned company if he or she "admittedly exercises influence on the concerned company's business activities through appointment of directors or other ways." This criterion has been further specified in the Presidential Decree of March 1997.[40] The other criterion was set in terms of the ratio of shares that a person owns in the concerned company either solely or together with any of the 'Related Persons.' If this ratio is thirty percent or higher and no one else owns more shares, then the person shall be considered to 'control' the concerned company. In this specification, 'Related Persons' did not only refer to the person's immediate family, blood relatives, and in-laws[41]; they also referred to companies and organizations under *de facto* control of the person.

This set of criteria and their specifications as *de facto* control did not differ much from those which the Bank Supervisory Board had been employing for the Credit Management System since 1974.[42] In particular, 30 percent was the critical ratio of inside shareholding for determining a "Group of Affiliated Companies" for which the Bank Supervisory Board would set a credit limit. The boundary of insiders was also much the same as that for 'Related Persons.'

2.2. Criterion for Bigness of Business Groups

Having specified how to determine the scope of Business Groups with the aid of the Presidential Decree, the MRFTA proceeded to set the criterion for bigness of Business Groups. Recall that the criterion was required to designate those Business Groups to which Articles 7.3 through 7.5 should apply. Yet the first clause of Article 7.3 only referred to

39. Article 2.2 of the Presidential Decree was renumbered as 3 in April, 1990.

40. Article 3 of the revised Presidential Decree further specified the less concrete criterion by enlisting four cases in which a company should be considered to be under *de facto* control of the same person. One of them, for instance, is the case that "the same person through a contract or an agreement with another major shareholder has appointed/dismissed the representative director or has appointed fifty percent or more of the directors, or there is a likelihood of such."

41. The boundary of blood relatives and in-laws was delimited by Article 2.2 of the Presidential Decree of April 1987. Included were blood relatives within the eighth degree of kinship, and in-laws within the fourth degree of kinship. The boundary of blood relatives was reduced to include those within the sixth degree in June 2012. In Korea the degree of kinship has a well-defined meaning.

42. See 3.2 of the previous chapter.

"total assets amount" in relation to the designation of its target groups while leaving further specifications to the Presidential Decree.[43]

Titled "Scope of Big Business Groups," Article 15 of the Presidential Decree of April 1987 defined the term Total Assets Amount differently between the two sorts of companies before setting the criterion for bigness of Business Groups in terms of the sum of such amounts.[44] That is, the sum should not include all assets, but rather equity capital in book value or par value, whichever is larger, for a financial or insurance company.[45] Given this article of the Presidential Decree, any company should abide by the provisions of Articles 7.3 through 7.5 of the MRFTA if it belonged to a Business Group with the obtained sum exceeding 400 billion won. It is by this criterion that the FTC designated thirty-two Big Business Groups comprised of five hundred eleven companies as of April 1, 1987.

Table 3-1 | Scope of Big Business Groups, 1987-1992

(Unit: billion won)

	1987	1988	1989	1990	1991	1992
Number of groups	32	40	43	53	61	78
Number of affiliates	509	608	673	798	933	1056
Total assets amount (a)	57,471	70,907	88,340	110,002	145,395	187,156
GDP (b)	117,938	140,524	158,620	191,382	231,428	263,993
Ratio (a/b)	.487	.505	.557	.575	.628	.709

1) The total asset amount was defined by the Presidential Decree. It includes the amount of equity capital in book value or par value, whichever is larger, for financial or insurance companies

Source: Fair Trade Commission

The criterion for bigness of Business Groups was not changed for years, and the number of Big Business Groups increased year after year as <Table 3-1> shows. The number increased to seventy eight before the Presidential Decree was revised to fix it in February 1993. Thirty was the fixed number of Big Business Groups then and after. Although the Total Assets Amount was summed up for the constituents of a business group in the same way as before, the sum was no longer compared to any fixed amount. The sum was to

43. Entitled "Designation of the Big Business Groups, etc.," Article 8.3 of the Act concerned the procedures for designation and notification, not the criteria for designation.

44. Article 15 of the Presidential Decree was renumbered as 17 in 1990.

45. The amount of assets is equal to that of debt plus equity capital. A financial company normally has a much higher ratio of debt to equity than a non-financial company. It does not make sense to sum up the amount of assets across both financial and non-financial companies if the sum measures the size of a group consisting of these two kinds of companies.

determine the ranking of Business Groups, and the thirty largest ones were designated for application of the three articles regarding inter-company shareholding, which had been renumbered as 9 through 11 through the second amendment of the MRFTA in January 1990.

As we shall see later, one of the three regulations on inter-company shareholding went through significant changes before it was abolished in February 1998 and recalled less than two years thereafter. The FTC, however, kept designating the thirty largest Business Groups for the two other regulations in accordance to the criterion set in the Presidential Decree. This procedure changed in April 2002 when the abolished and recalled regulation went into full effect; the criterion for application was set directly in terms of the Total Assets Amount of Business Groups. Accordingly, the number of Big Business Groups could and did vary every year, as it had once been the case. The argument for this change was that "relative size-based designation provided leeway for companies to engage in discretionary activities to be included or not included in the list of designation FTC (2011b, p. 112)."

There was another change in designation of the target groups. The Presidential Decree of April 2002 set two different criteria, one for designation of those Business Groups subject to the recalled regulation, and the other for designation of those Business Groups subject to the two sustained regulations.[46] That is why Article 17 of the Presidential Decree of April 2002 contained two separate clauses concerning the target groups of the three regulations. Given the "significant difference between the prohibition on cross-shareholding and the ceiling on the total amount of shareholding," the FTC (2011b, p. 112) did not consider it "desirable to apply the two regulations to the same business groups."

One more change occurred in July 2007; the criterion for designation of those groups subject to the recalled regulation was set by the amended MRFTA, not by the Presidential Decree. The recalled regulation, however, was abolished again in May 2009. Currently, the Presidential Decree is supposed to set the criterion for designation of those Business Groups subject to the two remaining regulations.

46. In the MRFTA and the Presidential Decree, the term Big Business Groups then was replaced with one of two new terms, namely, Business Groups Subject to the Ceiling on the Total Amount of Shareholding and Business Groups Subject to the Limitations on Reciprocal Shareholding.

3. Ceiling on the Total Amount of Shareholding: Phase One, 1987-1995

3.1. Details of the Regulation

Of the four additional articles put below Article 7 of the MRFTA through the amendment of December 1986, our examination shall begin with the third one numbered as 7.4. Its title may be translated to "Ceiling on the Total Amount of Equity Investment."[47] If one finds the term 'equity investment' to be awkward, one may replace it with 'shareholding.'

Article 7.4 of the MRFTA comprised six clauses until it went through a major revision in December 1994. One may translate the first clause as follows. "Any company belonging to a Big Business Group, except those which engage in financial or insurance businesses, shall be prohibited from acquiring or owning stocks of other domestic companies whose sum of book value (hereinafter referred to as the Total Amount of Equity Investment) exceeds the amount derived by multiplying the Net Asset Amount of the concerned company by 40/100 (hereinafter referred to as the Ceiling Amount of Equity Investment)."

A few points are to be made of this clause, beginning with one that often goes unnoticed. It is not a Big Business Group but a company belonging to a Big Business Group that was subject to the regulation named as Ceiling on the Total Amount of Equity Investment. The Ceiling Amount of Equity Investment was supposed to be set for *each* company belonging to a Big Business Group, and any surcharge and/or penalty would be imposed likewise upon a company for its violation of the regulation. This was equally the case for other equity investment regulations enacted through the first amendment of the MRFTA. Although the FTC was supposed to designate Big Business Groups for application of Articles 7.3 through 7.5 in accordance with Articles 2 and 8.3, they were not treated as legal entities with obligations in any article of the MRFTA.

More apparent but involved is the next point. The Ceiling Amount of Equity Investment would not be set or imposed on every company that belonged to a Big Business Group. Article 7.4 of the MRFTA excluded "those which engage in financial or insurance businesses." A financial or insurance company, therefore, could freely keep employing "equity investment as a means of asset management" despite the regulation on equity investment that was specified in Article 7.4 of the MRFTA in December 1986 (FTC 1991,

47. Article 7.4 of the MRFTA is comparable to Article 9.2 of the Antimonopoly Act of Japan amended in June 1977. The latter prohibits any non-financial company of a size larger than a certain level from owning stocks of domestic companies in excess of its equity capital, both being measured in terms of book value. After World War II, it had been entirely prohibited in Japan for a non-financial company to own stocks of other companies until 1949. This prohibition was intended to prevent the "excessive concentration of economic power."

p. 116). This exclusion, however, comes with Article 7.5, which prohibited any financial or insurance company from exercising its voting rights in stocks of affiliated companies if it belonged to a Big Business Group. We shall further discuss this matter below.

There is another point to make. It concerns the definition of Net Asset Amount, which was stipulated in the second clause of Article 7.4. According to this definition, the Net Asset Amount differs from what is commonly referred to as the net asset value of a company or the amount of equity capital in book value. That is, the Net Asset Amount is not equal to the amount of total assets minus total liabilities on a company's balance sheet. In order to get the Net Asset Amount as the second clause of Article 7.4 defined it, one has not only to deduct the amount of liabilities but "the Invested Money (the amount derived by multiplying the par value of one share by the number of shares owned) by affiliated companies to the concerned company."[48] This definition of Net Asset Amount has to do with the understanding that "a group of affiliated companies being taken as one economic entity, equity investment between them … is mere circulation of assets, yielding nothing but fictional capital" (FTC 1991, pp. 115-6). After all, the equity investment regulations were aimed to restrain the "group expansion through fictional capital." The Net Asset Amount had to be defined as if the so-called fictional capital might not be utilized as a means of group expansion.

Whatever had led to the definition of Net Asset Amount, it resulted in a discrepancy between two closely related ratios. Consider the weighted average ratio of intra-group shareholding in comparison with the ratio of Total Amount of Equity Investment to Net Asset Amount in total for a Business Group.[49] The former can also be computed from the total value of stocks issued by member companies and the total value of stocks owned by member companies. The two ratios, therefore, would be equal to each other only if the Net Asset Amount were defined as the amount of equity capital, not as the amount of equity capital minus the Invested Money.[50] This, of course, is not the case. The weighted average ratio of intra-group shareholding is normally lower than the ratio of Total Amount of Equity Investment to Net Asset Amount in total for a Business Group, and the gap is rather large. Article 7.4, therefore, amounts to obliging a Business Group to keep its weighted average ratio of intra-group shareholding far lower than the Ceiling Ratio of Equity Investment, that is, 40/100.

48. When the Bank Supervisory Board computed the consolidated ratio of debt to equity for each Group of Affiliated Companies subject to the Credit Management System, it subtracted the amount of intra-group shareholding from the total amount of equity capital. See Section 3.2 of the previous chapter.

49. Recall that the Total Amount of Equity Investment refers to the book value of stocks owned by the concerned company. Comparing the two ratios, therefore, will make no sense unless the average ratio of intra-group shareholding is a weighted one, the weight being each member company's equity capital in book value. The FTC's choice of weight for this kind of average, however, is not the equity capital in book value but the paid-in capital in par value. See 〈Table 3-2〉.

50. Another requirement for the equality is that a company's Total Amount of Equity Investment should only include stocks of affiliated companies, which is not always met in actuality.

There is another point to make in relation to the definition of Net Asset Amount. Recall that a company's Net Asset Amount is equal to the *book value* of stocks issued by the company minus the *par value* of its stocks held by affiliated companies. On the other hand, a company's Total Amount of Equity Investment is measured by the *book value* of stocks it owns in other companies.[51] Jointly adopted to calculate a ratio, the two different notions of stock value could lead to a peculiar outcome. Imagine a case in which all the involved companies rise at a same rate in their book value without any new stocks being issued or acquired.[52] Then the ratio of a company's Total Amount of Equity Investment to its Net Asset Amount, which Article 7.4 prohibits from exceeding 40/100, would certainly fall. Confusing or not, this is how the equity investment regulation was designed in its inception.

The regulation was enacted with a few measures for enforcement. If any company acquired other company's stocks in violation of Article 7.4, the FTC could order the concerned company to dispose of all or part of the acquired stocks while suspending their voting rights.[53] Another enforcement measure was the penalty for violation. It was imprisonment for not more than two years, or a fine not exceeding 100 million won.[54]

Box 3-2 | The Falling Ratio of Equity Investment

Consider a company whose equity capital in book value is currently 100 though its paid-in capital in par value is 50. If a company has issued stocks at a price higher than their par value, the company's equity capital in book value is greater than its paid-in capital in par value. The gap may be enlarged when earnings are retained or assets are reevaluated.

Given the company above, let us suppose that a half of its outstanding stocks are owned by affiliated companies. Then its Net Asset Amount is 100-25=75 because the Invested Money by affiliated companies amounts to 50×1/2=25. Let us also suppose that the company owns stocks of other domestic companies whose sum of book value is 33. Then its Ratio of Equity Investment will be 33/(100-25)=0.44. If, however, the book value of each and every company is doubled with no changes in shareholding among them, the concerned company's Ratio of Equity Investment will fall to 66/(200-25)≈0.38. That is, a company's Ratio of Equity Investment may fall even if the company does not dispose of any stocks of it owns.

51. This method of measurement later changed. Starting from April 1997, the Total Amount of Equity Investment was measured by the *acquisition price* of stocks.

52. A company can rise in its book value due to newly issued stocks, retained earnings, or reevaluated assets.

53. See Articles 10 and 10.2 of the MRFTA amended in December 1986. In addition to these, a surcharge was introduced through the amendment of January 1990. See Articles 16 through 18.

54. See Article 55 of the MRFTA amended in December 1986. It is a company's representative director that shall be charged and sentenced for violating the provisions of Article 7.4 or 10.2. The penalty was toughened later.

3.2. Accomplishments in the First Five Years

Table 3-2 | Inside Shareholding of Top Business Groups,[1] 1987-1995

(Unit: billion won, %)

	1987[2]	1988	1989	1990	1991	1992	1993	1994	1995
(Average) Number of member companies	493 (16.4)	504 (16.8)	535 (17.8)	557 (18.6)	570 (19.0)	590 (19.7)	604 (20.1)	616 (20.5)	623 (20.8)
Equity capital[3]	10,449	11,996	18,002	26,355	31,688	37,234	50,105	57,735	56,974
Paid-in capital in par value	6,887	8,629	10,525	13,649	16,090	17,954	22,232	24,439	24,036
Inside shareholding[4]	56.2	NA	46.2	45.4	46.9	46.2	43.4	42.7	42.9
Controlling family	15.8	NA	14.7	13.7	13.9	12.8	10.3	9.7	10.6
Affiliated companies	40.4	NA	31.5	31.7	33.0	33.4	33.1	33.1	32.4
Ultimate ownership[5]	26.5	NA	21.5	20.1	20.7	19.2	15.4	14.5	15.7
Net Asset [A][6][7]	7,476	9,430	13,460	18,334	21,248	25,820	29,145	36,100	42,884
Equity Investment [B][8]	3,257	3,569	4,401	5,890	6,747	7,435	8,158	9,683	11,292
Ratio [B/A]	43.6	37.8	32.7	32.1	31.8	28.8	28.0	26.8	26.3

1) First row for top thirty of the Big Business Groups designated each year. Other rows are for top twenty-nine of the thirty-two Big Business Groups designated in April 1987. Three groups are excluded because they were not designated in the following years

2) The figures below are as of April 1st for this and the following years

3) Earned surplus and assets reevaluation surplus are included

4) Weighted average, the weight being each company's paid-in capital in par value. Same for the two rows below.

5) Direct plus indirect ownership of the controlling family, computed by the formula, $w/(1-s)$. See the explanation in 3.3

6) Financial companies and insurance companies are excluded. Same for the two rows below

7) A company's net asset amount is equal to its total capital amount minus the par value of its stocks held by affiliated companies

8) Each company's equity investment is measured by the book value of stocks it owns in domestic companies

Source: The Fair Trade Commission; Yoo, Seong-Min (1999)

We have so far examined details of the regulation enacted and named as Ceiling on the Total Amount of Equity Investment through the amendment of the MRFTA in December 1986. It was to be effective as of April 1, 1987, but there was a grace period. Addenda to the amended MRFTA included an article declaring that if the Total Amount of Equity Investment of any company belonging to a Big Business Group exceeded its Ceiling Amount as of the effective date, its Total Amount should be deemed to be its Ceiling Amount for five years thereafter in applying the first clause of Article 7.4. Accordingly, no company had to disown any stocks until April 1, 1992.

The grace period implies more than a delay in disowning stocks. In <Table 3-2> we can compare the Total Amount of Equity Investment to the Net Asset Amount in total for the Big Business Groups over the five-year period. The weighted average ratio obtained is as high as 43.6 percent for April 1987.[55] This means that quite a few companies should have disowned stocks of considerable amount had it not been for the grace period. If one wanted to figure out the exact amount of stocks that should have been disowned, one could add up each company's amount of equity investment in excess of its Ceiling Amount. The FTC indeed figured it out for the thirty-two Big Business Groups as of April 1987 (FTC 1991, p. 119). The sum turned out to be 1,246 billion won, which was larger than a third of the Total Amount of Equity Investment. The Total Amount of Equity Investment, however, did not decrease in the following years. <Table 3-2> shows the contrary. The Total Amount of Equity Investment increased continuously and rapidly from 3.3 to 6.7 trillion won in total for the Big Business Groups over the four-year period. Few companies seem to have disowned any considerable amount of stocks. In fact, many companies did not have to disown stocks any longer since its Net Asset Amount had increased, pushing up its Ceiling Amount of Equity Investment accordingly, before the grace period ended. Many companies actually could, and often did, acquire more stocks.

Of course, some companies might still have had to disown some stocks to meet the requirement before the grace period ended. One might go a step further to claim that many companies would have acquired many more stocks if they had not been subject to the equity investment regulation as it was applied in April 1987. One might take it as supporting evidence that the weighted average ratio of equity investment fell down to 28.8% in April 1992 when the grace period was over.[56] This fact, however, is not a definite piece of evidence on the effectiveness of the equity investment regulation. The weighted average ratio seems to have fallen mainly because many existing member companies issued lots of new stocks,[57] of which a larger portion were acquired by others and not their affiliated companies. Hence the question to ask here is this: Did affiliated companies not acquire more of those stocks because Article 7.4 of the MRFTA prohibited them from doing so? Or is it because they did not have to do so for another reason? This is hard to determine before examining each and every case.

55. The Ceiling Ratio of Equity Investment must have been determined to be slightly lower than the current average ratio, which had previously been 48.5% for the top thirty business groups in December 1985 (MaeilKyungjeShinmun, September 3, 1986).

56. The FTC computed the ratio after adding up the Equity Investment and the Net Asset Amount of each and every company belonging to any Big Business Group. The ratio obtained is equivalent to a weighted average, the weight being each company's Net Asset Amount.

57. The number of member companies only increased by 15.6% while the amount of their paid-in capital more than doubled in the four-year period.

Perhaps more relevant is the number of member companies. After all, it is the group expansion through pyramiding that the equity investment regulation aimed to restrain. According to the FTC's report which comprised the thirty largest Business Groups for each year, the average number of member companies increased from 16.3 to 19.7 over the five-year period between April of 1987 and 1992. Comparing this increase to that of earlier years, it is hard to conclude that the equity investment regulation had effectively restrained the group expansion through pyramiding.

Finally, it could be noted that the weighted average ratio of intra-group shareholding fell from 40.4% to 33.4% over the five-year period.[58] Adding to it the ratio of shares directly owned by the controlling family, we find the ratio of so-called inside shareholding falling from 56.2% to 46.2%. This fall certainly has something to do with the lowered ratio of equity investment, and possibly with the equity investment regulation. The question then is whether this reflects a "mitigation of ownership concentration" (FTC 1991, 120), and the answer is hardly straightforward.

In this evaluation 'ownership' relates to two distinguishable notions, namely, residual claims and control power. Although the former may be said to have significantly decreased over the five-year period,[59] this is not necessarily the case for the latter. Would the lowered ratio of inside shareholding have made any difference at all to the control power of chaebol owners? What if the voting rights of 46.2% on average had been large enough for absolute and exclusive control of a group of companies? Theoretically speaking, it would be hasty to draw any inference without examining the distribution of outside shareholding as well, of which limited data is available. Yet there was reportedly no sign of meaningful change in control power due to the lowered ratio of inside shareholding. The family control does not seem to have ever been threatened or weakened at all in this period. "Mitigation of ownership concentration" seems to be an overstatement insofar as it refers to the control power of chaebol owners

58. There are two tendencies found in the business groups of Korea. The gap between book value and par value tends to be smaller for a smaller company, and a smaller company tends to have a higher ratio of shares held by affiliated companies. Being combined, these two tendencies yield a higher average ratio of intra-group shareholding which employs the par value of each member company for weight. That is why the average ratio of intra-group shareholding has turned out to be higher than the average ratio of equity investment for 1991 and 1992 in Table 1. If only the former employed the book value of each member company for weight, it would be lower than the latter.

59. The residual claims of a controlling family may be measured by the ratio $r=\frac{w}{1-s}$ where w denotes the family's direct ownership and s the intra-group shareholding. This ratio increased from 26.5% to 19.2% over the five-year period on average for the twenty-nine Business Groups.

4. Ceiling on the Total Amount of Shareholding: Phase Two, 1995-2009

4.1. Twists and Turns

When the regulation named as Ceiling on the Total Amount of Equity Investment was originally enacted by adding Article 7.4 in the MRFTA in December 1986, the article's first clause enumerated three 'cases of exception' in which a company should not be prohibited from acquiring stocks in excess of its Ceiling Amount. The concerned company had only to dispose of the excessive stocks in a given period of time after its acquisition of them.[60] Article 7.4 then was renumbered as 10 before its first clause was revised to include two more cases of exception in December 1992. One may consider this revision as minor, but it was foreshadowing for what was to come two years later.

In December 1994 the equity investment regulation went through a major change. The change was bidirectional. On the one hand, the first clause of Article 10 was revised to reduce the Ceiling Amount of Equity Investment from 40 to 25 percent of the Net Asset Amount. This revision made the regulation a lot tougher even though the ratio of equity investment had fallen to 26.8 percent on average for the top thirty Business Groups by April 1994 (see <Table 3-2> above). On the other hand, two new clauses were put below the first clause to allow of 'exclusion from application' while the fifth and last case of exception was extended to include a new category in them. This addition and extension constituted something more than a relaxation of the regulation. One may call them as a twist on the regulation, as we shall soon see.

Let us begin with Clause 2 of Article 10, one of the two clauses for 'exclusion from application' added in December 1994. Yet it should first be noted that the MRFTA had had no such term before. Appearing in Clauses 2 and 3 of Article 10, the term referred to what differed technically and confusingly from the 'cases of exception.' If certain acquisition of stocks were *excluded from application* of Clause 1, those stocks should not be counted into the Total Amount of Equity Investment. If, in comparison, certain acquisition of stocks were *excepted* in application of Clause 1, those stocks should still be counted into the Total Amount of Equity Investment. Once a company's Total Amount of Equity Investment had exceeded its Ceiling Amount because of any excepted acquisition of stocks, the company might not have acquired other stocks thereafter. One may thus say that 'exclusion from application' constituted a broader relaxation of the regulation than a 'case of exception.' Put below Clause 1 of Article 10 through the amendment of December, 22, 1994, Clause

60. The period differed for each case of exception.

2 specified one such exclusion from application. It read as follows: "Clause 1 shall not apply to acquiring or owning stocks of a company running the facility business of Class 1 under the conditions described in Item 2, Article 4 of the Act on Private Participation in Social Overhead Capital Facilities." The facility business of Class 1 herein referred to the infrastructure business.

Of the two clauses for 'exclusion from application,' Clause 3 was truly new in its form and contents.[61] It read as follows: "The provision of Clause 1 shall not apply to any company … fulfilling the requirements specified by the Presidential Decree as for stock ownership dispersion, financial structure, and so on." Recall that Clause 2 excluded certain acquisition of *stocks* from the application of Clause 1. In comparison, Clause 3 excluded certain *companies* from application of Clause 1. Clause 3 was new in its form in this sense. As for its contents, we should note the requirements that a company should fulfill to be excluded from application of Clause 1. The requirements involved something quite different from the specifications for the cases of exception enlisted in Clause 1. Particularly so was 'stock ownership dispersion.' The Presidential Decree specified it to include the controlling family's shareholding of eight percent or lower, the inside shareholding of 15 percent or lower, and so on. 'Financial structure' was another requirement. The Presidential Decree specified it as the equity-to-asset ratio of 20 percent or higher. The Presidential Decree added one more requirement, which is not just peculiar but ambiguous: "The concerned company must not be likely to affect economic power concentration." As it is repeated below, these requirements signify one or both of two changes. That is, the equity investment regulation was transformed to serve different goals and/or to serve its goals in a different manner.

It is Article 17.4 of the Presidential Decree amended in April 1995 that specified the requirements for exclusion from application in accordance with Clause 3 of Article 10 of the MRFTA. Interestingly, Article 17.4 of the Presidential Decree was titled "Company of Good Ownership Dispersion." It was also the title to be granted to a company which had fulfilled all the requirements as specified by the Presidential Decree. If any company belonging to a Big Business Group had fulfilled all the requirements, it could request to be designated as a Company of Good Ownership Dispersion. The designation, however, was only allowed to six companies in 1995 and seven more in 1996. Six more companies were designated as such in 1997 when the inside shareholding requirement was relaxed and raised to 20 percent.

61. Before Clause 2 excluded it from application of Clause 1 as of April 1, 1994, equity investment in a company running the infrastructure business had constituted part of the fifth case of exception enlisted in Clause 1. See Article 17.2 of the Presidential Decree whose effective date was April 1, 1992.

Although it was not really new in its form or contents, the extended case of exception was much more significant. Having been added in Clause 1 of Article 10 through the amendment of December 1992, the fifth and last case of exception referred to "acquisition or ownership of stocks which the FTC acknowledges is necessary for maintenance of technical cooperation with small and medium-sized component-manufacturing companies or enhancement of international competitiveness of the industry as specified by the Presidential Decree." This case of exception got a new meaning when Article 17.2 of the Presidential Decree was revised in April 1995. That is, it was so revised that the category of 'enhancement of international competitiveness' might include equity investment between a 'core company' and affiliated companies. A Big Business Group could have any of its member companies designated as 'core' if the company ran business in one of two or three industries of the Group's choice in accordance with the Notice of the Ministry of Commerce and Industry for Promotion of the Specialization of Big Business Groups.[62] A core company then should not be prohibited from acquiring or owning those stocks in excess of its Ceiling Amount which were newly issued by affiliated companies in the same industry.[63] Nor should any of the affiliated and listed companies be prohibited from acquiring or owning those stocks in excess of its Ceiling Amount which were newly issued by a core company. This exception was granted to as many as one hundred twenty six companies in April 1995.[64] In comparison, the total number of companies belonging to the top thirty business groups was six hundred twenty-three as of April 1995. Accordingly, one out of five companies belonging to a Big Business Group was relieved of the equity investment regulation.

62. The Notice was issued on November 18, 1993. It divided the whole industry into fifteen sectors, excluding three of them from the list of sectors that a business group could choose as 'core.' Any of the top ten business groups could choose three sectors as core, and the others two. A member company could be designated as core if more than 70% of its businesses were undertaken in one of the group's core sectors and its sales constituted more than 10% in the market. A core company was relieved of various regulations, the equity investment regulation being one of them.

63. Even if a core company could and did acquire stocks in excess of its Ceiling Amount of Equity Investment thanks to the provisions on exception, those stocks were counted into its Total Amount of Equity Investment. Accordingly, the company might not acquire more stocks unless they were newly issued by affiliated companies in the same industry.

64. They included twenty six core companies and seventy four affiliated companies.

Table 3-3 | Major Changes in the Ceiling on the Total Amount of Equity Investment, 1987-2007

Enactment Date	Effective Date	Designation Criterion	Ceiling Ratio	Cases of Exception	Requirements for Exclusion
Dec. 1986	April 1990	₩500 billion	40%	Industrial rationalization	No exclusion
Dec. 1992	April 1993	₩500 billion	40%	Industrial rationalization Cooperation with SME	No exclusion
Feb. 1993	April 1993	Top thirty	40%	Industrial rationalization Cooperation with SME	No exclusion
Dec. 1994	April 1998	Top thirty	25%	Industrial rationalization Cooperation with SME Core company	Investment in infrastructure business Dispersed ownership Low debt-to-equity ratio
Feb. 1998	Feb. 1998	None	NA	NA	NA
Dec. 1999	April 2002	Top thirty	25%	Infrastructure business Corporate restructuring Foreign-invested company Cooperation with SME	No exclusion
Jan. 2002	April 2002	₩5 trillion	25%	Corporate restructuring Foreign-invested company Cooperation with SME Designated new industries	Holding company Stocks of closely related companies Low debt-to-equity ratio
Dec. 2004	April 2005	₩6 trillion	25%	Foreign-invested company Cooperation with SME Designated new industries	Holding company and subsidiaries Stocks of closely related companies Low ownership-control disparity Good corporate governance
April 2007	July 2007	₩10 trillion	40%	Same as above	Same as above

The new clauses on exclusion from application and the extended case of exception signify one thing in common. It is that the equity investment regulation became loaded with other goals. The regulation's original goal was to restrain the "group expansion through fictional capital." The same regulation then was employed for "enhancement of international competitiveness" and "promotion of specialization" as well as "ownership dispersion."

Another goal was reducing the debt-to-equity ratio. The equity investment regulation had to serve these extraneous goals by offering exception or exclusion as inducement, and hence creating complications. Article 10 of the MRFTA was enlarged with more and longer clauses. More and longer articles were put in the Presidential Decree in relation to Article 10. They enumerated more requirements, the fulfillment of which should be acknowledged by the FTC or another department of the government. This became a tendency that was to recur in the years to come. Some of such changes are recorded in <Table 3-3>.

Exception or exclusion normally amounts to relaxation. The equity investment regulation could be no exception in this regard. In December 1994, however, such relaxation accompanied a major reinforcement that would have more than made up for it. To repeat, the Ceiling Amount of Equity Investment was reduced from 40 to 25 percent of the Net Asset Amount. This new ceiling ratio of equity investment was supposed to be effective as of April 1, 1995 with the grace period of three years thereafter for those companies of which the Total Amount of Equity Investment exceeded the Ceiling Amount at the effective date. Since the current ratio of equity investment was 26.3 percent on average for the Big Business Groups (see <Table 3-2>), many member companies should have reduced its equity investment in three years or so.[65] An official argument for this reinforced regulation cited the increased numbers of member companies and operating business sectors, as well as the still high ratios of general concentration and ownership concentration in the big business groups (Kim 1995), which we can confirm in <Table 3-2>. Would the reinforced regulation then have helped to reduce those numbers and ratios? This question is hard to answer because the reinforced regulation was abolished before the grace period ended.

4.2. Ups and Downs

The Korean economy fell into turmoil with the financial crisis in late 1997, for which the chaebol groups were primarily blamed. The government under new leadership demanded their restructuring.[66] In particular, all the member companies had to reduce their debt-to-equity ratio below 200 percent in a short period of time. This reduction was drastic compared to their current ratio that was as high as 518 percent on average for the thirty largest chaebol groups as of the end of 1997, according to a report of the FTC. Many member companies met the demand by issuing new stocks, a large portion of which its affiliated companies acquired and owned. That is, the chaebol groups reduced their debt-to-equity ratio largely by making up the so-called fictional capital.

65. When the equity investment regulation was introduced with 40 percent as the ceiling ratio in December 1986, the current ratio was 44.8% on average for the thirty largest business groups.

66. The presidential election date was December 19, 1997, and the inauguration date was February 25, 1998.

The government condoned this expedient. In fact, the government decided to help the chaebol groups with their acquisition of stocks by abolishing the regulation named the Ceiling on the Total Amount of Equity Investment in February 1998. Recall that the regulation had been significantly reinforced through the amendment of the MRFTA in December 1994 and would have been fully effective as of April 1998. That is, the Ceiling Ratio had been lowered from 40 to 25 percent, which all the companies belonging to Big Business Groups would have had to abide by had the regulation not been abolished in February 1998.

There is another reason that the government openly cited for abolishing the equity investment regulation. It was because of the presumed possibility of hostile takeover by foreigners. Foreigners had been prohibited from acquiring any outstanding stocks of a company without consent of the board of directors before the Foreign Capital Inducement Act was amended in February 1998.[67] Given the amended Act, foreigners could acquire freely up to a third of outstanding stocks of a company. The upper limit of stock acquisition was entirely removed three months later. There was another institutional change relative to hostile takeover by foreigners or any investors. The mandatory tender system, which had been adopted to render hostile takeover burdensome about a year ago, was abruptly dissolved in February 1998.[68] Referring to these two institutional changes, the government agreed that it would be "reverse discrimination" against the chaebol owners and violation of the "market economy principles" if the acquisition of stocks by affiliated companies could not be freely employed as a defensive measure against hostile takeovers. Hence the government had Article 10 deleted in its entirety from the MRFTA through the amendment of February 22, 1998. It was just four weeks before the lowered Ceiling Ratio of Equity Investment would have actually been imposed on most of the companies belonging to Big Business Groups.

67. In fact, 'Foreign Capital Inducement Act' had been the name before it was changed to 'Foreigner Investment and Foreign Capital Inducement Act' in January 1997. The Act was abolished and replaced with the Foreigner Investment Promotion Act in November 1998.

68. Given the mandatory tender system in March 1997, anyone who would acquire 25 percent or more of issued shares of a listed company had to acquire more than 50 percent of issued stocks by tendering the same offer to all shareholders. Although this system could work for the interest of small shareholders, it was mainly adopted to render hostile takeovers burdensome at the time. See Box 3-2 for further details.

Box 3-3 | Mandatory Tender System

In Korea the mandatory tender system was enacted through the amendment of the Securities Exchange Act followed by the revision of the Presidential Decree in March 1997. According to the system, anyone who would acquire twenty-five percent or more of issued shares of a listed company had to acquire more than fifty percent of issued stocks by tendering a same offer to all shareholders. Although this system could work for the interest of small shareholders, it was mainly adopted to render hostile takeovers burdensome at the time. The system, however, did not last long. It was dismantled in February 1998.

Enactment of the mandatory tender system had to do with the revision of Article 200 of the Securities Exchange Act which would become effective in April 1997. Prior to that date, no one could acquire more than ten percent of issued stocks of a listed company without permission of the Stock Management Committee. Shareholders owning more than ten percent of shares at the time of listing, however, were not subject to the regulation. Given the regulation, no hostile takeover had been possible at all. The mandatory tender system was a kind of substitute for the regulation.

Once abolished, the equity investment regulation was recalled in less than two years. The enormous increase of fictional capital or "circular equity investment" seems to have alarmed the government.[69] Amended in December 1999, the MRFTA got Article 10 back. It determined both the Ceiling Amount and the Total Amount of Equity Investment in the same way as before. The Ceiling Ratio was 25 percent. As a matter of fact, the regulation was toughened in some regards. No 'company of good ownership dispersion' was to be designated or excluded from imposition of the Ceiling Ratio. Equity investment between a 'core company' and affiliated companies was not treated as a case of exception in application under the name of 'international competitiveness.' Yet two new categories were put in its stead (see <Table 3-3> above). One was the equity investment for 'corporate restructuring,' and the other was for 'foreign capital inducement.' It may be said that the changed circumstances called forth the new cases of exception, and that coping with the financial crisis replaced the betterment of the ownership or business structure in the regulation's consideration.

69. "Circular equity investment" is an expression used in the President's address of August 15, 1998. The term circular, however, is not quite appropriate to describe the structure of intra-group shareholding in Korea. One might call it as circular if company A holds shares of company B, company B holds shares of company C, and company C holds shares of A. Such cases, however, were rare at the time. See Section 5.2 of this chapter for further discussion.

There is one more variation to note regarding the recalled regulation. About a year after Article 10 was deleted from the MRFTA, Article 8 was revised to allow the establishment of holding companies. A company is called defined as a holding company if most of its assets consist of stocks of other companies. Obviously, a holding company cannot be established unless it is excluded from application of the equity investment regulation. When Article 10 was restored in December 1999, it was so written as to exclude from application holding companies, as well as financial companies and insurance companies.[70]

The recalled regulation was not immediately applied. The first clause of Addenda reads: "However, the amended provisions of Article 10 (Ceiling on the Total Amount of Equity Investment) … shall go into effect on April 1, 2001." This was not the only clause concerning the effective date. The third clause of Addenda reads: "If a company's Total Amount of Equity Investment exceeds its Ceiling Amount as of the effective date, the former shall be deemed to be its Ceiling Amount for the first one year from the effective date." To sum, more than two years had to pass for the recalled regulation to be fully effective.

In actuality the equity investment regulation was not applied as it had been recalled. A few months before the fully effective date arrived, more categories and cases were put in the list for exception or exclusion (See <Table 3-3> above). Probably most notable are those in Clause 6. It enumerates four categories for exclusion, the third concerning "stocks of any company whose business is of a same sort or closely related with the concerned company as specified by the Presidential Decree." Such stocks were excluded from application of Clause 1. The fourth case of exception inserted in Clause 1 is also worth noting. It says that any company should not be prohibited from acquiring stocks in excess of its Ceiling Amount if that acquisition were "to enhance the international competitiveness of the new industries designated by the provisions of Article 7 of the Industry Development Act or of other industries designated by the Presidential Decree."

When the list of cases for exception or exclusion got longer in Article 10 through the amendment of January 2002, Clause 1 was revised so that the equity investment regulation might not be applied to relatively smaller business groups.[71] In addition, the so-called graduation requirement was reintroduced.[72] The requirement was that the consolidated debt-to-equity ratio be lower than 100 percent. If a business group fulfilled the requirement,

70. Subsidiaries of a holding company were excluded from application as well since April 2005. See 〈Table 3-3〉.

71. Article 1 was revised so that the criteria should be specified by the Presidential Decree. The total asset amount of 5 trillion won or more was the criterion applied in April 2002.

72. In December 1994 a similar requirement for exclusion from application was introduced under the title of the Business Group with Good Ownership Dispersion, but no business group was ever eligible for it.

its member companies would not be subject to the regulation any more.[73] Consequently, the number of business groups subject to the regulation fell to eleven in April 2002 if we continue only to count those under control of a person or family.[74]

The list of cases for exception or exclusion got even longer under the next government (see <Table 3-3> above). In addition, the number of business groups subject to the equity investment regulation was reduced as a result of two changes. One was the changed definition of Big Business Groups, and the other the new set of "graduation requirements." It included a good "ownership and governance structure" among others.[75] In April 2007, the first clause of Article 10 was revised again to raise the Ceiling Amount of Equity Investment from 25 to 40 percent of the Net Asset Amount. Article 10 then was entirely deleted again from the MRFTA in March 2009. A persistent and accepted claim was that the equity investment regulation hindered companies from making new investments and creating employment.

4.3. Spurious Impacts and Counterfactual Conjectures

In April 2005 the equity investment regulation applied only to nine chaebol groups whereas four of the top ten chaebol groups were excluded for one reason or another.[76] A calculation from the FTC's report showed that these nine chaebol groups' equity investment added up to 17.9 trillion won, of which 5.9 trillion won was excluded from application and 3.8 trillion won was acknowledged as exception.

The figures above do not include the equity investment of holding companies and their subsidiaries, to which the regulation did not apply in April 2005 and thereafter. Two of the nine chaebol groups subject to the equity investment had been transformed to a holding company system. Another chaebol group had transformed a part of it to a holding company system. The amount of their equity investment would certainly exceed 8 trillion won.

73. Only one group named Lotte fulfilled the requirement in 2002.

74. In April 2002 the equity investment regulation began to apply to the state-owned business groups as well. However, the figures relative to equity investment do not include them 〈Table 3-4〉.

75. See the first clause of Article 10 of the MRFTA as amended in December 2004 and the second clause of Article 17 of the Presidential Decree. See Section 3 of Appendix A for further details.

76. The four excluded chaebol groups are Samsung, Lotte, Hanjin, and Hyundai Heavy Industries. They fulfilled one of the so-called graduation requirements such as low debt-to-equity ratio (Samsung, Lotte) and small ownership-control disparity (Hanjin, Hyundai Heavy Industries).

Box 3-4 | Equity Investment of Holding Companies and their Subsidiaries

The two chaebol groups called LG and GS were ranked respectively as second and seventh among the Korean chaebol groups in April 2005. GS had been legally separated from LG in January 2005. LG had been transformed to a holding company system before the separation, but a few of its member companies were kept out of the system after the transformation. GS also kept a few member companies outside of its holding company system. 'LG' and 'GS' are also the names of two holding companies.

SK has long been the fourth largest chaebol group in Korea. The chaebol group transformed itself to a holding company system in 2007, including most of its member companies. SK E&S was one of those member companies, but it had been a holding company for itself. It had fourteen subsidiaries in April 2005, and its name was SK Enron at the time.

The equity investment of three holding companies (LG, GS, SK Enron) added up to 7.5 trillion won in December 2004. They had never been subject to the equity investment regulation. They had thirty-nine subsidiaries whose equity investment was also excluded from application of the equity investment regulation according to Article 10 of the MRFTA as amended in December 2004.

In sum, more than two-thirds of the nine chaebol groups' equity investment fell under the categories of exclusion or exception. The excluded or excepted portion of equity investment would be far bigger if it included the equity investment of those chaebol groups which were entirely excluded from application for one reason or another. It is, therefore, safe to say that the equity investment regulation had lost most of its weight, if any, *before* the Ceiling Ratio of Equity Investment was raised from twenty-five to 40 percent in April 2007.

Drawing inferences will be more involved if it concerns the immediate impact of the recalled regulation. Take a look at <Table 3-5>. It covers those years before and after the equity investment regulation was recalled in December 1999. It has been constructed in the same way as <Table 3-4> except for the business groups included. <Table 3-4> includes the thirty largest of those business groups under control of a person or family which the FTC designated each year in accordance with the Presidential Decree.[77] Yet the FTC does not disclose any data for the equity investment of other business groups than those subject to the regulation, of which the number was radically reduced in 2002 and further reduced in 2005. We thus have to draw inferences instead relying on the weighted average ratio of intra-group shareholding for the thirty business groups.

77. A few state-owned business groups were designated for the equity investment regulation and/or other regulations in April 2002 and thereafter.

Table 3-4 | Inside Shareholding of Top Business Groups,[1] 1995-2005

(Unit: billion won, %)

	1995[2]	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
(Average) Number of member companies	623 (27.7)	669 (22.3)	819 (27.3)	804 (26.8)	686 (22.9)	544 (18.1)	624 (28.0)	636 (21.2)	674 (22.5)	675 (22.5)	704 (23.5)
Equity capital[2]	56,974	70,542	75,183	75,592	101,997	135,060	167,269	162,123	179,287	205,827	242,326
Paid-in capital in par value	24,036	26,802	29,654	32,305	42,145	54,148	60,437	49,167	55,571	57,084	58,725
Inside shareholding	43.3	44.1	43.0	44.5	50.5	43.4	45.0	48.5	48.0	48.9	50.9
Controlling family	10.6	10.3	8.5	7.9	5.4	4.5	5.6	5.0	5.2	4.4	4.7
Affiliated companies	32.4	33.8	34.5	36.6	45.1	38.9	39.4	43.5	42.8	41.7	43.9
Ultimate ownership	15.7	15.6	13.0	12.5	9.8	7.4	9.2	8.8	9.1	7.5	8.4
Net Asset (A)	42,884	54,831	61,343	59,232	92,020	139,610	142,765	NA	NA	NA	NA
Equity Investment (B)[3]	11,292	13,571	16,876	17,674	29,941	45,938	50,842	NA	NA	NA	NA
Ratio (B/A)	26.3	24.8	27.5	29.8	32.5	32.9	35.6	NA	NA	NA	NA

1) Thirty largest of those business groups under control of a person which the FTC designated each year. State-owned business groups are excluded

2) Footnotes to Table 1 apply to this and other rows below except that of Equity Investment

3) Each company's equity investment is measured by the acquisition price of stocks it owns in domestic companies since April 1997

Source: The Fair Trade Commission

Table 3-5 | Business Groups Subject to the Equity Investment Regulation, 1995-2004

(Unit: billion won, %)

	1995[2]	1996	1997	1998	1999	2000	2001	2002	2003	2004
Groups[1]	9	9	9	9	9	9	10	11	11	12
Member companies	301	313	372	365	317	255	301	319	332	335
Equity capital[2]	32,526	42,133	46,794	46,891	67,307	120,723	124,690	126,049	141,511	161,394
Paid-in capital in par value	12,374	13,925	16,534	18,255	25,875	38,120	42,985	38,604	44,269	44,811
Inside shareholding	47.7	47.7	45.9	46.6	52.5	48.5	46.4	46.6	46.2	46.2
Controlling family	9.5	9.2	8.3	7.4	4.9	3.7	4.0	4.1	4.1	4.0
Affiliated companies	38.3	38.5	37.5	39.2	47.6	44.7	42.5	42.5	42.1	42.1
Ultimate ownership	15.4	15.0	13.3	12.2	9.4	6.7	7.0	7.1	7.1	6.9
Net Asset [A]	25,224	33,865	37,889	37,819	60,883	106,621	101,988	103,065	115,392	132,602
Equity Investment [B][3]	6,845	8,156	9,718	11,282	20,170	35,507	38,837	33,104	36,795	37,762
Ratio [B/A]	27.1	24.2	25.6	27.9	29.8	33.3	38.1	32.1	31.9	28.5

	1995[2)]	1996	1997	1998	1999	2000	2001	2002	2003	2004
Exclusion from application [C]	-	647	-	-	-	-	NA	8,953	16,306	18,059
Cases of Exception [D]	-	-	-	-	-	-	NA	6,345	4,592	4,285
Ratio [(C+D)/B]	-	-	-	-	-	-	NA	46.2	56.8	59.2

1) The names of the nine groups are Samsung, Hyundai, LG, SK, Hanjin, Hanwha, Kumho, Doosan, and Dongbu. The names of three groups added in 2001 and later are Hyundai Motors (2001), Hyundai Heavy Industries (2002), and LS (2004)

2) Footnotes to Table 2 apply to this and other rows below

3) Figures for April 2002 and later include the equity investment of holding companies and their subsidiaries that are excluded in the FTC's report. Same for the rows below

Source: The Fair Trade Commission

As <Table 3-4> shows, the weighted average ratio of intra-group shareholding visibly fell in a year or so after the equity investment regulation was recalled in December 1999. We may thus provisionally conjecture that the recalled regulation should have yielded a considerable impact. There is another piece of evidence. The weighted average ratio of intra-group shareholding rose to 43.5 percent in April 2002. We may take this to suggest that the recalled regulation would have had a lasting impact if the MRFTA had not been revised to extend the list for exclusion or exception and to relieve those relatively smaller business groups of the regulation. Whether this conjecture can be justified or not, we can safely infer that the recalled regulation was not binding after it was relaxed in January 2002. How could anyone claim the contrary and support that the ratio of intra-group shareholding would have been higher than 43.5% if it had not been for the equity investment regulation as it was after January 2002? After all, the ratio barely exceeded 43.5 percent after the regulation was further relaxed in December 2004.[78]

<Table 3-5> was constructed to include those Business Groups which were subject to the equity investment regulation for all the years before 2005.[79] The number of Business Groups included, therefore, would not have varied unless two Business Groups had been divided into five during this period of time.[80] The Net Asset Amount and Total Amount of Equity Investment have been identified for each of their member companies from various reports of the FTC and other sources. Given this table, we can compare the weighted average

78. The weighted average ratio of intra-group shareholding slightly fell to 43.7% in April 2006 before it rose to 44.3% in April 2007.

79. Five more business groups were excluded from application of the regulation in April 2005. If 〈Table 3-5〉 is constructed to include that year, it shall only include seven to eight business groups.

80. For instance, the business group called Hyundai was divided into four groups in this period of time, each group being controlled by one of the founder's sons. One of the four groups is not included in 〈Table 3-4〉 since it was not large enough to be subject to the equity investment regulation in April 2002 or thereafter.

ratios of equity investment before and after the equity investment regulation was recalled in December 1999. Rather surprisingly, the ratio was much higher for April 2001 than for April 1999. This increase contradicts our provisional conjecture that the recalled regulation should have had impact at least until the list for exclusion or exception was considerably extended in 2001 and 2002. In addition, the lowered ratio for April 2002 and the even lower ratios thereafter support our inference that the recalled and relaxed regulation was *not binding*.

Figures in the last row of <Table 3-5> offer us an explanation for the missing impact of the recalled regulation. Although the equity investment amounted to 33.1 trillion won in April 2002, 46.2 percent of it was either excluded from application or treated as exception. This portion was even larger in the following years.[81] With such a large portion of exclusion or exception, the equity investment regulation could hardly serve its original goal, that is, to restrain the "group expansion through fictional capital." The number of member companies was ever increasing since 2000 whether we look at <Table 3-4> or <Table 3-5>. The recalled and relaxed regulation was barely effective in restraining the group expansion through pyramiding.

What then should one say about the reinforced but abolished regulation? Recall that the reinforcement was enacted in December 1994 after a series of debates and consultations. As we can see in <Table 3-2> above, the weighted average ratio of equity investment was already as low as 26.8 percent in April 1994. The ratio fell to 26.3 percent in April 1995 before it further fell to 24.8 percent in April 1996 (see <Table 3-4>). Although this fall was due to the faster increase in the Net Asset Amount compared to the increase in the Total Amount of Equity Investment, one may still consider it as an advance effect of the reinforced regulation that was supposed to be fully effective as of April 1998. The weighted average ratio of equity investment, however, jumped to 27.5 percent in April 1997 (see <Table 3-4>). According to the FTC's report, one hundred and seventy-one companies should have reduced their equity investment by 2.4 trillion won in total in order not to exceed their Ceiling Amount,[82] lowering the weighted average ratio of equity investment to 23.6 percent in April 1997.[83] Given these figures, we can make a counterfactual conjecture

81. Since two companies belonging to the LG group transformed themselves to a holding company with many subsidiaries after April 2002, the holding company was excluded from application of the equity investment regulation. The holding company's equity investment, which amounts to 6.7 trillion won as of April 2003, is not listed under the category of exclusion in the FTC's report. This is the main reason why our figures are much bigger for 2003 and 2004 than those in the FTC's table.

82. One hundred eighty-seven companies should have reduced their equity investment by 3.8 trillion won in total in order not to exceed their Ceiling Amount, but sixteen of them were and excluded from application of the regulation as they and four others were designated as a company of good ownership dispersion in April 1997.

83. $\frac{16,876-2,388}{61,343}$ =,2362.

that the reinforced regulation would have been quite binding for the Big Business Groups had it not been abolished in February 1998. More suggestive are those figures for 1999 and later. The aggregate ratio of equity investment rose to 32.5 percent in April 1999 and 35.6 percent in April 2001. Obviously, the ratio could never be that high if the Big Business Groups had to and did abide by the reinforced regulation.

4.4. Implication for Policymakers

The regulation named Ceiling on the Total Investment had not been noticeably effective in suppressing "economic power concentration" or curbing the chaebol groups' "expansion through fictional capital." Its ineffectiveness, however, was not due to any defects in itself. The regulation could have been much more effective if it had not allowed massive exceptions or broad exclusions.

Consider a group of companies under control of a person or family with limited private funds, and suppose that the controlling power rely on a high ratio of intra-group shareholding which implies a high ratio of equity investment. It then is a simple matter of arithmetic that only two options are allowed for the controller if each and every member company must lower its ratio of equity investment than the current ratio. One is to reduce the ratios of intra-group shareholding, and the other is to reduce the number and/or scale of companies under its control. Whichever option is taken, the controller's economic power is repressed.[84] That is, the equity investment regulation could not help attain its goal in this sense. If it had been ineffective, it should have been due to either an insufficiently low Ceiling Ratio or massive exclusions and broad exceptions. We have seen that the latter actually happened in Korea. The equity investment regulation was ineffective because few companies had to actually lower their ratio of equity investment in spite of the Ceiling Ratio, which was a lot lower than their current ratio.

It might have been unavoidable for the government to relax the equity investment regulation with exclusions and exceptions in the mid-1990s and later. The government wanted to curb the chaebol groups' "expansion through fictional capital," but did not want to curb the chaebol groups' growth through 'real' investment. It then was argued that the latter should be accompanied or preceded by the former. In fact, it sounded more like demand than argument of the chaebol owners. Giving in their demand, the government opted for loosening the equity investment regulation with loop holes in the name of exclusions and exceptions instead of raising the Ceiling Rate, probably for political reasons.

Exclusion and exception did not only constitute relaxation but transformation in the case of the equity investment regulation as we have seen above. exception and exclusion

84. See Appendix A for further explication.

were brought into the equity investment regulation more or less for other goals than the regulation's original and genuine goal. The equity investment regulation served these extraneous goals by offering exception or exclusion as inducement, which was equivalent to a rather significant transformation of the regulation itself.

Complication was another serious outcome of exclusions and exceptions. For instance, Article 10 of the MRFTA was enlarged from a few lines to a few pages. Relevant articles of the Presidential Decree got even larger. The articles were filled with categories and cases to specify, criteria and terms to define, requirements to fulfill for exclusion, conditions to meet for exception, administrative procedures to follow, and so on. Many of them were done away, and more were brought in. It is almost impossible to record all the details and variations without missing any of them. It would hardly be an exaggeration to say that the equity investment regulation got out of control.

Having been loosened, transformed, and complicated with exclusions and exceptions, the equity investment regulation looked awkward. It lost its *raison d'etre* mostly before the Ceiling Ratio was raised to 40 percent in April 2007. Inducement was more prominent than suppression; the Ceiling Ratio seemed to exist for loopholes and privileges. Complication was overwhelming. Not many would argue for maintenance of the regulation as it was, and Article 10 was deleted from the MRFTA in March 2009.

5. Prohibition of Reciprocal Shareholding

5.1. Earlier Enactments

It might be stated in English that cross shareholding is prohibited in Korea. One might substantiate the statement by reading the title of Article 9 of the current MRFTA as it appears in an English translation of the Act, that is, "Prohibition, Etc. on Cross-Shareholding."[85] The statement, however, could be misleading.

The source of misunderstanding exists in the term cross shareholding. The term is usually and casually employed to refer to the situation in which one company owns stocks of another company. Inter-company shareholding, however, is not exactly what is prohibited in Korea by the provisions of the MRFTA. Article 9 of the MRFTA defines what it prohibits in the following statement: "Any company … shall not acquire or own stocks of an affiliated company which acquires or owns its stocks." It thus seems to be more proper to translate the article's title as Prohibition of Reciprocal Shareholding. A more direct translation would

85. The translation is posted at the FTC's homepage prepared in English (http://eng.ftc.go.kr). The Legislative Office offers a slightly different translation (http://www.law.go.kr).

be “Prohibition of Reciprocal Equity Investment.”[86] Both shall be used interchangeably hereinafter. To repeat, ‘reciprocal equity investment’ or ‘reciprocal shareholding’ refers to a situation in which one company owns stocks of another company *and* the latter owns stocks of the former. The provisions of the MRFTA prohibit such bi-directional shareholding between a pair of domestic companies if both companies belong to a same Business Group of a certain or larger size.

It is through the amendment of December 31, 1986 that a new article was put in the MRFTA to prohibit the Reciprocal Equity Investment. The article was numbered as 7.3 at the time, and renumbered as 9 four years later. Prior to the amendment of the MRFTA in December 1986, some reciprocal shareholding had been prohibited by the provisions of Article 342.2 of the Commercial Act. This article had been added in April 1984. Their ranges of application, however, were limited. Titled “Acquisition of a Parent Company’s Stocks by its Subsidiary Company,” Article 342.2 applied only to a pair of companies of which one owned forty percent or more of the other’s stocks.[87]

When Article 342.2 was added in the Commercial Act, a new clause was added in Article 369 of the Act. It denied voting rights of some stocks involved in reciprocal shareholding, and its range of application was wider than that of Article 342.2. The denial of voting rights applied to any case of reciprocal shareholding between two companies of which one owns 10 percent or more of the other’s stocks. If in this case the latter acquired the former’s stocks, voting rights should be denied for those stocks.

As it has been noted in Section 1 of this chapter, the amendment of the Commercial Act was a response of the government to criticisms on the high ratio of intra-group shareholding of chaebol groups. Most fierce criticisms were leveled at reciprocal shareholding even though no data were available regarding its portion in the intra-group shareholding of chaebol groups. “Fictional capital” was a frequently used term in those criticisms. Apparently, such criticisms were not abated by the amendment of the Commercial Act in April 1984. Stronger regulations were called for when the provisions of Article 342.2 turned out to be applicable to a tiny portion of the intra-group shareholding of chaebol groups (DongAIlbo, April 14, 1984; DongAIlbo, May 15, 1984). The regulations must have been designed specifically for chaebol groups with a complex structure of intra-group shareholding.

86. Some people prefer ‘equity investment’ to ‘shareholding’ for various reasons or no reason at all. It might look less negative or more positive if chaebol companies invest in equity of other companies instead of acquiring and holding stocks of other companies.

87. The range of application was further narrowed since Article 342.2 of the Commercial Act was revised to raise the shareholding criterion for application from forty to fifty percent in July 2001. This shareholding criterion has been maintained thereafter.

Box 3-5 | Cross Shareholding or Reciprocal Shareholding

"Reciprocal equity investment" is the present author's translation of the Korean word (상호출자, 相互出資). The translation shall be interchangeably used with "reciprocal shareholding."

The MRFTA defines the term specifically as any two companies' holding of each other's shares. An official translation of the term, however, is "Mutual Contribution." One may visit the FTC's homepage (http://www.ftc.go.kr) for the whole translation of the MRFTA.

Yet it is not the only official translation. In fact, the same Korean word is translated more often as "cross-shareholding" in official documents. See, for instance, the translation of the MRFTA posted at the FTC's homepage prepared in English (http://eng.ftc.go.kr). The term "cross-shareholding" also appears in the FTC's *2011 Annual Report* (p. 113). The present author, however, finds it confusing because the term "cross shareholding" is often used to refer to either any company's shareholding in another company or shareholding between financial companies and non-financial companies in many countries.

5.2. Details and Variations

Article 7.3 of the amended MRFTA was relatively straightforward as to the range of application. Its provisions applied to any pair of companies belonging to a same Big Business Group with one category for exclusion from application. The excluded category included financial companies and insurance companies, which were no longer excluded from application in April 1990. The shortened article read: "Any company belonging to a Business Group … shall not acquire or own stocks of an affiliated company which acquires or owns its stocks." No company belonging to a Big Business Group has been excluded from application thereafter.

"Big Business Group" is the term that appeared for the first time in Article 7.3 of the MRFTA. The term was shared with Article 7.4 as both articles concerned the same groups of companies. The scope of a Business Group was to be determined according to Article 2 of the Act and the Presidential Decree. Article 7.3 of the Act had to set the criterion for bigness of Business Groups. Yet the first clause of Article 7.3 only referred to "Total Assets Amount" in relation to the designation of Big Business Groups while leaving further specifications to the Presidential Decree. Article 15 of the Presidential Decree defined the term Total Assets Amount and set the criterion in terms of it. The criterion was 400 billion

won. The FTC designated thirty-two Big Business Groups comprising five hundred eleven companies according to the criterion in April 1987.

The number of Big Business Groups increased year after year until their number was fixed at thirty through the revision of the Presidential Decree in February 1993. The criterion was changed again and set directly in terms of the Total Assets Amount in March 2002. The critical amount was 2 trillion won.[88] The FTC designated thirty-one chaebol groups for application of the regulation according to the new criterion in April 2002.[89] The number of designated chaebol groups increased to forty-three in April 2012.

Article 7.3 also enumerated four cases of exception. Two of them were removed when the article was renumbered as 9 through the amendment of January 1990. One of the two remaining cases was "merger of companies or acquisition by transfer of a whole business,"[90] and the other "exercise of security rights or receipt of payment in substitutes." 'Exception' herein meant suspension like that in Article 7.4. Six months were allowed for the excepted cases of reciprocal shareholding to be resolved. No case of exception has ever been added.

The range of application is not the only difference between the two Acts as for the prohibition of reciprocal shareholding. Measures for enforcement were set in the MRFTA. If any company acquired stocks of an affiliated company in violation of Article 7.3, the FTC could order the concerned company to dispose of the acquired stocks while suspending their voting rights.[91] Another measure for enforcement was the penalty. Not surprisingly, the penalty for violation was the same as that for violating Article 7.4 titled "Ceiling on the Total Amount of Equity Investment." It was an imprisonment for no more than two years, or a fine not exceeding 100 million won.[92]

The penalty was toughened in January 1990, and a penalty surcharge was introduced as an additional measure for enforcement at that time. It should be ten percent or less of the book value of those stocks acquired in violation of Article 9.[93] Article 9 and other related articles have stayed there with minor changes.

88. A different amount was set as the criterion for application of Ceiling on the Total Amount of Equity Investment in 2002 and later. Accordingly, the term Big Business Groups was replaced with "Business Group subject to Prohibition of Reciprocal Equity Investment."

89. The FTC designated forty-three Business Groups for application of the regulation in April 2002. Twelve of them, however, were not under control of a person or family. They were either owned by the state or public companies. Such business groups had not been subject to the regulation until April 2002.

90. Merger of two companies could yield a case of reciprocal shareholding with another company only if the three companies had been involved together in a case of circular shareholding.

91. See Articles 10 and 10.2 of the MRFTA amended in December 1986. They were renumbered respectively as 16 and 18 in January 1990.

92. See Article 55 of the MRFTA amended in December 1986. It was renumbered as 66 in January 1990.

93. See Clause 1 of Article 17. The same surcharge applied to the violation of the ceiling on the total amount of equity investment.

5.3. Accomplishments in the First Three Years

Article 7.3 of the amended MRFTA became effective as of April 1, 1987 with a three-year grace period, which was two years shorter than that for Article 7.4. Any company belonging to a Big Business Group had to dispose of those stocks involved in reciprocal shareholding with its affiliates before April 1, 1990.

What would the prohibition of reciprocal shareholding have been intended to achieve? Let us quote from FTC (1991, p. 114). "Companies could alienate real investors by exchanging and possessing control power upon fictional equity investment. Relying on this function of reciprocal equity investment, the chaebols have controlled companies so far without equity investment, thereby concentrating economic power in their hands." Nevertheless, it was not told how heavily the chaebol owners had relied on reciprocal shareholding to extend or enhance their control power before Article 7.3 was put in the MRFTA. We are only provided with data on reciprocal shareholding as of April 1987 and later.

According to FTC (1991, p. 118), the book value of stocks involved in reciprocal shareholding was 62 billion won in total for the thirty-two Big Business Groups as of April 1987. FTC (1991, p. 118) also reports that the thirty-two Big Business Groups freed themselves completely from reciprocal shareholding by disposing of that amount of stocks in less than three years. Although eleven Business Groups were newly designated in April 1988, they also resolved all the reciprocal shareholding in a year. <Table 3-6> is constructed to show the details.

Table 3-6 | Reciprocal Shareholding of Big Business Groups, 1987-2002

(Unit: billion won, %)

	Amount of reciprocal shareholding				Amount (ratio) disposed of
	1987	1988	1989	2000	
Designated in 1987	61.9	35.7	17.9	0.0	61.9 (100)
Designated in 1988	-	7.4	7.0	0.0	7.4 (100)
Total	61.9	43.1	24.9	0.0	69.3 (100)

1) 'Amount' refers to the least amount of stocks that the chaebol groups should have disposed of in order to get free of any reciprocal shareholding as of April 1 of each year

2) Thirty-two Big Business Groups were designated in 1987, and eleven Big Business Groups were newly designated in 1988

3) No reciprocal shareholding was found in those Big Business Groups which were newly designated in 1989

Source: Fair Trade Commission (2001, p. 118)

Let us compare the figures above with those in <Table 3-2>. The table has excluded the two smallest of the thirty two Big Business Groups for 1987. According to the table, equity capital and equity investment respectively amounted to 10,449 billion won and 3,257 billion won in total for the top thirty chaebol groups in April 1987. In other words, it is just 0.6 percent of equity capital or 1.9 percent of equity investment that the Big Business Groups had to dispose of in order to avoid violating the provisions of Article 7.3 of the MRFTA.[94]

It is also unlikely that there had been much more reciprocal shareholding in the Big Business Groups before April 1987. A government agency had reportedly surveyed eleven top chaebol groups in 1984, finding out 41 billion won of reciprocal shareholding (DongAIlbo, April 14, 1984). We may take this figure as reliable, comparing it with the figure for 1987 in <Table 3-6>.

Given these and other figures, we can hardly attribute any reduction in the intra-group shareholding of chaebol groups to the prohibition of reciprocal shareholding. Although the average ratio of intra-group shareholding fell rather radically in the years 1987-1989 (see <Table 3-2>), it must have been due to some other causes or circumstances. Neither the provisions of Article 342.2 of the Commercial Act nor the provisions of Article 7.4 of the MRFTA could have had any significant impact on the ownership structure of chaebol groups or the economic power concentrated in the chaebol owners' hands.

5.4. Not Reciprocal but Circular

We have just concluded that the prohibition of reciprocal shareholding had little impact on the concentration of economic power. Most of all, the amount of reciprocal shareholding had been negligible in most of the chaebol groups even before the prohibition was enacted. The chaebol owners had not relied on reciprocal shareholding for their control power. Yet a counterfactual question is worth asking. What if reciprocal shareholding had not been prohibited for the Big Business Groups? Would their reciprocal shareholding have significantly increased anytime later?

The counterfactual question is especially worth asking because circular shareholding grew suddenly in a few chaebol groups around the year 2000 (see Appendix B). 'Circular shareholding' refers to a case in which a sequence of inter-company shareholding constitutes a closed circle. If Company A owns stocks of Company B, Company B owns stocks of Company C, and Company C owns stocks of Company A, then we may say that the series

94. This ratio makes sense because equity investment was measured in terms of book value in April 1987. The Total Amount of Equity Investment began to be measured in terms of acquisition price in April 1997.

of stock holdings constitutes a case of circular shareholding.[95] Of course, more than three companies may be involved in a case of circular shareholding, and the case may be more complicated than the one above.

However complicated a case of circular shareholding may be, it is a variant or extension of reciprocal shareholding. As a matter of fact, circular shareholding is a nearly perfect substitute for reciprocal shareholding. They differ from each other merely in the number of companies involved. A case of circular shareholding consists of three or more companies whereas a case of reciprocal shareholding consists of two companies. If two companies can "alienate real investors" through reciprocal shareholding between them, three or more companies can "alienate real investors" through circular shareholding among them. A chaebol owner can employ either reciprocal shareholding or circular shareholding to control a group of companies without equity investment, thereby concentrating economic power in his/her hands.

Such a substitute for reciprocal shareholding had significantly increased around 2000 in the face of the stern prohibition of reciprocal shareholding. This fact leads to a positive answer to the question above. Reciprocal shareholding would have significantly increased had it not been prohibited for the Big Business Groups since April 1987.

5.5. Implication for Policy Makers

What then does it imply for the prohibition of reciprocal shareholding that circular shareholding had increased instead? Should we take it as an accomplishment of the prohibition or an evasive response of chaebol groups to the prohibition? Interestingly, Article 342.2 of the Commercial Act was equipped with a clause regarding circular shareholding. The clause read as follows: "Provided that a parent company and its subsidiary or its subsidiary owns more than forty percent of any company's stocks, the concerned company is considered as the parent company's subsidiary in application of this Act." In short, a subsidiary's subsidiary is also a subsidiary in the eyes of Article 342.2.[96] If a subsidiary's subsidiary acquires stocks of the parent company, it shall constitute a case of reciprocal shareholding that the provision of Article 342.2 prohibited.

As we have just witnessed in Article 342.2 of the Commercial Act, a short clause is sufficient for ensuring an extended application of the prohibition to circular shareholding. It can preclude any evasion of the prohibition via circular shareholding. A similar clause

95. In Korea, the term circular shareholding has been confusingly used. More often than not, it refers to *any* inter-company shareholding whether or not the sequence of inter-company shareholding constitutes a *closed* circle. This is not exactly what is herein meant by 'circular shareholding.'

96. It is not obvious but likely that the clause should apply to a subsidiary of a subsidiary of a subsidiary of a parent company as well.

should have been put in Article 7.3 of the MRFTA if indeed the government intended to prohibit circular shareholding as well as reciprocal shareholding. Yet no such clause was put in Article 7.3 or 9. The article has not gone through any revision intended to extend the prohibition to circular shareholding as well as reciprocal shareholding.

There is one explanation for this ambivalence. Such an extension was deemed unnecessary due to Article 7.4 or 10 of the MEFTA that imposed an upper limit on the Total Amount of Equity Investment. It seems to have been a concurrent view that Article 7.4 or 10 should help to curtail circular shareholding one way or another. The facts, however, defied this view as it has already been noted (see Appendix B).

One may state that the regulation called Prohibition of Reciprocal Shareholding has successfully accomplished its mission. Reciprocal shareholding, if any, has completely disappeared from the Big Business Groups. There is no such thing as fictional capital based on reciprocal shareholding any more. One may also attribute the success to a few features of the regulation, namely, its simplicity and appropriateness. The regulation is so simple that no chaebol group may deceptively violate it. The regulation sounds so appropriate that few may object to it. The regulation seems to be unable to fail.

Nonetheless, the regulation had a loophole. Chaebol owners could circumvent the regulation with circular shareholding. Chaebol owners made up fictional capital based on circular shareholding instead of fictional capital based on reciprocal shareholding whenever they wanted it. The only difference between these two forms of fictional capital exists in their degree of complication. Could it be possible that the simple regulation yielded a more complicated structure of intra-group shareholding? Could it be that the government had no real intention to ban any fictional capital based on reciprocal shareholding or the like?

6. Restrictions on the Voting Rights of Financial Companies

6.1. Financial Companies and Economic Power Concentration

All the commercial banks of Korea had been nationalized in 1962 before they were privatized in the early 1980s. With two commercial banks being founded in 1982 and 1983, there were seven nationwide commercial banks before the MRFTA was amended to enact the anti-concentration measures in December 1986. None of the seven commercial banks, however, were under full control of chaebol owners at the time. In fact, the government had strictly prohibited it with various measures. One such measure was the limitation on ownership. Added in the Banking Act in December 1982, Article 17.3 read: “no one shall

own more than eight percent of outstanding stocks of a commercial bank or substantially control it."[97]

Yet the limitation on ownership did not apply to local banks or non-bank financial intermediaries, of which the latter included insurance companies, securities companies, mutual savings and finance companies, investment and finance companies, and merchant banking companies.[98] Many of them were founded in the early 1980s, and most of them were under control of chaebol families in the mid-1980s. To be specific, twenty-four of the thirty-two investment and finance companies and all of the five merchant banks' were reportedly owned by chaebol companies or family members (DongAIlbo, October 30, 1984). In addition, the chaebols had already taken control of all of the six life insurance companies and eleven of the twenty six securities companies (MaeilKyungjeShinmun, June 12).

The banks or non-banking financial intermediaries attracted particular attention for a few reasons. Those reasons had to do with their high leverage ratio, which is quite natural. Compared to the funds necessary to own and control a financial or insurance company, a huge amount of funds can be raised through it from a large number of clients in various forms of debt such as savings, deposits, liability reserves, and so on. The raised funds are supposed to be invested in various financial and real assets for profits and returned with profits to its clients. The raised funds should not be invested in improper assets or diverted to other purposes. These were the concerns of people and the government as to financial companies and insurance companies under control of chaebol owners.

The high leverage ratio itself was a reason for concern. A chaebol owner could easily multiply the size of funds under his/her control through a financial or insurance company. In other words, financial companies and insurance companies could be an ideal means for a chaebol owner to enhance his/her economic power. This concern would be hard to resolve without extending the limitation on ownership to the non-bank financial intermediaries. Selective prohibition would be a more effective alternative. The government, however, did not opt for either. To the contrary, the government controls on entry into and ownership participation in the non-bank financial institutions were relaxed in the early 1980s. A result of the relaxation was the rapid increase in the number of 'investment and finance companies' and 'merchant banks.' As it has already been noted, most of them were under control of chaebol families.

97. Any excessively owned bank stocks should have been disposed of by the end of 1985. Nonetheless, chaebol groups could keep holding quite a large portion of the bank stocks through their member financial companies (DongAIlbo, May 9, 1986). The ten largest chaebol groups as a whole held anywhere between 11.9 and 51.6 percent of the bank stocks as of December 1983 (Kim 199#, p. 287).

98. Both the 'investment and finance company' and the 'merchant banking company' were established in accordance to the Short-term Finance Business Act which had been enacted in 1972. The Mutual Savings and Finance Company Act had also been enacted in 1972.

Another reason for concern was the possibility of improper investments by financial or insurance companies. People and the government were particularly concerned with their investments in real estate. Financial or insurance companies were subject to the so-called 9/27 measures of 1980, which prohibited chaebol groups from purchasing real estate for non-business use. It also did not please the government for the chaebol-owned financial or insurance companies to purchase bank stocks.

What most concerned the government, however, was the high likelihood of their turning into "private vaults" of chaebol groups. Owned and controlled by a chaebol group, the financial or insurance companies were likely to allocate the raised funds in exclusive favor of their affiliates. This likelihood was particularly problematic given the 'financial repression' in Korea. Keeping the interest rates lower than the market-clearing level, the government intervened officially and unofficially in allocation of the loanable funds. It was, therefore, a benefit of privilege for a company to get loans from the banks. For that matter, it was the next best alternative for a company to obtain funds via non-bank financial intermediaries. The alternative, however, was hard for a company to seize unless it belonged to a chaebol group which owned and controlled financial or insurance companies. It was thus one of the duties of the financial supervisors to prevent such misuses of the raised funds.[99]

There was one more reason for the government to give particular attention to financial or insurance companies. Having raised a huge amount of funds, a chaebol-owned financial or insurance company might divert the raised funds to the chaebol's 'empire building.' That is, the funds might be used to take over other companies or set up new companies. As it has been said, the raised funds themselves signify the enhancement of the chaebol owner's economic power. If the funds were turned to stocks and voting rights in other companies, the chaebol owner's economic power would be further enhanced. Financial companies and insurance companies could be an ideal means for a chaebol owner to further enhance his/her economic power.

It is mainly the last concern that led to the addition of Article 7.5 in Chapter 3 of the MRFTA through the amendment of December 31, 1986. Recall that the new title of Chapter 3 included the phrase "Suppression of Economic Power Concentration." The title of Article 7.5 was "Restrictions on the Voting Rights of Financial or Insurance Companies."

99. The Korea government had four separate agencies for financial supervision, the Bank Supervisory Board, the Securities Supervisory Board, the Insurance Supervisor Board, and the Credit Control Fund. They were merged to the Financial Supervisory Services in 1999.

6.2. Significance of the Restriction

To translate Article 7.5 of the MRFTA as amended in December 1986: “Neither financial nor insurance companies belonging to a Big Business Group shall exercise its voting rights in stocks of domestic affiliated companies which it has acquired or owns.” A financial or insurance company might still acquire and own stocks of affiliated companies, but it was prohibited from exercising its voting rights in those stocks.

In a recent *Annual Report*, the FTC recapitulated the significance of this addition of Article 7.5 in December 1986. The following quotation although rather long is worthwhile.

> As financial or insurance companies are supposed to manage the funds deposited by working class people, the funds should not be used as a means to strengthen or increase the power of large business groups. On the other hand, equity investment is one of the major asset management methods for financial or insurance companies, and, at the same time, the shares of affiliated companies cannot be excluded from asset management. As a result, the regulation of restricting financial or insurance companies from exercising their voting rights for the shares of other affiliates they acquired or owned was introduced in order to prevent the financial or insurance companies from being used to expand and strengthen the control of the business group (FTC 2011a, p. 118).

It would be repetitious to add words to the above explanation. Emphasis, however, might be worthwhile. That is, the restriction was intended to prevent the raised funds of financial or insurance companies from being used as a means of strengthening or increasing “the power of large chaebol groups.” One may replace the quoted phrase with “the control power of chaebol owners.”

In a Korean edition of *Annual Report*, the FTC explicated the significance of the restriction in more specific terms.

> In Korea the Big Business Groups are in command of a large number of financial companies and insurance companies. The problem is that the Big Business Groups often attempt to expand their control power by acquiring stocks of non-financial companies with the raised funds of financial or insurance companies. In this case the structure of economic power concentration becomes permanent, and the foundation of fair market competition is damaged. Furthermore, the outside control system is unable to properly work due to equity investment in affiliated companies by the financial or insurance companies belonging to a Big Business Group (FTC 2011b, p. 283).

6.3. Partial Restoration after Elimination

The FTC closes the *Annual Report's* subsection on "Limitation on Voting Rights of Financial/Insurance Companies" with the above quoted paragraph. The subsection does not explicate the ensuing variations of the regulation, which are troubling.

Article 7.5 of the MRFTA as amended in December 1986 was short. No case of exception was listed. No company or stock was excluded from application. Its application was suspended only for six months.

Article 7.5 of the MRFTA was renumbered as 11 before a sentence was added to it through the amendment of December 8, 1992. The added sentence read: "Note, however, that this provision does not apply to cases of acquiring or owning stocks to carry on a financial business or an insurance business, or … to ensure efficient operation and management of insurance assets." Chaebol owners were thus allowed to own and control other financial or insurance companies, though not any other companies, by using the raised funds of financial or insurance companies. According to FTC (2011b, p. 283), the government deemed the earlier regulation "excessive" in the sense that it should be "normal asset management activities" for a financial or insurance company to own stocks of other financial or insurance companies.

The revision of Article 11 noted above was not insignificant. Yet not many would object to calling it a relaxation. On the other hand, few would agree to calling the next revision as such. In January 2002, Article 11 was revised to add one more case to which the restriction on voting rights did not apply. The added case is that of "passing a resolution for any of the following matters in the general meeting of stockholders." The 'following matters' included almost every matter of importance, such as appointments or dismissal of officers, alterations of the articles of incorporation, and mergers or transfers of business. Nonetheless, one may insist on calling the revision a relaxation, citing the remaining restriction that "the number of voting rights … shall not exceed 30/100 of the gross number of stocks issued."

Whatever it is called, the revision of January 2002 altered the provision of Article 11 to be non-binding. The controlling shareholder might exercise up to 30 percent of the voting rights on any of the critical matters in the general meeting. Given 30 percent of voting rights, the controlling shareholder can have any matter decided as he/she likes in most of the large public companies.[100] In short, the restriction on the voting rights of financial or insurance companies was *practically* eliminated.

100. Furthermore, the voting rights can be enhanced through treasury stocks. If, for instance, a company owns 21 percent of its own stocks, one can exercise 38 percent of voting rights by owing 30 percent of its issued stocks.

Elimination of the restriction was a long-standing demand of chaebol owners. The demand got stronger and louder as their control power was seemingly weakened or threatened in the late 1990s. The government finally acceded to the demand and practically eliminated the restriction in January 2002. The government made it explicit in an official document that the "intent of amendment" was to help the controlling shareholders to "defend the management rights." The government did not complete the statement with a phrase like "against foreigners' threat of hostile takeover." The phrase appears in the FTC's *Annual Book* (FTC 2011b, p. 284).

Article 11 of the MRFTA went through a change in December 2004 under the new government. The change occurred to the restriction to the previously added case of exception in which a financial or insurance company may exercise its voting rights in stocks of affiliated companies. The change was simple but significant. It was so simple that the whole article could remain the same except for one figure. It was so significant that the voting rights to exercise might be cut in half, from 30 to 15 percent. That is, "the number of voting rights … shall not exceed 15/100 of the gross number of stocks issued."

It might be confusing, but a reinforced restriction (A) to a case of exception to a restriction (B) implies a reinforced restriction (B). Yet the former does not imply a *fully* restored restriction (B), which can be attained by expunging the case of exception. The former only implies a *partially* restored restriction. The partially restored restriction had to wait three more years to become fully effective. The fully effective date was April 1, 2008.

A government official was quoted as saying that the partial restoration of restriction was required to "block the extension of the chaebol owners' control power via financial or insurance companies"(Yeonhap News, February 20, 2003). It was the government's assessment that "financial companies and insurance companies took advantage of the voting rights to expand the group rather than to defend the management rights unlike the claims made before (FTC 2011b, p. 284)."

6.4. Implication for Policy Makers

According to Samsung Electronics' Annual Report of 2007, the two insurance companies named Samsung Life and Samsung Fire & Marine could not exercise fully their voting rights in stocks of Samsung Electronics. The former jointly owned 11.3 percent of the latter's issued stocks as of December 31, 2007. The ratio of other insiders' shareholding was 5.3 percent. The ratio of inside shareholding, therefore, was 16.6 percent. Calculated

with the treasury stocks in consideration, the ratio of voting rights was 19.3 percent.[101] The ratio had not been higher than this since 2000.[102] As the partially restored restriction came into full effect in 2008, the two insurance companies and other insiders might exercise their voting rights only up to 15 percent. That is, their voting rights were reduced by 1.8 percent due to the restriction.[103]

Nonetheless, Samsung took seriously the partial restoration of the restriction on the voting rights of financial or insurance companies. The two insurance companies mentioned above and another affiliated company jointly filed a constitutional appeal in June 2005. The appeal was withdrawn only after the chaebol family was accused of a series of financial irregularities, political scandals, and tax evasions.

The partially restored restriction does not seem to have affected other chaebol groups so much as it affected Samsung. In fact, not many chaebol owners relied on financial or insurance companies for their control power when the restriction was partially restored. Effective as of March 1997, the provisions of the Finance Industry Act had been prohibiting financial or insurance companies from acquiring or owning stocks of an affiliated company in excess of 5 percent of the issued stocks.[104] The revision of Article 11 of the MRFTA only concerned those financial or insurance companies which had acquired stocks in affiliated companies before March 1997. Samsung Life and Samsung Fire & Marine happened to be such companies.

Two features have been noted of the partially restored restriction on the voting rights of financial or insurance companies; it was seemingly critical and selective in its impact. Although it was not specifically targeted to any chaebol, Samsung Group or its controlling shareholder could have taken it as such. Its reaction is understandable.

There is another point to make. The partial restoration of the restriction reflected an ambivalence of the government to one question. The question is: Should chaebol owners be allowed to defend their control rights by means of the raised funds of financial or insurance companies? This was the question raised and answered by the government in the mid-1980s. The answer was straightforward. It was 'No' with no 'But.' The answer was changed to 'No' with 'But' in 1992. The government changed its answer again under the new leadership in 2002. The changed answer was 'Yes' with no substantial 'But.' The government announced

101. 'Treasury stocks' are stocks which have been bought back and held by the issuing company. Treasury stocks have no voting rights. Samsung Electronics' treasury stocks amounted to 14.2 percent of the issued stocks at the end of 2007.

102. The ratio of inside shareholding fell as a huge number of new stocks were issued in 1998 and 1999.

103. The ratio that was obtained is as follows: $\frac{16.6-15.0}{100-14.2} \times 100 = 1.8$.

104. See Article 24 of the Act, of which the full name is Act on Structural Improvement of Finance Industry. Its addenda failed to mention the stocks acquired before the effective date.

that chaebol owners should use the raised funds of financial or insurance companies in defending their control rights against the "foreigners' threat of hostile takeover." The next government was ambivalent on the issue. According to it, the raised funds of financial or insurance companies might be used in defending the control rights of a chaebol owner, but not in expanding the scope of a chaebol group. What measure could be discernible between the two usages? Are 15 percent of the voting rights sufficient for the former but not for the latter?

The restriction on the voting rights of financial or insurance companies has recently emerged again as an issue in Korea. Granted that any policy issue is also an issue of politics, the issue is unlikely to be debated and settled on the ground of 'scientific' analysis.

7. Ban on Holding Companies

7.1. Holding Companies Defined and Banned

Many companies engage in their own businesses while holding stocks of other companies and controlling their business activities. A company is referred to as holding company if the latter is its only or main business.[105] It is in order to ban this type of companies that Article 7.2 was put in the MRFTA through the amendment of December 31, 1986.[106] Entitled 'Prohibition of Establishment of Holding Companies,' Article 7.2 consisted of two clauses. The first clause defined the term 'holding company' to have such a company banned.[107] "No one shall establish a company (hereinafter referred to as 'holding company') whose main business is to control any domestic company's business activities through the ownership of stocks, nor an established company shall be converted to a holding company in the country." This prohibition applied to the existing holding companies as well; Article 2 of the Addenda made this application explicit by setting the one-year grace period for "those holding companies which have been established as of the enforcement date," that is, April 1, 1987.

The definition of a holding company was given in the first clause of Article 7.2. Yet it included two terms to be specified; that is, 'control' and 'main.' Specified in the FTC's Guidelines for Determination of the Scope of a Holding Company, the term 'control' did not differ much from the same term specified in the Presidential Decree as for the Scope of

105. If it is a company's *only* business to hold stocks of other companies and control their business activities, we may call the company a *pure* holding company to differentiate it from a *mixed* holding company.

106. Article 7.2 of the MRFTA is comparable to Article 9 of the Antimonopoly Act of Japan. The latter, however, was revised to lift the ban on holding companies in June 1997.

107. The phrase for definition of a holding company was moved into Article 2 when the MRFTA was amended in February 1999.

a Business Group.[108] That is, a company shall be considered to 'control' another company's business activities if the former is the latter's largest shareholder with more than thirty percent of outstanding stocks.[109] The other term 'main' was specified by Article 14 of the Presidential Decree.[110] It adopted as a criterion the amount of stocks that the concerned company owns to control any domestic company's business activities. Specifically, the concerned company shall be considered as a holding company if such stocks constitute more than a half of its total assets, both being measured in terms of book value.[111]

The prohibition of establishment did not apply to any holding company. The second clause of Article 7.2 listed two cases of exceptions in application of the first clause. One referred to a holding company established by a law. The other referred to a holding company established for joint investment with foreigners in accordance with the Foreign Capital Inducement Act. In this case, the establishment of a holding company should be approved by the FTC. An article of the Presidential Decree specified the procedures for approval.

The ban on holding companies accompanied a few measures for enforcement. One of them was the same as that for enforcement of the equity investment regulations enacted in Article 7.3 and 7.4. If any company fit the definition and specifications of a holding company, the FTC could order the concerned company to dispose of all or part of the stocks it owned while suspending their voting rights.[112] In addition, the FTC could file a lawsuit to invalidate the establishment of a holding company.[113] Another enforcement measure was the penalty for violation. It was imprisonment for not more than two years, or a fine not exceeding 100 million won.[114] The penalty was toughened in January 1990. A penalty surcharge, however, did not apply to the ban on holding companies whereas it was introduced as an additional measure for enforcement of the equity investment regulations in January 1990.[115]

108. See Article 2.2 of the Presidential Decree. This article was renumbered as 3 in 1990.

109. When a company's share was counted for determination of the scope of a holding company in accordance with Article 7.2 of the MRFTA, the share of its affiliates and controlling family was included as well. A company, therefore, might be considered a holding company even if it was not the largest shareholder of any company for itself. This was changed after the ban on holding companies was lifted in 1999. Currently, a company shall be considered a subsidiary of a holding company only if the latter is the former's largest shareholder.

110. When Article 7.2 was put in the MRFTA in December 1986, it failed explicitly to have the Presidential Decree specify the term 'main business.' It was not until the MRFTA was amended in February 1999 that this was fixed.

111. The FTC of Japan applied the same criterion for designation of holding companies.

112. See Articles 10 and 10.2 of the MRFTA amended in December 1986.

113. See the second clause of Article 10 of the MRFTA amended in December 1986.

114. See Article 55 of the MRFTA amended in December 1986. It is a person or a company's representative director that shall be charged and sentenced for violating the provisions of Article 7.2 or 10.2.

115. See Articles 17 of the MRFTA amended in January 1990.

Article 7.2 of the MRFTA was renumbered as 8 in January 1990, and it kept the ban on holding companies for nine more years. In February 1999, however, Article 8 was replaced with a very different one. Instead of prohibiting holding companies from being established, the new article obligated holding companies to report on establishment. Article 8 was thus given a new title, that is, 'Report on Establishment of and Conversion into Holding Company.'

Although the ban on holding companies was lifted in February 1999, holding companies and their subsidiaries had to abide by various regulations which were put in Article 8.2 of the MRFTA. For instance, the second clause of Article 8.2 was to prohibit a holding company's subsidiary from owning stocks of other domestic companies except for a few specified cases. This ban on sub-subsidiaries, however, was lifted a few years later. Other regulations got weaker, too. Interestingly, Article 8.2 got longer and longer as the regulations got weaker and weaker.

7.2. Intentions and Actualities

Unlike Articles 7.3 through 7.5 of the MRFTA, Article 7.2 applied to any domestic company whether it belonged to a Big Business Group or not. Nevertheless, the four articles shared the same goal. They all were intended to prevent a concentration of economic power in the chaebol's hands. Article 7.2, in particular, banned holding companies so that they might not be employed as a device to establish or enlarge a business group based on 'fictional capital.'[116]

In actuality, however, holding companies had not been a favorite device for the chaebol to extend or enhance its control power over companies at least until they were banned through the enactment in December 1986. The FTC found only three companies to be in violation of the provisions of Article 7.2 as of April 1987.[117] Instructing them to resolve the unlawful situations in a year, the FTC searched for other cases of violation.[118] The FTC then found out one more unlawful holding company in April 1988, and ordered the company to dispose of part of the stocks it owned.[119] Among these four holding companies, only one belonged to a Big Business Group.

116. FTC (1991, pp. 112-3) confirms this intended goal of the ban on holding companies.

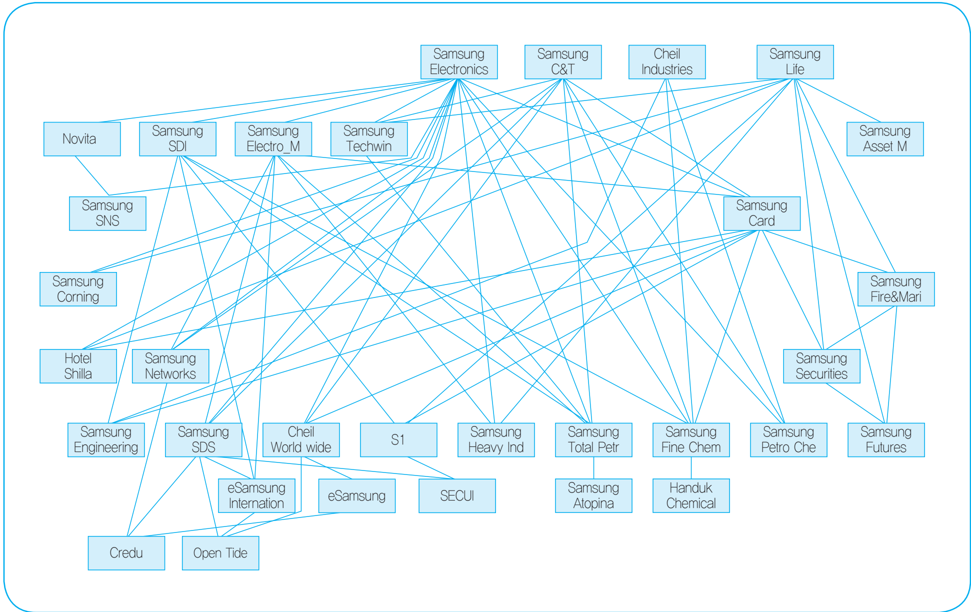
117. They are KoryoCaprolactam, Sungshin Holdings, and Hankuk Investment.

118. Recall that Article 7.2 applied to the established holding companies as well.

119. The company's name is Yeosu Petrochemical. It had been established as a holding company for joint investment in Honam Petrochemical with foreigners, and the FTC approved it as legitimate. Yet it violated the provisions of Article 7.2 by owning stocks of other companies as well. The FTC ordered Yeosu Petrochemical to dispose of those stocks. Cf. Lee 2000, pp. 140-1.

The chaebol had certainly relied on pyramiding in order to build and control a big business group, but it did not require a holding company as defined and specified by the MRFTA, the Presidential Decree and the FTC Guidelines. A company could own stocks of other companies without those stocks constituting more than a half of its assets. A company could own stocks of other companies without being their largest shareholder. A company could be the largest shareholder of other companies without owing more than a third of their outstanding stocks. Furthermore, no two or more companies could be a holding company in order for them *jointly* to own a sufficiently large portion of another company's outstanding stocks. It is through this type of inter-company shareholding that the chaebol had built and controlled a big business group.[120] Such a business group would hardly be disturbed by the ban on holding companies enacted in Article 7.2 of the MRFTA in December 1986. The ban merely forced the chabols to keep doing what they had been doing, that is, pyramiding without holding

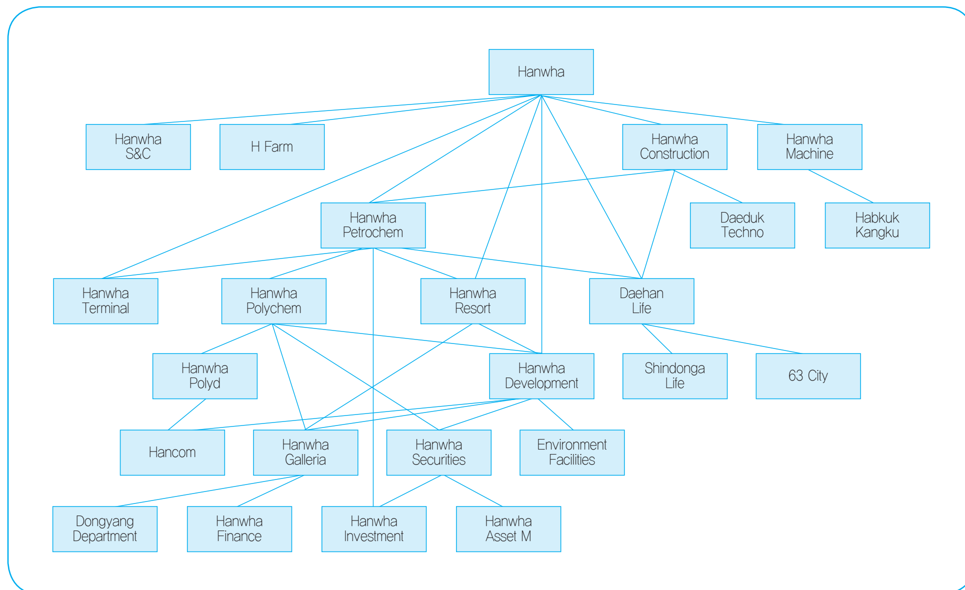
Figure 3-1 | Pyramiding of Samsung as of 1997



Source: Kim, Jinbang (2005)

120. See J. Kim (2005) for the structure of inter-company shareholding of Korean chaebol groups.

Figure 3-2 | Pyramiding of Hanwha as of 1997



Source: Kim, Jinbang (2005)

companies. [Figure 3-1] and [Figure 3-2] illustrate such pyramiding of two chaebol groups as of 1997.

Redundancy is another point to make regarding the ban on holding companies relative to the ceiling on the total amount of equity investment. Recall that these two regulations were enacted in Articles 7.2 and 7.4 of the MRFTA, respectively. The former is redundant in the sense that it should be less restrictive than the latter for most companies belonging to a Big Business Group. In other words, it is hardly plausible for a company belonging to a Big Business Group to violate the provisions of Article 7.2 while abiding by the provisions of Article 7.4. A company would rarely own stocks of other domestic companies in excess of a half of its total assets without its total amount of equity investment exceeding forty percent of its net asset amount as defined by Article 7.4.

Being redundant for companies belonging to Big Business Groups, the ban on holding companies would hardly restrain the concentration of economic power in the chaebol's hands. The ban on holding companies was symbolic at best when it was enacted along with the equity investment regulations in December 1986. This was, however, no longer the case when the ban on holding companies was lifted in February 1999; the ceiling on the total amount of equity investment had already been removed. It should also be noted that when the equity investment regulation was recalled in December 1999, the regulation

was designed to exclude holding companies from application.[121] The lifted ban on holding companies could thus have to do with the concentration of economic power at that time and thereafter, as we shall see below.

7.3. From Ban to Regulations

Due to the turmoil of the economic crisis of late 1997, the government put forth four targets of structural reform under the new leadership. One of them was the chaebol reform, for which the proclaimed principles were transparency and accountability, among others. It then was suggested that holding companies could somehow help to enhance the transparency of corporate management and the accountability of controlling shareholders.[122] This was not the only argument in support of lifting the ban on holding companies. Perhaps more appealing to the government was the argument that a business group would be advantageous in restructuring its businesses if it consisted of a holding company and its subsidiaries.[123] It is this argument that the government cited submitting a bill to change the MRFTA in August 1998.[124] The bill passed through the National Assembly in February 1999, and the ban on holding companies was lifted as of April 1, 1999. It was about a year after the ceiling on the total amount of shareholding had been removed. It should also be noted that the holding company was exempted from the recalled ceiling on the total amount of shareholding which was to be applied in 2001 and thereafter.

To be sure, the ban on holding companies was not lifted without hesitations. Holding companies had been banned in suspicion of their being employed sooner or later to enlarge a business group based on 'fictional capital.' There were no grounds to dismiss the suspicion while it was still a pronounced goal of the MRFTA to restrain the concentration of economic power. Article 8.2 was put in the MRFTA to alleviate this conflict by regulating the act of holding companies and their subsidiaries.

Article 8.2 consisted of three clauses. The first clause explained the act that no holding company should perform. It comprised five categories. (1) An act of holding liabilities in excess of net assets (referring to the amount obtained by deducting liabilities from total assets on the balance sheet). (2) An act of owning less than 50/100 of the total number of stocks

121. Subsidiaries of a holding company were excluded from application of the equity investment regulation since April 2005.

122. Although the simplicity of ownership structure was often noted as for holding companies in relation to the transparency of corporate management and the accountability of controlling shareholder, the relation was never explained.

123. Lee (2000) critically examines the argument.

124. It seems that the government had considered lifting the ban on holding companies before the economic crisis of 1997. A few researches had been conducted on the issue at the request of the government. See, for instance, Park and Kim (1997) and Kim et al. (1997).

issued by the subsidiary (in cases where the subsidiary is a listed company, the ratio shall be 30/100). (3) An act of holding stocks of a domestic company that is not a subsidiary. (4) An act of owning stocks of a domestic company other than those of a company conducting the financial business or insurance business for a holding company which owns stocks of its subsidiary conducting the financial business or insurance business (hereinafter referred to as 'financial holding company'). (5) An act of owning stocks of a domestic company conducting the financial business or insurance business for a holding company which is not a financial holding company (hereinafter referred to as 'general holding company').

We can easily relate the above explicated act to the concentration of economic power insofar as the first two categories are concerned. First, debt financing is an attractive way of raising funds for a holding company to acquire stocks of subsidiaries. A higher debt ratio would lead to a larger number or size of subsidiaries of a holding company. Second, if a holding company acquired a smaller portion of stocks of one subsidiary, it would have more funds left for other subsidiaries.[125] Relevance of the other categories, however, is not obvious. In particular, the last two categories seem to have more to do with the principle of separation between finance and industry. Yet they have to do with the concentration of economic power as well; a business group is forced to leave financial companies and insurance companies behind when it transforms itself to a general holding company with subsidiaries.

The second clause of Article 8.2 concerned the subsidiary of a general holding company. Part of it may be translated as follows: the subsidiary of every general holding company shall not hold stocks of any domestic company (excluding those which are closely related in business activities to the concerned subsidiary as specified by the Presidential Decree). One cannot fail to see the intention behind this explicit ban on sub-subsidiaries with exceptions and the implicit ban on any sub-sub-subsidiaries for a holding company. As [Figure 3-1] and [Figure 3-2] illustrate, multi-layer pyramiding was a prominent feature of the business groups at the time. Their pyramiding often reached down to the fifth or sixth layer. In comparison, the business groups should delimit their pyramiding to the first or second layer in order to take advantage of a holding company. The second clause of Article 8.2, therefore, would bring out smaller business groups with fewer layers of pyramiding.

The two clauses of Article 8.2 have gone through many changes thereafter.[126] Most of all, a sub-subsidiary no longer has to be exceptionally permitted; the subsidiary of a general holding company can hold stocks of any non-financial company whether or not they are "closely related in business activities." Two other significant changes concern the minimum

125. One could also note that the higher ratio of shareholding would yield the less conflict of interests between a holding company and its subsidiaries.

126. The two clauses were renumbered as 2 and 3 when a new clause was inserted in 2004.

shareholding ratio and the maximum debt ratio. The former was lowered to 40 percent for unlisted companies, and to 20 percent for listed companies. The latter was raised to 200 percent. All these changes were made in 2007. Yet the principle of separation between finance and industry is still applied to any holding company and its subsidiary.

7.4. Rising Number of Holding Companies and the Significance

The ban on holding companies was enacted in December 1986 and became effective as of April 1, 1987. The FTC found only three companies to be in violation of the regulation as of the effective date. None of the three companies belonged to a chaebol group. The ban on holding companies must have been meaningless to chaebol groups at least for a while.

The ban on holding companies was lifted as of April 1, 1999. The ban was replaced with some regulations on their shareholding and financing. In addition, holding companies were excluded from application of the recalled regulation called Ceiling on the Total Amount of Equity Investment, which came into full effect as of April 1, 2002. What would have been the reaction of chaebols?

If other things had been the same as in 1987, it would not have mattered to chaebol groups whether the ban on holding companies was lifted or not. If other things had been the same as in 1987, chaebol groups would have had no interest in transforming themselves to a holding company system. Not surprisingly, that was not the case. Of the 'top thirty' and their derivatives,[127] as many as twelve chaebol groups have transformed themselves to a holding company system by 2010.[128] Their names are listed in <Table 3-7>. In addition to them, nine more chaebol groups own respectively one or more holding companies in 2010. What could be a better explanation of this?

127. 'Top thirty' herein includes those chaebol groups that were ranked as such according to their total amount of assets as of 1999. Five of them have been divided into fourteen groups thereafter. The number of these 'derivative' groups increased to nine in 2000.

128. A chaebol group is said to have transformed itself to a holding company system if its core company is converted to a holding company with subsidiaries.

Table 3-7 | Chaebol Groups Transformed to Holding Company System

	2002	2004	2007	2008	2009	2010
Total Number	1	2	5	8	10	12
Transformed	LG	GS	Hanjin Heavy Ind.	CJ	Doosan	Booyoung
			SK	LS	Korea Investment	Kolon
			Kumho	KISCO	-	-

1) Smaller than the top thirty chaebol groups are not included

2) GS and LS have been separated from LG. Hanjin Heavy Industries has been separated from Hanjin

Table 3-8 | Voting Rights Before and After Conversion to Holding Company

(Unit: %)

	Holding Company	Treasury stocks	New stocks assigned to controller	Voting rights		
				Before (B)	After (A)	A/B
April 2001	LGCI	6.66	52.90	17.91	45.85	2.56
April 2002	LGEI	10.75	61.47	17.78	54.16	3.05
July 2007	SK	17.34	87.74	14.72	32.11	2.18
Aug. 2007	Hanjin Heavy Ind	19.58	98.58	20.79	56.65	2.72
Sept. 2007	CJ	19.10	98.05	24.34	50.08	2.06
Sept. 2008	KISCO	22.68	91.37	49.28	59.11	1.20
Dec. 2009	Hanjin Marines	15.82	71.17	21.74	57.34	2.64
Dec. 2009	Kolon	19.91	99.78	19.11	59.10	3.09
Average		19.07	91.12	23.21	51.80	2.44

Source: Annual reports of each company

<Table 3-8> illuminates an aim that the chaebol owners would have wanted to attain. The chaebol owners' control power has been further strengthened through the chaebol groups' transformation to a holding company system. The chaebol owners did not have to put their private funds at all in stocks of affiliated companies to reach this outcome. Their further strengthened control power was an outcome of nothing but the three processes that the conversion went through.

The three processes mentioned above are not easy to explicate. First, the core company bought back a large amount of its stocks that had been issued before. This process yielded a large amount of treasury stocks in the core company. Second, the core company was spilt into two companies, a holding company and an operating company. This process turned the treasury stocks into the operating company's stocks owned by the holding company, restoring the voting rights in stocks. Note that treasury stocks have no voting rights. Third and last, the chaebol owner changes the operating company's stocks for the holding company's new stocks, raising its share in the latter. As soon as these three processes were over, the chaebol owner, on average, was able to exercise 2.4 times as many voting rights as before at the holding company's general meeting. In addition, the holding company was possessed of a sufficiently large share in the operating company and other subsidiaries. In sum, the chaebol owner's control power got much stronger than before. And the chaebol owner did not even have to pay for it.

7.5. Implication for Policy Makers

It has never been a secret that holding companies could be an ideal means for the controlling shareholder to further strengthen his or her control power. That is exactly why the government banned holding companies through the amendment of the MRFTA in December 1986.

There had been some arguments for holding companies before the ban was lifted in 1999. A simpler structure of intra-group shareholding was often cited as a merit of the holding company system compared to the current structure of chaebol groups. Yet it seemed there was another argument that led the government to lift the ban on holding companies. The argument was that holding companies could be a convenient means of corporate restructuring. 'Restructuring' was a key word in Korea after the economic crisis of 1997.

When the new government lifted the ban on holding companies, it surely did not want the controlling shareholder's aim to be attained through holding companies. Suppressing the concentration of economic power was still one of the government's key priorities, if not the top priority. The government even claimed that a few measures would help prevent holding companies from being employed as a means of concentrating economic power , although not many agreed to the claim.

Suppressing the concentration of economic power was not at the top of the next government's list of aims, either. Attracted to the merits cited of holding companies, the government relaxed the measures that the preceding government trusted to prevent holding companies from being misused. The number of holding companies kept increasing. Yet it is not hard to tell how much of the increase can be attributed to the relaxation of the preventative measures.

There have been few assessments of holding companies as they operate in Korea. Their merits were claimed, cited, and expected by interested persons and agencies, but rarely confirmed by experience. On the other hand, their relation to economic power concentration is not just apparent but repeatedly confirmed by experience. Nonetheless, further relaxation of the preventative measures is called for in the name of improvements. The direction of institutional change is difficult to redirect once it has been set towards relaxation or liberalization.

8. Limitation on Debt Guarantees

8.1. Introduction and Reinforcement

The four anti-concentration measures explicated above were enacted through the amendment of the MRFTA in December 1986. Another anti-concentration measure was enacted six years later in December 1992. One of the four earlier measures was not quite substantial from the beginning, and the three others have been relaxed or abolished thereafter. The last-comer differs in this regard. It was reinforced twice after its introduction and has remained intact until now. Its name is Limitation on Debt Guarantees, which is also the title of Article 10.2. Of course, Article 10.2 has resided in Chapter 3 of the MRFTA.

When Article 10.2 was added in the MRFTA, its first sentence read: "Any company belonging to a Big Business Group … shall not give debt guarantees to its domestic affiliated companies in excess of the amount derived by multiplying its amount of equity capital by 200/100." The last phrase starting with 'in excess' was deleted in January 1998 after the ratio '200/100' was lowered to '100/100' in December 1996. That is, the upper limit on the total amount of debt guarantees had been lowered from 200 percent to 100 percent of equity capital before any debt guarantees were prohibited in principle. Those were two major reinforcements noted above. Having been through the two reinforcements, the provision of Article 10.2 completely banned new debt guarantees from April 1, 1998, and at the same time, existing debt guarantees needed to be removed before April 1, 2000.

There is another change to note. The regulation stopped being applied to financial or insurance companies after the amendment of December 1996. Financial companies and insurance companies have been allowed to give debt guarantees to affiliated companies despite the provision of Article 10.2. This exclusion from application may be called a relaxation unlike the two major changes.

8.2. Range of Application

In its inception, the provision of Article 10.2 included a few cases of exception, the substance of which has not changed thereafter. To be exact, the current provision includes two cases of exception. If we judge from the amount of debt guarantees that fell under each category after April 2000, the first case of exception is more substantial.[129] It refers to "a guarantee made in connection with any obligation of a company, which is taken over according to the criteria for rationalization under the Restriction of Special Taxation Act." More intriguing is the second one, that is, "a guarantee on debts which is deemed necessary to enhance the international competitiveness of companies, or which is set forth in Presidential Decree." One may recall that the term 'international competiveness' appeared in the article titled Ceiling on the Total Amount of Equity Investment.

The "cases of exception" refer to certain debt guarantees to which the regulation should not apply. It has already been noted that financial companies and insurance companies are also excluded from application even if they belong to Big Business Groups. All the other companies belonging to a Big Business Group are subject to the regulation. Article 10.2, therefore, would be incomplete if it did not refer to the criteria for 'bigness.' Its first sentence includes the phrase "a Big Business Group which falls under the criteria set forth in the Presidential Decree." Yet the relevant provision of the Presidential Decree is simple for a good reason. The criteria do not differ between the two regulations, Limitation on Debt Guarantees and Prohibition of Reciprocal Shareholding. Recall that the FTC had designated the thirty biggest Business Groups for the latter until April 2002. The number of designated Business Groups has varied thereafter because the criterion is set in terms of the absolute amount of Total Assets.

8.3. Mission to Accomplish

Debt guarantees, the total amount of which the provision of Article 10.2 put a limit on, are a sort of liability. The guarantor has an obligation to repay a debt if the borrower does not make the payment. A debt guarantee, therefore, implies enhanced safety for the lender, especially if it is provided by a company belonging to a Big Business Group. The lender would prefer a borrower who could get a debt guarantee from a company belonging to a Big Business Group. A company could seldom get a debt guarantee from a company belonging to a Big Business Group unless it itself belongs to the same Big Business Group. A company, therefore, could borrow more with better terms if it belongs to a Big Business Group. That

129. For instance, the case of "industrial rationalization" accounted for more than two thirds of those debt guarantees which were excluded from application of the regulation in April 2003. In April 1998, however, the same case accounted for only a quarter of the excluded debt guarantees. The FTC has not disclosed such data for the years in between.

is, all the member companies of a Big Business Group could borrow more and with better terms from banks and non-bank financial institutions by giving debt guarantees to each other. That is what happened in the 1970s and 1980s in Korea, and what the Limitation on Debt Guarantees was intended to change.

FTC (2011a, p. 115) explains the regulation's purpose by itemizing it. The first item concerns the "financial structure" of companies belonging to Big Business Groups. To be more specific, the regulation was introduced to lower their debt-to-equity ratio. The second item concerns the so-called system risk. To quote, the regulation was introduced to "reduce the risk of simultaneous insolvencies due to deepening interdependence among affiliated companies arising from mutual debt guarantees." The third and last item concerns a bias in the capital allocation which affected unfavorably the small- and medium-sized enterprises. "Due to concentration of credit on affiliated companies of large business groups," the FTC says, "the SMEs [were] excluded from credit extension … regardless of credit rating or business prospect." If one asks what the regulation has to do with Suppression of Economic Power Concentration, the title of Chapter 3 of the MRFTA, the last item could be a viable answer.

Another question could be asked. What led to the sudden reinforcement in January 1998? In fact, it took only thirteen months for the reinforcement to replace the previous one. FTC (2011a, p. 115) attributes the second reinforcement to a growing recognition that the complicated debt guarantees among affiliated companies of large business groups triggered a chain reaction of bankruptcies of large business groups after the financial crisis hit the economy at the end of 1997. Furthermore, it became necessary to eliminate debt guarantees among affiliated companies, which was one of the major obstacles to corporate restructuring. Given this explanation as to the second reinforcement, one may note that the Limitation on Debt Guarantees meant something other than a suppression of economic power concentration.

8.4. Implication for Policy Makers

The FTC has been keeping and disclosing the records of debt guarantees. The records substantiate a part of the FTC's evaluation: "The prohibition on debt guarantees between affiliated companies of a large business group has been successfully implemented" (FTC 2011a, p. 115-6). Further evidence, however, is needed to substantiate the other parts of the FTC's evaluation: "[It] contributed to reducing concentration of financial resources, establishing credit rating-based lending practice, reducing the risk of simultaneous insolvencies, and enhancing financial soundness of companies." We shall only take a look at the record of debt guarantees.

Table 3-9 | Debt Guarantees of Business Groups Subject to Limitation, 1993-2000

(Unit: billion won)

	1993	1994	1995	1996	1997	1998	1999	2000
Applied	1,206	725	483	352	336	269	98	15
Excepted	449	382	338	323	313	366	126	58
Total	1,655	1,107	821	675	649	635	224	73

Source: Fair Trade Commission

As we can confirm from the bottom row of <Table 3-9>, the total amount of debt guarantees has rapidly decreased after the regulation became effective in April 1993. The decrease in the total amount is mainly due to the decrease in the amount of debt guarantees to which the regulation applies. The amount further decreased after April 1999. Recall that new debt guarantees were completely banned as of April 1998, except for those falling under cases of exception. Existing debt guarantees had to be removed before April 1, 2000. According to the FTC, no company violated the regulation.[130]

Given this record of debt guarantees, one should agree to the FTC's evaluation of the regulation: "Among various policies on big business groups, the Limitation on Debt Guarantees was relatively better accepted by companies and achieved visible results" (FTC 2011b, p. 279). The FTC's analysis of the success is also reasonable. The analysis cites the insolvency crisis to which an entire group of companies fell due to the debt guarantees that had been given to faltering affiliated companies. "This experience," it says, "led to a wide agreement that some regulations on indiscrete debt guarantees were unavoidable."

130. The relevant figure is not zero for 2000 in 〈Table 3-8〉 only because a few groups were designated as Big Business Group in April 2000.

2012 Modularization of Korea's Development Experience
Chaebol Policy for Suppression
of Economic Power Concentration

Chapter 4

Concluding Remarks

Concluding Remarks

The constitution of Korea proclaims that the nation is a democratic republic. Yet some people call it a 'chaebol republic' in dismay. One reason for the dismay is the economic power concentrated in the hands of chaebols. A chaebol family typically owns a large portion of shares only in one or two core companies, but its control power reaches a large number of big companies. One of the means is the so-called equity investment in affiliated companies. Given the high ratio of inside shareholding in affiliated companies, the chaebol family exercises exclusive controlling rights within them.

A number of chaebol groups grew rapidly in the 1970s. Their growth owed much to a benefit of privilege that the government granted in implementing its policy for national economic growth. The chaebol groups kept growing more rapidly than the national economy in the 1980s, further raising their share in the national economy. In 1982, for instance, the top ten chaebol groups accounted for 30.2 percent of the total manufacturing sales (see <Table 2-4>).The ratio had increased by 9.0 percentage points in the past five years.

"Prevention of excessive concentration of economic power" had been an aim of the government before the phrase was put in the first article of the Fair Trade Act in 1980. The Credit Management System had been one of the earlier measures, and continued to work in the 1980s. Five more measures were enacted through the amendments of the Fair Trade Act in 1986 and later. Ceiling on the Total Amount of Equity Investment was seemingly the most significant of them.

Not all the measures against economic power concentration have accomplished their mission. The prohibition of reciprocal shareholding was inapplicable to its nearly perfect substitute, namely, circular shareholding. The ceiling on the total amount of equity investment was lifted before it became fully effective in a reinforced form. The ban on holding companies was replaced with regulations on their shareholding and financing, and

those regulations were relaxed later. The restriction on the voting rights of financial or insurance companies was practically removed although it was partially restored later.

Except for the limitation on debt guarantees, the anti-concentration measures were abolished or relaxed after the economic crisis of 1997. It was not that the concentration of economic power had been repressed, but rather, the contrary. The share of top chaebol groups rose again a few years after the economic crisis. In fact, the government abolished or relaxed the anti-concentration measures to attain other aims than the suppression of economic power concentration.

Although the suppression of economic power concentration was still on the list of aims, the government was willing to give in to other aims. Any anti-concentration measure was relaxed or abolished if it was seemingly or arguably obstructive to such aims as "facilitation of corporate restructuring," "promotion of corporate investment," and "protection of incumbent control rights." Of these three aims, the last one was particularly incompatible with the aim of the anti-concentration measures. Nonetheless, the government attempted to attain both aims by adjusting the details of the anti-concentration measures, which one may call 'mission impossible.'

Ambivalence is often unavoidable in policymaking. It is easier said than done that no policy should be designed to attain conflicting aims. The chaebol policy of Korea makes an excellent case in this regard. Chaebols had been the engine of economic growth. Their aggressive investment had been critical to the growth of the national economy. In addition, some people considered chaebol groups as a 'national treasure' to keep from foreigners. Yet many people deplored the concentration of economic power. The government had to tread a thin line between them with its chaebol policy. The distortions of the anti-concentration measures were hard to avoid.

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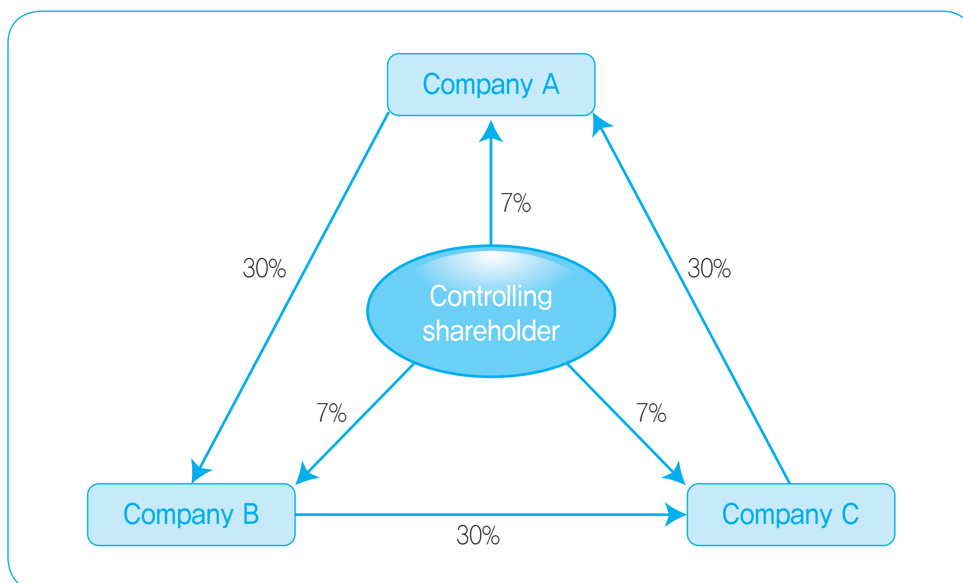
Appendix A. Theoretic Analysis of Equity Investment Regulation[131]

1. Variables Redefined and their Relations

Let us imagine a business group consisting of three companies, of which the ownership structure [Figure A-1] illustrates. Each company has exactly the same ownership structure insofar as its inside shareholding is concerned; its outstanding stocks are partially and jointly owned by one of its two affiliates and one individual, and their ownership ratios are exactly the same in each of the three companies.[132] In particular, one of its two affiliates owns thirty percent of its outstanding stocks, and the individual owns seven percent. The remaining stocks are owned by outside investors. All these particularities are for the sake of simplicity in analysis. Generality can be easily restored. The individual shall be called as controlling shareholder.

Figure A-1 | Inside Shareholding of an Imaginary Business Group



Given the case above, we shall define a few variables. Most complicated is the controlling shareholder's *ultimate* ownership ratio which we shall denote as u. In our imaginary business group, it is greater than seven percent for each company since the controlling shareholder

131. This Appendix is based on J. Kim (2007b).

132. The circularity of intra-group shareholding is required for the sameness of the ownership ratios among member companies.

indirectly owns one company through two others as well. This indirect ownership ratio can be computed for Company A or others as follows:

$$\upsilon = .07 \times .30 + .07 \times .30 \times .30 \times + .07 \times .30 \times .30 \times .30 + \cdots.$$

The first term of the right hand side is included because the controlling shareholder owns seven percent of Company C's stocks and Company C owns thirty percent of Company A's stocks. The sequence of figures in the second term starts from the controlling shareholder's ownership in Company B, and reflects the intra-group shareholding from Company B through C to A. The third term relates to the fact that Company A indirectly owns itself through Companies B and C. There is an indefinite number of terms to follow, hence the equation above. Adding to it the controlling shareholder's direct ownership, we obtain a formula for her ultimate ownership:

$$u = .07 + .07 \times .30 + .07 \times .30 \times .30 + .07 \times .30 \times .30 \times .30 + \cdots = \frac{.07}{1 - .30} = .10.$$

That is, the controlling shareholder's ultimate ownership ratio is ten percent in each member company of our imaginary group. It goes without saying that their weighted average does not differ whatever the weight is.

Having so computed the ultimate ownership ratio, we may have it measure the residual claims. That is, the ratio could measure the controlling shareholder's rights to the profits of the three companies in total after all prior obligations have been paid. Another significance emerges when we take its inverse, that is, $1/u$. This inverse ratio is to show how much equity capital the controlling shareholder can control by a unit amount of equity investment. We may call it the controlling shareholder's 'equity leverage ratio' in that sense. As we shall see below, it may also be employed as an index of economic power concentration.

Returning to [Figure A-1], let each member company's equity capital be 100 billion won for the sake of further simplicity. The group's nominal equity capital then is 300 billion won, of which seven percent or 21 billion won has come from the controlling shareholder. However, thirty percent of the nominal equity capital or 90 billion won is 'fictional'; it exists only in the balance sheets of the member companies, and cancels each other out in their consolidated balance sheet. The real equity capital that the three member companies have jointly raised is 210 billion won, and that is what the controlling shareholder actually controls. To sum, the controlling shareholder, who has invested 21 billion won in a group of companies, controls a group of companies with equity capital of 210 billion won in total. The controlling shareholder controls ten times as much equity capital as her equity investment. Note that this 'equity leverage ratio' is exactly equal to the inverse of ultimate ownership ratio, $1/\upsilon$.

Compared to the ultimate ownership ratio or its inverse, other variables are straightforward. One of them is the ratio of inside shareholding that we shall denote as x. It is derived by adding the shareholding of an affiliate to that of the controller. Obviously, the ratio will be same for any member company of our imaginary group illustrated by [Figure A-1]. The ratio is 37 percent. The ratios so obtained or their average may be employed to measure the controlling shareholder's power over business activities of the member companies. The controlling shareholder can exercise as many voting rights as the inside shareholding against outside shareholders in the general meeting of any member company. To repeat, the ratio of inside shareholding can measure the control power.

Another variable of interest is the ratio of equity investment between member companies. We shall denote it as q. It is a little less than 43 percent for each member company of our imaginary group illustrated by [Figure A-1]. Note that the denominator should not be 100 billion won, but rather 70 billion won, because 30 billion won has come from another member company. To use the MRFTA's terms, each member company's Net Asset Amount is 70 billion won because 30 of 100 billion won is the Invested Money by an affiliated company.[133]

Before moving towards a more realistic case with many member companies of differing sizes and differing ownership structures, let us find out the relations between the three variables for the simplest case like our imaginary group of companies. That is, we shall continue for a while to consider a group consisting of identical member companies under the control of the same person. We do not have to distinguish a variable for each member company and their average in this case. The relations between the three variables may be summed up by the following equation.

(1) $\frac{1-u}{1-x}=1+q.$

Equation 1 is not difficult to derive once each of the three variables is related to w and s, the former being the direct ownership ratio and the latter the ratio of intra-group shareholding.

(2) $u=\frac{w}{1-s}$

(3) $x=w+s$

133. If we adopt the definition of Net Asset Amount as specified in the MRFTA, we should deduct "the Invested Money (the amount derived by multiplying the par value of one share by the number of shares owned) by affiliated companies to the concerned company." Nonetheless, our theoretic analysis shall ignore the possible difference between par value and book value.

(4) $q=\frac{s}{1-s}$

Instead of deriving Equation 1 from Equations 2 through 4, let us confirm Equation 1 by those figures which we have derived for our imaginary group, that is, u=.10, x=.37, and q=3/7.

We have so far considered the simplest case in which all the member companies are of the same size and the same ownership structure. In this case, each of the five ratios is the same for every member company, and an average or aggregate ratio does not differ from the ratio for any member company. How then should Equation 1 be revised for a case in which the ownership ratios and/or the size of equity capital differ among the member companies? We first need a subscript to each variable for a company. For instance, the ultimate ownership ratio for company i shall be denoted as u_i, and it shall be defined in terms of w_i's and s_{jk}'s where s_{jk} denotes the shareholding ratio of company kin company j.[134] Given such a set of variables, Equation 1 will still hold if its three variables are redefined as *appropriately weighted* averages. For instance, q must be a weighted average of q_i's, the weight being each company's Net Asset Amount.[135] The weight for u is less obvious,[136] but the redefined variable u itself can still be obtained from w and s with the help of Equation 2.[137] Of course, these two variables must be redefined likewise as weighted averages of w_i's and s_i's where $s_i=\sum_j s_{ij}$. The appropriate weight for either average is each company's equity capital without any adjustments unlike that for q or u. The redefined variable q can also be obtained from the redefined variable s with the help of Equation 4. To repeat, Equations 2 through 4 will still hold if their five variables are redefined as appropriately weighted averages. If Equations 2 through 4 hold true, then Equation 1 cannot but hold true.

134. The definition is

$u_i=w_i+\sum_j s_{ij}w_j+\sum_j s_{ij}\sum_k s_{jk}w_k+\cdots$

We can simplify the definition by using matrices.

$u=(I-S)^{-1}W$

135. That is,

$q=\frac{\sum_i \tilde{e}_i q_i}{\sum_i \tilde{e}_i}$

where

$\tilde{e}=e_i(1-\sum_j s_{ij})$.

136. The weight should be each company's equity capital after having distributed to its shareholders all the stocks it owns. That is,

$u=\frac{\sum_i \hat{e}_i u_i}{\sum_i \hat{e}_i}$

where

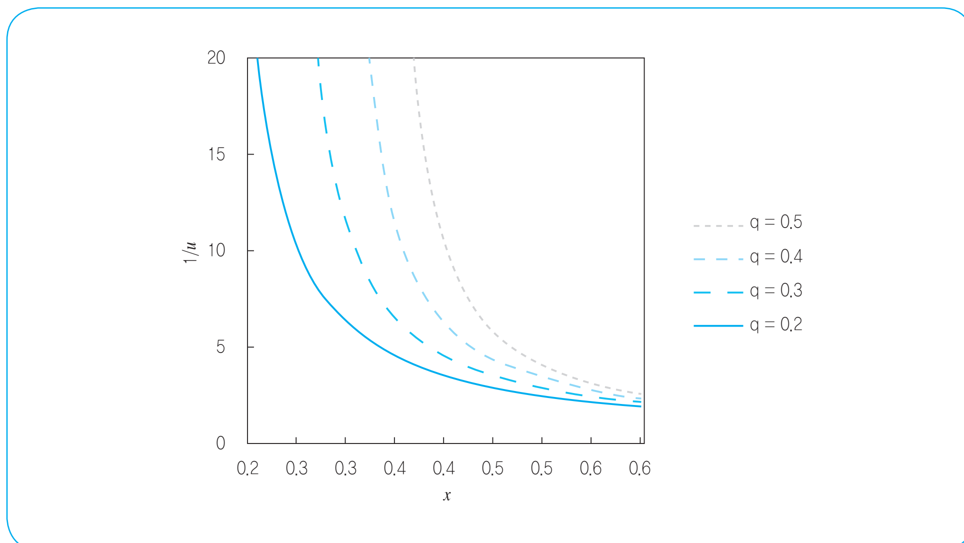
$\hat{e}_i=e_i-\sum_j e_j s_{ji}$.

137. Kim (2007) makes use of matrix algebra to prove this and other equations.

2. Regulation as a Constraint on the Combination of Two Variables

One way of reading Equation 1 is the following: either u must be raised or x must be lowered in order for q to be lowered. A slight change makes it simpler and easier to appreciate: either $1/u$ or x must be lowered in order for q to be lowered. As it has been said before, the inverse of ultimate ownership ratio, $1/u$, represents the real amount of equity capital that the controlling shareholder can control by a unit amount of equity investment. We have thus called it the controlling shareholder's equity leverage ratio. On the other hand, the ratio of inside shareholding measures the controlling shareholder's control power, or the voting rights that the controlling shareholder can exercise in the general meeting. We can employ these two ratios as indices to measure the concentration of economic power into a few controlling shareholders' hands.

Figure A-2 | Relations among Three Ratios



Having reminded ourselves of the significance of the two ratios denoted as $1/u$ and x, we shall have [Figure A-2] illustrate their relations to q, the ratio of equity investment. The loci of possible values of x and $1/u$ are drawn for various values of q in [Figure A-2]. If [Figure A-2] included a line for q=3/7as well, the line would pass through the locus of x = 10 and $1/u$=10. We can be sure of this locus because we have already computed the three ratios for our imaginary group of companies illustrated by [Figure A-1] above. We can be equally sure that q cannot be lowered to .4 without either x or 1/υ being lowered in our imaginary group of companies. [Figure 4-2] informs us that one possibility is .36 for x and 9.62 for 1/υ. In order for q to be further lowered, either $1/u$ or x must be further lowered. It

is a simple arithmetic based on Equation 1 which holds for any group of companies under control of the same person.

Roughly speaking, this is how the regulation named as Ceiling on The Total Amount of Equity Investment is supposed to work. Imposing a lower ratio of Equity Investment than the current ratio, the regulation constitutes a binding constraint upon a group of companies under control of the same person or family. Two options are allowed for the controlling shareholder. One is to reduce the amount of equity capital under its control, and the other to reduce the voting rights that it can exercise in the general meeting of member companies. Either way, the equity investment regulation restrains the concentration of economic power into a few controlling shareholders' hands. If the regulation had not been effective at all, it must be because the ratio of equity investment did not have to be lowered at all. There cannot be any other explanation for the ineffectiveness.

There is a point to make as to the differences between the regulation in our model and that in reality. Equation 1 relates the three *average* ratios whereas the actual regulation concerns the ratio of equity investment for *each* member company. If a ratio is lower than a certain level in each member company, its average is normally even lower. In this sense, and in this sense alone, the regulation named Ceiling on The Total Amount of Equity Investment was more stringent than in our theoretical model.

As it has been said in Section 4 of Chapter 3, the equity investment regulation has not been of much effect in actuality. Take a look at<Table 3-4>. Neither the equity leverage ratio ($1/u$) nor the ratio of inside shareholding (x) visibly fell after the regulation was reinforced or recalled. The only possible explanation for this is that not many companies actually reduced their ratio of equity investment. As the column of <Table 3-5> for April 2002 shows, the equity investment regulation only applied to eleven of the top thirty business groups, and nearly a half of their equity investment was excluded from application or treated as exception in April 2002. The portion of exclusion or exception got larger and larger in the following years. Provisions of Article 10 of the MRFTA and the Presidential Decree made it possible for most of the six hundred and thirty-six companies to acquire and own much a greater amount of stocks in excess of twenty five percent of their Net Asset Amount.

3. Regulation as to Ownership-Control Disparity

To conclude beforehand, the equity investment regulation has as much to do with ownership-control disparity as with economic power concentration. Let us take one more look at Equation 1 to confirm the relation. Equation 1 says that either u must be raised or x must be lowered in order for q to be lowered. The variable u measures the controlling shareholder's ultimate ownership, and the variable x measures the controlling shareholder's control power. Accordingly, a combination of the two variables can measure the disparity

between ownership and control. Of course, the two variables must be so combined that the measured disparity shall decrease if either u rises or x falls. The measured disparity then is likely to decrease if the variable q falls. Recall that q denotes the ratio of equity investment as defined by Equation 4.

What then would be a proper combination of the two variables, u and x, to measure the disparity between them? Three combinations are conceivable.

$$d_A = x - u$$

$$d_B = \frac{x}{u}$$

$$d_C = 1 - \frac{u}{x}$$

The first two combinations are straightforward. In fact, they are the same as those that the FTC once employed to evaluate the ownership structure of companies belonging to chaebol groups. Amended in December 2004, the MRFTA included such provisions that any company should be excluded from application of the equity investment regulation if its “ownership and governance structure” met certain conditions. The Presidential Decree specified the conditions in terms of two ratios, which are equivalent to our x and w. In particular, their difference and ratio should have been less than .25 and 1/3, respectively.

Compared to the first two combinations above, the last one had two desirable features. First, it may vary only between 0 and 1. That is, d_C=0 if the controlling shareholder can exercise exactly as much voting rights as she owns, and d_C=1 if the controller exercises some voting rights without owning any stocks at all. Second, the law of diminishing returns applies properly to the relations between d_C and x; d_C shall not increase much with x once the latter has exceeded a certain level, say, .5.

Whichever we choose from the three indices of ownership-control disparity, it is no mathematical function of q, the ratio of equity investment. There exists no one-to-one correspondence from one to the other. None of the three indices can avoid this weakness. Nonetheless, we may say at least that a decrease in q shall yield a decrease in d_C unless

the decrease in q accompanies a decrease in w,[138] which is unlikely to happen.[139] It may certainly be said, therefore, that a decrease in the ratio of equity investment is likely to lead to a decrease in the ownership-control disparity measured by d_C.

138. A rather complicated computation is required to get the sign of the partial derivative, $\frac{\partial}{\partial q}(\frac{y}{x}) = \frac{w[2-(1+w)(1+q)]}{1+q} < 0$, or $\frac{\partial dc}{\partial q} > 0$. It is more straightforward to get the sign of another partial derivative, $\frac{\partial dc}{\partial w} < 0$. Combining them, we get a combined result of changes in q and w. The conclusion applies $d_B = \frac{1}{1-dc}$ as well.

139. It is unlikely that any controlling shareholder reduces his/her ratio of direct shareholding when the intra-group shareholding must be reduced.

Appendix B. Circular Shareholding in Korea[140]

1. Definition of Circular Shareholding

If a company owns stocks of another company and the latter owns stocks of the former, we may call it 'reciprocal shareholding.' A case of reciprocal shareholding requires a pair of companies. In comparison, a case of 'circular shareholding' requires three or more companies. The simplest case requires for three companies. [FigureA-1] illustrates one such case in which Company A owns stocks of Company B, company B owns stocks of Company C, and Company C owns stocks of Company C. The sequence of shareholding constitutes a closed circle. A slightly more complicated case is illustrated in [Figure B-1] below. Of course, a much more complicated case of circular shareholding is not improbable.

'Reciprocal shareholding' is the term that the present author recommends as the English translation of what is prohibited by the provision of the MRFTA. The Korean word that appears in the MRFTA is 상호출자(相互出資). In Korea, 'cross shareholding' is used more often as the English translation of the Korean word. 'Circular shareholding,' on the other hand, is a common translation of what Koreans call 순환출자(循環出資). The latter might cause some trouble in communication because it is often used to refer to *any* inter-company shareholding. Some Koreans use a repetitive word to avoid possible confusion. If one asks for a direct translation of the Korean word, the translation would be 'ring-type circular shareholding.' It certainly refers to what is defined as and called circular shareholding above.

2. Emergence of Circular Shareholding

In Korea, circular shareholding suddenly grew large in a few chaebol groups around 2000. The most notable case is that of the chaebol group called Hyundai Motors. The chaebol group is one of five groups into which the chaebol group named Hyundai has been divided in 1999 and later. Hyundai Motors Group is the largest of the five 'derivative' chaebol groups.

Both <Table B-1> and <Figure B-1> illustrate the circular shareholding of Hyundai Motors Group as of December 31, 2001. Although the structure of circular shareholding was built through a bit more complicated process, the key elements were the acquisition of stocks of Hyundai Motors (A) by two affiliated companies (B1, B2) and the acquisition of the latter's stocks by Kia Motors (C). Having been preceded by Hyundai Motors (A) acquiring stocks of Kia Motors (C), the series of stock acquisitions closed a circle of shareholding among the four member companies (C←A←B1&B2←C).

140. This Appendix is based on J. Kim (2007a).

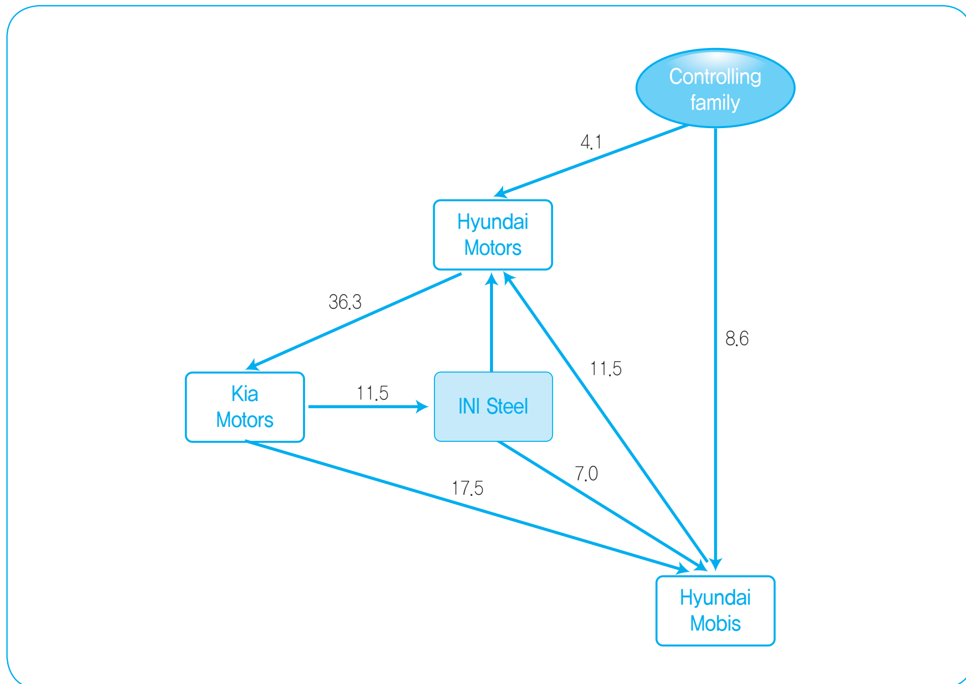
Table B-1 | Circular Shareholding of Hyundai Motors Group (December 31, 2001)

(Unit: %)

Member Companies	Inside Shareholders				
	Hyundai Motors	Kia Motors	Hyundai Steel	Hyundai Mobis	Controlling Family
Hyundai Motors	0.4		4.9	11.5	4.1
Kia Motors	36.3	0.4			
Hyundai Steel		11.5	22.6		7.2
Hyundai Mobis		17.5	7.0	4.4	8.6

Source: Annual reports of each company

Figure B-1 | Circular Shareholding of Hyundai Motors Group (December 31, 2001)



The two affiliated companies that acquired stocks Hyundai Motors are INI Steel (B1) and Hyundai Mobis (B2). Their shareholding ratios in Hyundai Motors were respectively 4.9 percent and 11.5 percent as of December 31, 2001. Kia Motors' shareholding ratios in these two companies were respectively 11.5 percent and 17.5 percent as of December 31, 2001. All the shareholding resulted from stock acquisitions during the three previous years.

There is a further point to make of the circular shareholding of Hyundai Motors Group. Before Hyundai Steel acquired stocks of Hyundai Motors in 1999, the latter had been a major shareholder of the former (see <Table B-2>). Hyundai Steel's acquisition of Hyundai Motors' stocks, therefore, would have yielded a case of reciprocal shareholding between the two companies. It was avoidable because Kia Motors had bought those stocks of Hyundai Steel from Hyundai Motors. That is, a case of reciprocal shareholding was avoided by making up a case of circular shareholding. Circular shareholding was indeed a substitute of reciprocal shareholding.

Table B-2 | Pyramiding of Hyundai Group (December 31, 1998)

(Unit: %)

Member Companies	Inside Shareholders				
	Hyundai Heavy Ind	Hyundai Motors	Hyundai Steel	Hyundai Mobis	Controlling Family
Hyundai Heavy I					31.8
Hyundai Motors	13.6	6.1			6.8
Hyundai Steel		7.8	0.6		14.4
Hyundai Mobis			21.1	1.2	8.3

1) In 1999 and later, Hyundai Group has been divided into five groups, of which Hyundai Motors Group is the largest

Source: Annual reports of each company

3. Significance of Circular Shareholding

Circular shareholding was not a unique choice of Hyundai Motors Group around 2000. <Table B-3> has been constructed to demonstrate it. The figures in this table have been obtained through a series of simulations with each of the thirty largest chaebol groups for each of the years 1997-2005. A matrix of inter-company shareholding had to be constructed prior to each series of simulations. Each matrix has as many columns and rows as affiliated companies of a chaebol group.

Table B-3 | Circular Shareholding of Top Chaebol Groups, 1997-2005

(Unit: billion won, %)

		1997	1999	2001	2003	2005
Top 11-15	Equity capital	52,961	138,729	141,516	180,960	240,998
	Equity investment [A]	13,676	37,017	39,600	50,458	69,576
	Circular shareholding [B]	283	1,211	1,798	2,480	3,589
	Ratio [B/A]	2.1	3.3	4.5	4.9	5.2
	Cases with 1% or more	28	27	28	23	24
	Cases with 5% or more	7	11	13	14	16
Other 14-20	Equity capital	11,706	25,280	23,364	29,779	39,050
	Equity investment [A]	2,275	4,695	4,983	8,516	11,848
	Circular shareholding [B]	20	38	60	129	183
	Ratio [B/A]	0.89	0.8	1.2	1.51	1.54
	Cases with 1% or more	7	8	10	13	19
	Cases with 5% or more	3	5	7	8	11
Total 25-35	Equity capital	64,667	164,008	164,880	210,739	280,048
	Equity investment [A]	15,951	41,711	44,583	58,974	81,424
	Circular shareholding [B]	303	1,249	1,858	2,608	3,772
	Ratio [B/A]	1.9	3.0	4.2	4.4	4.6
	Cases with 1% or more	35	35	38	36	43
	Cases with 5% or more	10	16	20	22	27

1) Included are the thirty largest business groups under control of a person or family as of April 2004, of which 'top' business groups are those with total assets of 5 trillion won or more. The number of business groups included varies because six of them were divided into sixteen business groups during the period

2) Equity capital, equity investment, and circular shareholding are measured in terms of book value

3) The amount of circular shareholding is the least amount of stocks that member companies have to dispose of in order to resolve circular shareholding

Source: Annual reports and/or auditor's reports of each member company

A brief explanation of some figures in the table might be helpful. Let us start with the 'number of cases.' We can count the cases of circular shareholding while ignoring any shareholding of less than one or five percent. In any case, the 'number' refers to the *smallest* number of those companies of which stocks must be disposed of for the concerned group of companies to completely get rid of circular shareholding. The 'number,' of course, will be smaller if we count the cases while ignoring any shareholding of less than five percent instead of one percent. The 'number of cases' so obtained and added for the thirty chaebol groups was doubled in December 2001, and almost tripled in December 2005.

We can also compute the *least* amount of stocks that the top thirty chaebol groups should have disposed of in order to completely get rid of circular shareholding. <Table B-2> includes the result of my simulations and computations. Comparing the least amount to the total amount of intra-group shareholding for each year, we shall see that the ratio rose from 1.9 percent to 4.6 percent during the four years after 1997. The ratio rose to 4.9 percent in December 2005. The portion of circular shareholding in intra-group shareholding more than tripled in those years.

The ratio of circular shareholding should not be mistaken. If anyone calls 4.6 or 4.9 percent "tiny," he/she should be reminded that it is a weighted average ratio. Not all chaebol owners relied on circular shareholding to maintain or strengthen their control power. A few chaebol owners relied much more heavily on circular shareholding than others. Circular shareholding is critical to the former, if not to the latter. It is no less important to note that one or more key companies are involved in most cases of circular shareholding. More often than not, circular shareholding was a strategic choice of chaebol owners who had difficulties in maintaining a sufficiently high ratio of inside shareholding in key companies with their private funds. Prohibition of circular shareholding, therefore, could have been critical to them.

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Ministry of Strategy and Finance, Republic of Korea

339-012, Sejong Government Complex, 477, Galmae-ro, Sejong Special Self-Governing City, Korea Tel. 82-44-215-2114 www.mosf.go.kr

KDI School of Public Policy and Management

130-722, 85 Hoegiro Dongdaemun Gu, Seoul, Korea Tel. 82-2-3299-1114 www.kdischool.ac.kr

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