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Economic Analysis of Associates in Terms of Antimonopoly Regulation

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Introduction

This paper has been prepared as part of a dedicated RECEP project intended to be used in the unfolding debate on improvement of the market competition rules in Russia, including *inter alia* discussions on the new draft law "Concerning Competition Protection". The main objective of this paper is to outline approaches to definition of associates as a group of multiple economic agents subject to specific proprietary and binding (contractual) relationships that impact or may impact the terms of competition on the market. The set objective presupposes resolving the following two interrelated issues:

- (1) identify significant qualification criteria for associates definition;
- (2) assess applicability of "associate" definition in antimonopoly regulation.

"Associates" is among the basic definitions employed in antimonopoly regulatory practices. Improvement of the antimonopoly policy of the Russian Federation requires finding solution to diverse problems, including *inter alia* changes in the regulatory constituent of the government antimonopoly policy. The proposed option comprises several sections each of which is dedicated to a relevant issue that needs to be resolved.

First, an "associates" definition must be introduced in the existing antimonopoly legislation. In Section 1, problems associated with the use of this definition will be outlined.

Second, initial criteria critical for further clarification of and changes in the "associates" definition will be outlined.

Third, various situations qualifying for the use of the "associates" definition will be described.

Fourth, approaches to finding a tradeoff vis-à-vis definition of "associates" based on a "contractual" or a binding criterion will be presented.

Fifth, international best practices in applying similar definitions will be considered.

Sixth, approaches to applying the "associates" definition in terms of antimonopoly policy will be proposed.

We will base our analysis on phraseology used in the existing regulatory acts. We also take account of the fact that the new draft law "Concerning Competition Protection" has been subjected to public debate. In view of the latter in the final section we will analyze the draft law provisions relating to associates, changes in the antimonopoly legislation applicable to associates and definition of "collective dominance".

1. Current Definition of "Associates"

Article 4 of the effective law "Concerning Competition and Restrictions on Monopolistic Activities" gives a description of this and a close definition "affiliated parties". Insert 1 presents criteria and descriptions relating to the definitions of "associates" and "affiliated parties".

Insert 1. Associates and Affiliated Parties: Scope of Definition

"Associates" – a group of legal entities and (or) individuals qualifying under the following one or several criteria:

1. An entity or a group of entities collectively as a result of an agreement (agreed activities) has the right to directly or indirectly manage (including *inter alia* through purchase, trust management, joint venture, agency contracts or other covenants) more than 50 percent of the votes attributable to shares (investments, stakes) making up the charter (share) capital of a legal entity. Indirect management of the legal entity's voting rights shall be deemed to mean their actual disposal via third parties whereby the former holds the above right or authority with respect to the latter;

2. An entity or a group of entities has acquired an opportunity whether in contract or otherwise to determine terms of commercial activities to be abided by another entity or group of entities or exercise powers of that other entity's (entities') executive body based on the relevant contract;

3. An entity has the right to appoint a sole executive body and (or) over 50 percent of a collegial executive body of the legal entity and (or) per its proposal over 50 percent of the board of directors (supervisory board) or any other collegial executive body of the legal entity may be elected;

4. An individual may exercise powers of the sole executive body of the legal entity;

5. Same individuals, their spouses, parents, children, siblings and (or) individuals proposed by the same legal entity constitute over 50 percent of the collegial executive body and (or) the board of directors (supervisory board) or any other collegial executive body of two or more legal entities;

6. Same individuals, their spouses, parents, children, siblings and (or) legal entities have the right either independently or through representatives (agents) to dispose of more than 50 percent of the votes attributable to shares (investments, stakes) making up the charter (share) capital of each of the two or more legal entities;

7. Individuals and (or) legal entities have the right either independently or through representatives (agents) to dispose in aggregate of more than 50 percent of the votes attributable to shares (investments, stakes) making up the charter (share) capital of one legal entity whilst at the same time the very same individuals, their spouses, parents, children, siblings and (or) individuals proposed by the same legal entity constitute over 50 percent of the collegial executive body and (or) the board of directors (supervisory board) or any other collegial executive body of another legal entity;

8. Legal entities are part of the same financial industrial group (FIG);

9. Relevant individuals are spouses, parents, children or siblings;

"Affiliated parties" – means individuals and legal entities that are capable of exerting influence on legal entities and (or) individuals engaged in commercial activities;

1. Affiliated parties include the following:

2. A member of the board of directors (supervisory board) or any other collegial executive body of the applicable legal entity or an individual exercising powers of its sole executive body;

3. Entities belonging to a group of entities that own the legal entity in question;

4. Entities that have the right to dispose of more than 20 percent of the total votes attributable to shares (investments, stakes) making up the charter (share) capital of legal entity in question;

5. A legal entity in which this legal entity has the right to dispose of more than 20 percent of votes attributable to shares (investments, stakes) making up its charter (share) capital of that legal entity;

6. Where a legal entity is part of a financial industrial group (FIG) its affiliated parties also include members of boards of directors (supervisory boards) or any other collegial executive bodies of FIG members or individuals exercising powers of sole executive bodies of such FIG members;

7. Affiliated parties of an individual entrepreneur include the following:

8. Individuals belonging to a group of entities to which the relevant individual belongs;

A legal entity in which the relevant individual has the right to dispose of more than 20 percent of the total votes attributable to shares (investments, stakes) making up the charter (share) capital of the above legal entity.

Commenting on the above definitions the following should be emphasized:

1. Associates may be either legal entities or individuals which are collectively referred to as "business entity". The Law "Concerning Competition and Restrictions on Monopolistic Activities" says that all its provisions relating to a business entity shall be deemed extended to associates as well. In other words, associates are recognized as a business entity in economic terms.

2. A principle of soft complementarity of criteria is applied whereby associates are identified if they qualify under any one of the established criteria (9 altogether).

3. Not only proprietary but binding (contractual) relationships criteria are used as well. In this regard, one should focus on the second associates' qualification criterion which is closely related to such widely known in economic theory definitions as vertical and horizontal integration and vertical and horizontal restrictions.

4. Whereas "capability to exert influence" is used as a common criterion to qualify under the "affiliated parties" definition, the law is not specific as to what "associates" common criterion might be. However, such common criterion to identify "associates" for the antimonopoly regulatory purposes seems quite obvious, i.e. capability to exert control over companies being presumably part of the associates.

The law enforcement practices show that the "associates" definition needs further clarification. The complexity of the problem is evident from the fact that the EU first tried to codify relationships under the concept close to the "associates" definition more than 20 years ago and to date there have been no positive results achieved in terms of identifying common criteria. We will discuss this problem in greater detail in Section 4.

2. Reference Conditions for Associates Analysis

In view of the need to resolve two interrelated issues – identification of significant qualification criteria for the "associates" definition and assessment of the "associates" definition applicability in antimonopoly regulation, it is important for the purposes of meeting the set objective to take account of reference conditions that provide the basis for any further analysis.

First, all aspects of understanding the "associates" definition and its applicability in antimonopoly regulation will be discussed in terms of decision-making by economic agents, more specifically, individual selection logic. The above logic proceeds from the assumption that all parties concerned pursue their own definite ends with account taken of restrictions comprising not only prices but the existing rules and interests of other parties as well. At the same time such concept of the general approach requires a clearer understanding of "business entity" and "associates" definitions relationship.

Second, general background for identifying and describing significant criteria of "associates" is a totality of applicable concepts which may be considered as being related to the "associates" definition. These include "affiliated parties" and "parent and affiliate". What matters for us here, is not so much the legal techniques to define these terms but rather the role of this notion in the entire legal system.

Third, the notion "associates" as it has been developed in the Russian judicial and law enforcement practices including its relationships with "similar" notions, is not independent from a path-dependency effect.

Fourth, definitions close to the "associates" notion that are currently used in the European Union given the absence of generally accepted criteria for identification of the "associates" notion.

Fifth, the use of a comparative analysis of discrete institutional options which represents one of the key features of the new institutional economic theory allows us to speak more precisely about tradeoffs that will be inevitable in applying the notion in question.

Insomuch that the decision-making process as such along with methodology of decision-making and mutual positions of parties in the decision-making process are, strictly speaking, common for the economic analysis of the mentioned notions, the first problem that needs to be

given an answer to is where to draw distinction between the notions in use unless we do not recognize the need to apply different legal structures.

The posed question is, strictly speaking, a reciprocal form of presenting the problem of correlation between various elements of the legal system, particularly, competitive (public) laws, corporate law and civil law. As relationships within a certain area of relationships become more complex so do the laws that regulate them. From this perspective, the corporate law in the developed legal system is deemed an independent branch of law rather than a part of the civil law. In this connection it should be noted that as far as jurisdiction is concerned, litigations in the area of corporate governance fall under the jurisdiction of arbitration courts. The scope of this analytical paper does not include a detailed description of numerous corporate litigations that fall under the arbitration jurisdiction.

The first option of the approach to building a notional basis for each area may draw on invariability of the above notions definitions. However, this approach obviously cannot be employed without significant costs due to the fact that the above legal branches regulate **different** albeit interrelated sets of relationships between all parties concerned. Moreover, from the economic perspective the above differences are not so much important per se rather than for the results that might be achieved through conjugate solutions (actions) of economic agents. So long as interrelation of solutions as such does not cause inefficient use of resources or put barriers to emergence of new combinations as a means of economic development, the concept of "associates" must take account of specific risks associated with interrelated decisions.

As for the area of competitive or antimonopoly (when more narrowly understood) right, the notion of interrelated, conjugate solutions proposed by several parties is viewed first and foremost in terms of impact (or opportunities to exert impact) that such solutions (or possible solutions) might have on competition. In other words, this relates to the risks of adverse impact on competition, however, such risks do not presume that their very fact (contingencies including those determining the structure of the market) must be precluded. Accordingly, as such collective dominance (its inclusion in the new law "Concerning Competition Protection" is actively debated) does not constitute a breach of the antimonopoly legislation or entail imposition of sanctions. True though, in this case we need to make one reference: lack of sanctions does not at all mean that antimonopoly regulatory costs (these may be incurred by associates in meeting various requirements, including informational, set forth by the antimonopoly regulatory body) would remain unchanged.

In its turn the above conjugation in the area of corporate law is primarily analyzed in terms of the effect produced by the corporate governance (depending, certainly, on what we mean by this definition) translatable into such corporate efficiency indicators as shareholder's value (capitalization) or, more precisely, protection of investors/shareholders' interests. To the extent the antimonopoly regulation's objective coincides with that of corporate governance relationships one can speak about conjugation of the above two notions.

Finally, if we take a "parent and affiliate" notion, its very concept consists in that it helps to segregate liabilities between the parent and the affiliate when it comes to settling liabilities of either one.

It is clear that the logical application of "affiliated parties" notion does not very often ensure an unambiguous answer as to how and in what way affiliated parties' activities impact competition on commodity markets. On the other hand, if we pose a question about segregation of liabilities between the parent and the affiliate in terms of antimonopoly legislation applicability there this may give rise to significant difficulties already at the stage of situation description which in turn will complicate its understanding.

In view of the above, we deem it reasonable to opt for the *second option* whereby relative yet different notions are assigned to different applicable areas of the law. By in so doing we will preserve in the very definition the context of the relationships in question. The latter will help both cut the costs of law enforcement and ensure more consistent codification of definitions. Consistency in codification will also mean lesser transactional costs associated with subsequent changes in the legislation. The proposed approach will reflect the idea which essentially comes down to abandonment of any attempts to regulate with one notion the whole diversity of relationships between legal entities and individuals subject to effect or possibility of interrelated solutions.

At the same time the above does not mean that there is no possibility of numerous correlations between various types of "associates" and "affiliated parties".

3. Area of application of the "associates" concept

In the context of the antimonopoly regulation it is rather difficult to give a simple and concise definition of associates (a group of economic entities) although it is not so difficult to describe the situations which may call for application of such concept. Below is a description of such situations.

First, these are agreements which restrict competition on commodity markets. It should be noted that there is a great variety of such agreements. In particular, they can be classified by the location of entities in respect to this or that technological chain of a product (these are mainly horizontal and vertical restrictions). As to vertical restrictions, we should indicate the multiple forms in which they exist (restriction on resale prices, tied sales, quantitative and territorial limits). Restrictions may also be considered in terms of severity whose level can be judged by the parameters in question, on one hand, and enforcement mechanisms, on the other. It is understandable that when directors of competing companies or directors of technologically allied companies participate in the management of a competitor or an allied supplier, respectively, there are much more grounds to suspect that such companies may enter into an agreement restricting competition and affecting consumer interests, on one hand, and value creation, on the other, than when companies are not legally bound by ownership rights to companies including management powers. But it should also be noted that direct involvement in management decision-making is not a condition *sine qua non* to qualify this or that group of entities as associates. In this case it would be sufficient to indicate the presence of long-term reproduced contract relations which may significantly influence the competitive environment.

Second, these are concerted actions. The peculiarity of this type of situations is that associates (economic entities) may have no binding relations - either proprietary or contractual, which rules out the application of such characteristics which are used to describe groups of economic entities deemed to be affiliated parties. At the same time it would be possible to conjugate two notions, i.e. "associates" and "collective dominance". Therefore, it should be emphasized that neither of these notions can be considered as signs of violation of antimonopoly regulations. Each of them is only one of factors which may be used for distribution of limited resources of antimonopoly agencies to monitor competition on commodity markets.

Third, it is abuse of collective dominance which, strictly speaking, is in line with the agreements and concerted actions described in the first two paragraphs. It should be mentioned that even the effective antimonopoly laws provide for sanctions against persons acting as an "economic firm" and suspected of anti-competitive actions (see also sections 4 and 5). Since according to the law "Concerning Competition and Restrictions on Monopolistic Activities",

associates act as an economic entity, then members of associates may act as defendants accused of abusing their dominance (Article 5 of the law "Concerning Competition").

Fourth, these are actions and agreements involving executive bodies when such actions or agreements lead to restriction of competition.

Fifth, it is control over economic concentration transactions. As economic concentration transactions presuppose changes in the distribution of decision-making authorities among economic entities and/or individuals, then to the extent that such redistribution may affect the competitive environment such transactions may attract the attention of antimonopoly bodies. Such attention may be in the form of preliminary control (in case of unusually large deals) or follow-up control (for less significant deals which may also modify the competitive environment). It should be noted that this type of situations is most closely connected with the corporate governance issue.

The "associates" concept in principle calls for potential application of antimonopoly laws, even excluding the cases when associates act as defendants or a defendant. The idea of associates as a single market participant changes the conclusions on the structure and behavior of market participants. In particular, information about actual market participants, as opposed to the formally independent enterprises, may significantly modify the evaluation of market shares and concentration.

Let us show it by the example of the sector which was studied in great detail and where the nature of distribution of shareholding control is well known, i.e. the Russian oil & oil products sector. Figures 1 and 2 show the production concentration data: Concentration Rate 3 (CR3) and Herfindahl-Hirschman Index (HHI) cited from Russian statistical reports (where market participants are separate entities) and calculated for Russian oil companies viewed as market participants (based on the same data contained in the reports of the State Statistical Committee - Goskomstat). It is easy to note that concentration indices calculated for two versions differ significantly, and the difference is increasing as new business groups emerge in the oil sector. Moreover, we can see that the use of the data of the State Statistical Committee in the oil sector may lead to wrong conclusions not only about the scope but also about the trends in the production concentration.

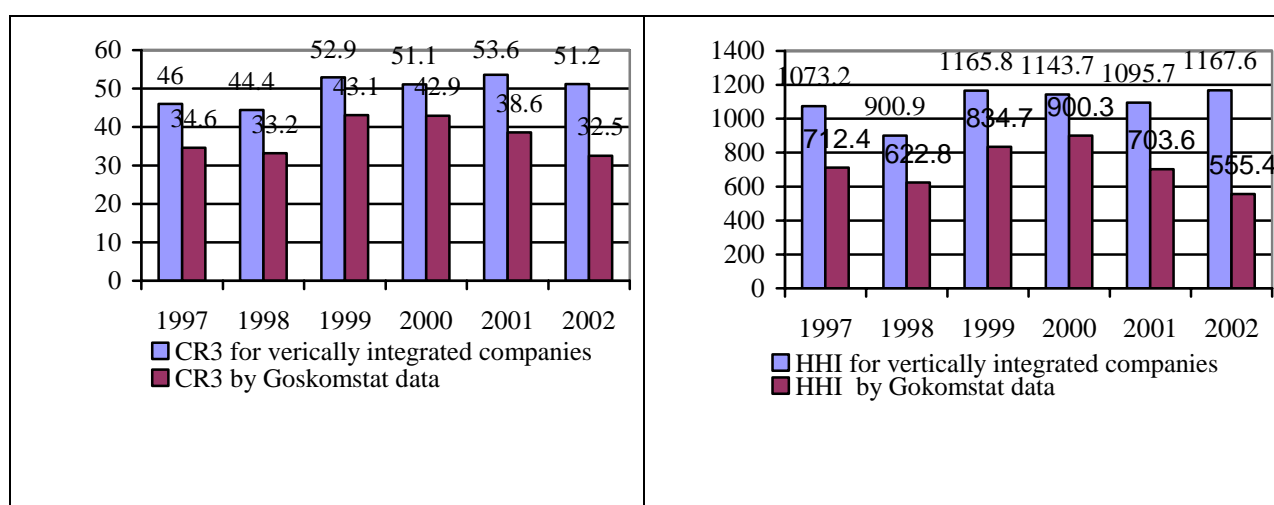


Рис.1. Concentration rates in oil refining by the State Statistical Committee and for Vertically-Integrated Companies: 1997-2002

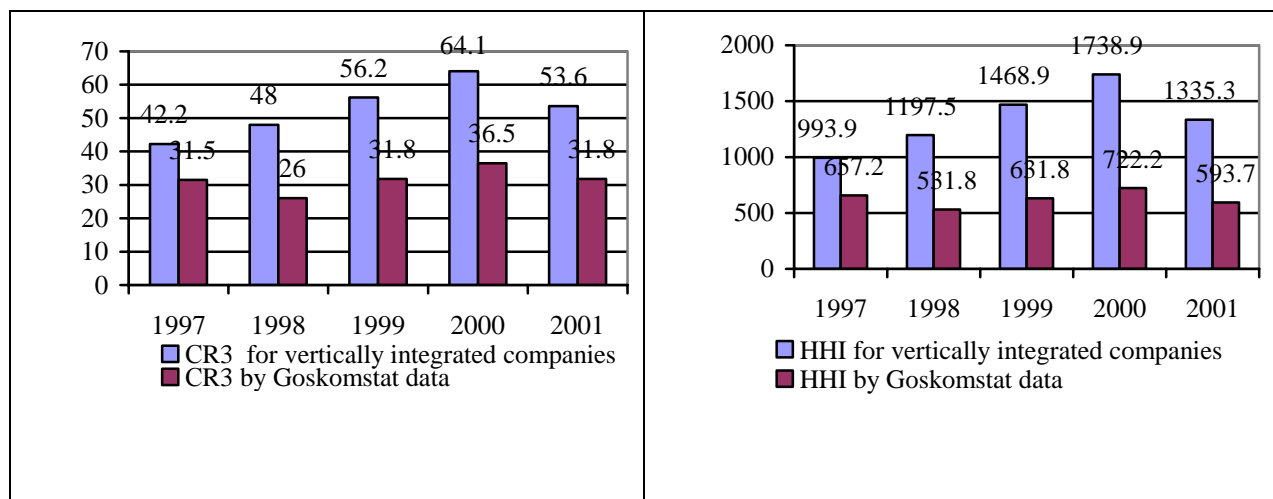


Рис.2. Concentration rates in oil refining by the State Statistical Committee and for Vertically-Integrated Companies: 1997-2001

Application of the term "associates" in daily practices is fraught with two dangers. The first is due to multiple grounds for control measures and the general lack of transparency in the Russian business groups. Both the shareholding and non-proprietary ties within Russian business groups are characterized by a number of distinctive features affecting the clear definition of the borders of the firm ("associates").

Most of the Russian business groups have a non-transparent shareholding structure. Very rarely the parent company directly holds a control stake in its subsidiaries. More often than not the controlling interest in the subsidiary belongs to a group of firms affiliated with the parent company. Moreover, it is rather difficult to identify the ties between the parent company and affiliated owners of subsidiaries.

More often than not the shareholding structure in a typical Russian holding is not stable. Even in case of a stable control by the parent company over the subsidiary the latter's formal owners may change frequently. Such rotation of formal owners is *inter alia* due to the parent's desire to reduce the transparency of shareholding structure and management and therefore, create a Russian analogue of a "poison pill" for potential raiders¹.

Russian holdings have multiple levels of control. If we take the parent's management of a subsidiary as level 1 control, then Russian business groups have five, six and even seven levels of control. It is rather difficult to say to what extent shareholding ties match the actual control levels. It is not improbable that three out of seven companies in the vertical chain were included exclusively for the purpose of reducing transparency of the organizational structure.

Russian holdings widely use both the legal forms of open and closed joint stock companies and partnerships. Unlike open joint stock companies, other legal forms presuppose fewer obligations to disclose information which makes them a convenient instrument to set up convenient control frameworks but at the same time complicates identification of actual borders of a firm by antimonopoly bodies.

The important tendency to consolidate real ownership rights in industrial production over the last few years is accompanied by consolidation of shares either in the hands of owners or of affiliated companies. But the second process significantly lags behind the first one: consolidation of a block of shares as a result of their transfer from numerous minor owners to the major owner is a slower process than concentration of actual control over a company.

¹ We mean not only the usual hostile takeover but also unfair corporate takeover as described in detail in "Identification of Unfair Corporate Takeover and Development of Countermeasures (Based on World Experience)". Ed. R.A. Kokorev, A.E. Shastitko, Bureau of Economic Analysis, Moscow, Teis, 2004.

In addition to the corporate instruments of control, coordination of economic solutions can be performed on a non-proprietary basis, e.g. due to control over supplies of key resources or distribution channels for finished products.

The role of controls based on non-proprietary rights was very high in the first years of liberalization; along with the economic development non-proprietary controls either served as a basis for emergence of property rights (e.g. when a sole-source supplier purchased assets of processing enterprises) or gradually subsided. Nevertheless, the share of non-proprietary control instruments in the Russian economy is higher than in a developed market economy.

Tolling may be an example of a specific Russian instrument of coordination which served as a basis for a number of rather stable business groups. Tolling represents such production structure when an industrial enterprise processes raw materials provided by an independent (though not necessarily) supplier. The latter pays for processing either with living money or with part of finished products. During the 1990s various goods were produced from give and take raw materials – from sugar to non-ferrous metals². Tolling schemes frequently entailed establishment of control and acquisition of actual property rights to the assets of an enterprise which formally did not belong to the raw material supplier.

In a word, maze patterns of joint stock structures in Russia complicate the task of identifying a market participant as an economic entity.

The second difficulty in using the "associates" concept is connected with adoption of the new law "Concerning Competition Protection" in the version which has lately been discussed by legislators. The concept's definition in the context of antimonopoly regulation is based on a multiple criterion which relates, on one hand, to coordination (interrelation) of solutions, and on the other hand, to changes in the competitive environment as a result of the activities of economic agents. This difficulty is due to the set of qualifications proposed in this draft law.

4. "Affiliates" in the context of comparative analysis of discrete structural alternatives: theoretical issues

The main purpose of this section is to set up a rationale for the search of a compromise in filling the "associate" concept with real contents. With this goal in mind we will use an approach known as "comparative analysis of discrete structural alternatives".

Participants of transactions in the economic system enter into contract relations with each other, which shows their common interests and limitation of the ability of each participant to ensure a mutually advantageous exchange. Extension of the "associate" concept to all participants of an economic transaction excessively broadens the concept. Therefore, it is very important to limit the spectrum of relations (both contractual and proprietary) which may be interesting in terms of antimonopoly regulation.

Therefore, it is reasonable to identify three basic forms of coordination: price mechanism (market coordination), hierarchic (in-house coordination) and hybrid. Speaking of the existing norms it should be noted that the list of economic entities (in accordance with the new draft law "Concerning Competition Protection") includes for-profit organizations, not-for-profit organizations (which perform income-generating activities), self-regulated organizations and individual entrepreneurs which allows us to distinguish between a legal entity and an economic firm. An economic firm may include numerous for-profit organizations and at the same time have specific ways of decision-making, exercise of control, and adaptation to changing

² Avdasheva S., "Tolling Contracts in Russian Industries: Impact on Processing Companies", in: *Statistical Issues*, 1999, No. 3, pp.62-67.

conditions, which may be described with the term "hierarchy" or a unilateral mechanism of transaction management. From this point of view, an economic firm may be considered as one market agent. In this connection the "associates" concept may be used as a legal analogue of an economic firm.

Moreover, it is important to take into account that a business firm dominated by a single-sided transactions control approach where parties to the transaction do not aspire to the residual income, not to mention the ultimate rights, does not cover the entire range of relations which at the same time involve significant constraints. Unregulated relations are the so-called "hybrid forms" or hybrid institutional agreements. Hybrid institutional agreements are long-term contractual relations implying autonomy (formal independence) of the parties to a transaction, which nevertheless require transaction-specific security measures which would prevent the participants' opportunistic behavior and ensure adjustment to the changing circumstances at the background of existing or potential uncertainties³. It is important to note that within the framework of hybrid forms the choice of forms is limited, and such limitations may restrict competition, which in its case is due to the fact that it is required to provide guarantees for the owners of specific assets. Please be reminded that specific assets are the type of assets yielding an income under one specific transaction which continuously exceeds income from any other transaction.

Hybrid forms are diverse. In particular, they include subcontracts, networks, clusters, franchising, collective trademarks, alliances, as well as partnerships and cooperatives⁴. Hybrid forms of institutional agreements differ a lot from the point of view of the tightness of control. Hybrid forms of institutional agreements represent the most serious challenge to the interpreters of the notion of "associates" and antimonopoly regulators, since it is quite difficult to draw a demarcation line between business entities that can be qualified as associates and entities entering into standard contractual relations with one another, including long-term contracts and/or contracts subject to prolongation, which cannot be qualified as such.

The present materials do not include any final and theoretically grounded solution to the problem of drawing a demarcation line between contracts that qualify for associates and those contracts that do not qualify for this category. However, it should be noted that recurrent transactions with one and the same set of participants may be based on reputation effects. Inclusion of such type of relations as a characteristic of associates would considerably expand the range of relations falling within this definition, since a specific feature of the example given is that mutual dependence here is to a minimum extent related to establishing a special tool for transactions management, which, strictly speaking, represents the basis for evaluating the strictness of control. It should be specified once again that any legal definition of associates is only a compromise which had to be agreed upon at the stage of institutional development.

5. Application of similar concepts in European antimonopoly legislation

European antimonopoly legislation does not provide for a term defined as "associates". Position of the European Competition Commission is defined in a number of so-called "interpreting notices" with a status of bylaws. For the purpose of our analysis two interpretations are of great importance: Commission notice on the concept of **undertakings concerned** under Council Regulation (EEC) No 4064/89 on the control of concentrations between undertakings, published in Official Journal OJ C 66 of March 2, 1998 and

³ Shastitko A.E., *Balanced approach in the context of administrative reform and economy liberalization*. M.: Teis, 2005

⁴ Menard C., *The Economics of Hybrid Organizations // Journal of Institutional and Theoretical Economics*. 2004. V.160. P.4-6

Commission notice on the concept of **full-function joint ventures** under Council Regulation (EEC) No 4064/89 on the control of concentrations between undertakings published in Official Journal OJ C 66 of March 2, 1998)⁵.

In the first of the above documents it is specified that *"it is the concept of "acquiring control" that will determine which are the undertakings concerned* (Clause 7). In the second document it is specifically pointed out that *"it is appropriate to define the concept of concentration in such a manner as to cover only operations bringing about a lasting change in the structure of the undertakings concerned"* (Clause 5).

When analyzing an impact a transaction may have on the competition, information to be taken into consideration by the competition authority will include not only data on the formal parties to a transaction, but, in the first place, the group to which the applicants belong. This principle is made specific with respect to a parent company and a subsidiary (Clauses 18-20):

"Where the target company is acquired by a group through one of its subsidiaries, the undertakings concerned for the purpose of calculating turnover are the target company and the acquiring subsidiary.

All the companies within a group (parent companies, subsidiaries, etc.) constitute a single economic entity, and therefore there can only be one undertaking concerned within the one group. The subsidiary and the parent company cannot each be considered as separate undertakings concerned.

Article 5(4) of the Merger Regulation provides that it is the turnover of the whole group to which the undertaking concerned belongs that will be included in the threshold calculations".

A special treatment in the Commission's Interpreting concepts is given to a notion of a full-function joint venture. A commonly occurring case is analyzed when the company acquiring control is only a "vehicle" and is part of the so-called "corporate cover", but at the same time it cannot be qualified as a subsidiary with respect to a specific parent company. In this case, which is typical for Russia, co-owners of the specified acquiring company may be participants of the group. The question of whether the joint venture itself or its owners should be regarded as the acquirer is resolved depending on whether the joint venture may be regarded as a "full-function" joint venture (Clauses 27-28):

"27. Where the acquisition is carried out by a full-function⁶ joint venture, i.e. a joint venture which has sufficient financial and other resources to operate a business activity on a lasting basis, which is already operating on a market, the Commission will normally consider the joint venture itself and the target company to be the undertakings concerned (and not the joint venture's parent companies).

28. Conversely, where the joint venture can be regarded as a vehicle for an acquisition by the parent companies, the Commission will consider each of the parent companies themselves to be the undertakings concerned, rather than the joint venture, together with the target company. This is the case in particular where the joint venture is set up especially for the purpose of acquiring the target company, where the joint venture has not yet started to operate, where an existing joint venture has no full-function character as referred to above; or where the joint venture is an association of undertakings. The same applies where there are elements which demonstrate that the parent companies are in fact the real players behind the operation. These elements may include a significant involvement by the parent companies

⁵ In 2004, merger regulations of the European Union underwent considerable changes. However, as of early April 2005 the interpreting notices relating to the issues under consideration were not replaced by new revisions.

⁶ Criteria of a full-function joint venture are provided in the Notice on the concept of full-function joint ventures.

themselves in the initiative, organization and financing of the operation. Moreover, where the acquisition leads to a substantial diversification in the nature of the joint venture's activities this may also indicate that the parent companies are the real players in the operation. In those cases the parent companies should be regarded as undertakings concerned.

A special document dealing with "full-function" joint ventures defines the criteria of their "full-function" nature (Clauses 11-15):

The joint venture must perform, on a lasting basis, all the functions of an autonomous economic entity. Joint ventures which satisfy this requirement bring about a lasting change in the structure of the undertakings concerned. They are referred to as 'full-function' joint ventures.

Essentially this means that a joint venture must operate on a market, performing the functions normally carried out by undertakings operating on the same market. In order to do so the joint venture must have a management dedicated to its day-to-day operations and access to sufficient resources including finance, staff, and assets (tangible and intangible) in order to conduct on a lasting basis its business activities within the area provided for in the joint-venture agreement.

A joint venture is not full-function if it only takes over one specific function within the parent companies' business activities without access to the market. Such joint ventures are auxiliary to their parent companies' business activities...

The strong presence of the parent companies in upstream or downstream markets is a factor to be taken into consideration in assessing the full-function character of a joint venture where this presence leads to substantial sales or purchases between the parent companies and the joint venture. The fact that the joint venture relies almost entirely on sales to its parent companies or purchases from them only for an initial start-up period does not normally affect the full-function character of the joint venture. It will normally not exceed a period of three years, depending on the specific conditions of the market in question.

Where sales from the joint venture to the parent companies are intended to be made on a lasting basis, the essential question is whether, regardless of these sales, the joint venture is geared to play an active role on the market. In this respect the relative proportion of these sales compared with the total production of the joint venture is an important factor. Another factor is whether sales to the parent companies are made on the basis of normal commercial conditions.

The joint venture must be intended to operate on a lasting basis. The fact that the parent companies commit to the joint venture the resources described above normally demonstrates that this is the case. In addition, agreements setting up a joint venture often provide for certain contingencies, for example, the failure of the joint venture or fundamental disagreement as between the parent companies. This may be achieved by the incorporation of provisions for the eventual dissolution of the joint venture itself or the possibility for one or more parent companies to withdraw from the joint venture. This kind of provision does not prevent the joint venture from being considered as operating on a lasting basis. The same is normally true where the agreement specifies a period for the duration of the joint venture where this period is sufficiently long in order to bring about a lasting change in the structure of the undertakings concerned, or where the agreement provides for the possible continuation of the joint venture beyond this period. By contrast, the joint venture will not be considered to operate on a lasting basis where it is established for a short finite duration."

Therefore, European antimonopoly legislation does not provide for a definition of a group of entities as a separate construction, while it defines the required standards of antimonopoly regulations ad hoc, *using economic criteria rather than legal standards*. Thus, as far as merger transactions are concerned, the law-makers rely on the concept of "control" and

"ability to operate independently". It should be noted that the approach that the EU Competition Committee applies to joint ventures may also be applied to vehicle type companies as a whole. In the first place, differentiation between "full-function" and "vehicle" companies contributes to resolving the question of identifying the ultimate owner. In its turn, information on the ultimate owner is required to identify the composition of the group (more detailed analysis of the approaches used to identify the structure of the group will be given in the next paragraph).

Thus, the notion of control is essential to define a group of entities in European antimonopoly legislation. It is recognized that both shareholding and non-property instruments of control may be used. However, in various cases antimonopoly regulations actually make use of various criteria for identifying a group of entities as an economic entity. Thus, when judging as to the requirement to exercise preliminary antimonopoly control of an economic concentration transaction, only a combination of entities united by *property control* is regarded as a group of entities. If an X entity files a concentration application, when calculating the turnover of "an undertaking concerned" the latter concept includes the following:

- (a) economic entity X;
- (b) economic entities in which X, either directly or indirectly:
 - (1) holds over one half of shares or assets *and/or*;
 - (2) controls over one half of the voting shares *and/or*;
 - (3) is in a position to appoint over one half of the members of the management body;
- (c) an economic entity or an individual exercising control over X as specified in (b);
- (d) economic entities controlled by the economic entity specified in (c), as specified in (b);
- (e) economic entities to which any combination of the participants specified in (a), (c), (d) may jointly apply the instruments of control specified in (b)⁷.

At the same time, when analyzing concentration transactions themselves and their effect on the competition, a possibility to use various instruments of control is taken into account, including non-property control instruments which are not based on the titles to property.

To what extent can the European approach be applied to Russia? An advantage of the above described approach is the priority of the economic nature of structural connections as compared to their legal form. However, as far as Russia is concerned, failure to provide for a clear definition of a group of entities (for the purpose of antimonopoly regulations) may result in the so-called "lack of legal clarity" and an increase of law enforcement cost to follow. That is why it is appropriate to provide for a compromise option, which may be to provide for a possibly short definition of a group of companies in the law "Concerning Competition Protection" (the definition may be based on the definition in Methodical Recommendations on Turnover Calculation of the European Competition Committee), while interpretations concerning the application of this norm may be included into special methodical documents.

The proposed variant divides all forms of hybrid coordination into two groups: those types of hybrid coordination that create grounds for one-sided hierarchical control are included into the notion of "a group", while those types of hybrid coordination which do not provide grounds for a one-sided hierarchical control are not regarded as grounds for establishing a group of entities. It should be noted that if we apply this approach we will inevitably fail to

⁷ Commission notice on **calculation of turnover** under Council Regulation (EEC) No 4064/89 on the control of concentrations between undertakings, published in the *Official Journal* OJ C 66 02.03.1998.

take into account a certain part of the instruments of mutual coordination of behavior. However, such approach provides at least two advantages:

- Basis for identifying a group becomes more specific from the analytical point of view (even if it is not always unambiguous from the point of view of the legal form);
- We have a possibility to differentiate between "a group of entities" as a combination based on the possibilities of hierarchical control and "joint dominance" as a market structure creating great stimulus for parallel behavior, which is vitally important from the point of view of applying antimonopoly regulations.

The second of the aspects will be considered in detail below, since these two types of situation are confused in the newly developed draft law "Concerning Competition Protection", which results in the above mentioned ambiguity as to whether specific types of coordination may be referred to characteristics of a group or the effect of the above specified types of coordination on the competition should be added.

6. Statistical monitoring of groups of enterprises in France ⁸

Experience of monitoring of groups of enterprises interests us insofar as the applicable instructions to fill in and interpret statistical forms incorporated the EU classification of justifications for associates' formation. In addition to that, the adopted classification uses not only notions and definitions, which may be successfully included not only into statistical instructions but also into certain legislative areas. It is appropriate to pay attention to the similarity and differences between group classification criteria adopted in the French statistical practice and in the EU anti-monopoly legislation. Finally, such system of monitoring over groups of companies is interesting as a sample introduction of which into practice of statistical monitoring of Russian enterprises would significantly improve justification of different state policy directions.

Basic provisions related to organization of ongoing monitoring of operations of groups of companies were adopted in 1979. The first survey of financial relations between enterprises was carried out in 1980 based on data taken as of 31.12.1979. Only sufficiently large private enterprises from various industries with staffing levels of not less than 500 people provide information on their financial relations with other economic entities.

According to the definition adopted in French statistics, **group** represents an association of business units (enterprises or other legal entities) activities of which depend on a single decision-taking center called "the group center" through establishment of appropriate property relations.

Group center represents a company operations of which are not directly or indirectly controlled by any other company and which in turn controls, minimum, one company.

Nucleus or group properly represents an aggregate of enterprises more than 50% of stock of which is directly or indirectly controlled by the headquarters.

Group in the broad sense of the word represents an aggregate of all enterprises controlled by one or several group centers irrespective of the degree of such control (i.e. the center's stake in the authorized capital).

⁸ Prepared on the basis of: *Analysis of Integrated Structures in Russian Commodity Markets*. Eds. S.B. Avdasheva, A.Z. Actapovich, A. E. Shastitko, Economic Analysis Bureau, Moscow, Teis, 2000. Chapter 2.

Subsidiary enterprise means an enterprise in which the group center company directly or indirectly owns 50% or more of its stock.

Branch means an enterprise controlled by the parent company by more than 50%⁹.

Control can be exercised **directly** (company A owns the controlling stake of company B) and **indirectly** (company A owns a controlling stake of company B via companies C and D), and depending upon degree of influence over the company's activity it can be described as **complete and joint control**, as well as **the significant influence**.

Full control criteria encompass:

(a) Direct or indirect possession of the controlling stock (control based on voting rights).

(b) Appointment by the head office of the majority of management and control staff for two years in a row (factual control).

(c) Decisive impact on economic operations in accordance with an agreement or Articles of Association (contractual control)¹⁰.

Joint control takes place in cases when control rights (proportions of shares) are distributed between a relatively small numbers of shareholders so that association of an owner of a large stock package with any one "coalition" can ensure passing of decisions. Usually it is related to administration of a block of shares (or similar control rights) to the extent exceeding the blocking stock but still being lower than the controlling stake.

Significant influence presupposes direct or indirect possession of not less than 20% of the stock of the enterprise under control.

Such notions as "control procedure" and "level of control" are applied to characterize a corporate architecture inside the group.

Control procedure determines the branch's positioning in relation to the group center company. 1st order controls are exercised in case the enterprise is directly controlled by the group center. 2nd order controls are formed when the enterprise is controlled by one or several companies representing direct branches of the group center.

Level of control of company A over company B is defined as an aggregate stake in the authorized capital of company B of immediate shareholders controlled by company A plus the stake of company A in the capital of company B. The level of control corresponds to the share of voices at the general meeting of shareholders (in %). Company B is said to be fully under control of company A, if the level of control of the latter exceeds 50%.

A company is considered independent from any other economic agent when 99% of its authorized capital belongs to the sole shareholder being a physical person. In other words, independent companies are the companies whose decision-making process is not influenced by any other legal entity.

Interpenetration may exist between groups in the broad sense of the word (the number of participants exceeds the number of the group nucleus members). In case the study presupposes consideration only of non-interpenetrating groups (each company belongs to a single group), it should be limited to review of enterprises, which make up the group nucleus.

⁹ Take note that the present definition of a branch does not coincide with the Russian legal definition of a branch but corresponds to the notion of a subsidiary company.

¹⁰ Thus, we come to another version of the control definition: let's compare it with the requirement adopted for the anti-trust legislation purposes to satisfy one of the three conditions: (1) possession of more than half of the shares or assets *and/or*; (2) administration of more than half of voting shares *and/or*; (3) the possibility to appoint more than half of the governing body members;

The consolidated report by the results of review of financial relations permits classifying groups of enterprises in the economy. The analysis sequence is as follows:

- To identify companies which potentially play the role of the group center (control at least 50% of the stock of an enterprise) and their affiliates;
- To identify actual group centers (exercise control over others but are not controlled by anybody). Together with their affiliated companies centers they form groups of enterprises;
- To compile the list of group center member companies.

Comparison of the definition of associates in the law "Concerning Competition...", on the one hand, and approaches to the definition of associates put forward by the EU Commission on Competition, as well as the French experience of group monitoring, once again demonstrates that:

- The list of criteria adopted in the Russian anti-trust legislation to classify associates is characterized by particular peculiarities; in some aspects it proposes a wider interpretation, and in some other aspects – a more limited interpretation of group belonging criteria;
- Thus, in Europe they use to include **joint control** entities into the category of associates, while the Russian legislation does not mention any joint control¹¹;
- At the same time the European practice does not tend to classify criteria for inclusion into associates based on "personal union" control¹².

7. «Associates» in the draft law "Concerning Competition Protection"¹³

The developed draft law in comparison with the applicable law "Concerning Competition and Restrictions on Monopolistic Activities", the definition of associates acquires significantly greater importance.

Similar to the previous law version, associates are actually viewed as an equivalent of an economic agent, which fully corresponds to the "economic firm" concept. The associates like any other economic agent may be accused of anti-trust legislation violations: of abuse of the domineering position and anti-competitive agreements and of concerted actions. It is specifically indicated that all legislative provisions related to economic agents apply to all types of associates.

¹¹ Criteria which determine belonging to associates in accordance with the law "Concerning Competition and Restrictions on Monopolistic Activities in Commodity Markets" comprise the following: "an entity or a group of entities collectively as a result of an agreement (agreed activities) has the right to directly ... manage ... more than 50 percent of the votes attributable to shares (investments, stakes) making up the charter (share) capital of a legal entity". Nevertheless, as can be seen the word "collectively" is used here in the sense of "as a result of agreed activities" while in Europe the notion of joint control encompasses the understanding of the *possibility to exercise significant influence* on enterprise's operations. In this context the joint control notion in the European anti-trust legislation is closer to the notion of the "golden share holder" applied in the Russian corporate practice.

¹² In particular, according to the law "Concerning Competition and Restrictions on Monopolistic Activities in Commodity Markets": "Individuals and (or) legal entities have the right either independently or through representatives (agents) to dispose in aggregate of more than 50 percent of the votes attributable to shares (investments, stakes) making up the charter (share) capital of one legal entity whilst at the same time the very same individuals, their spouses, parents, children, siblings and (or) individuals proposed by the same legal entity constitute over 50 percent of the collegial executive body and (or) the board of directors (supervisory board) or any other collegial executive body of another legal entity".

¹³ The review relates to the draft law as of February 28, 2005.

Definition of associates in comparison with the effective law " Concerning Competition and Restrictions on Monopolistic Activities in Commodity Markets" was supplemented by another qualifying attribute: *"several persons executed an agreement or perform agreed actions giving its parties significant operational or trading advantages against other economic operators on an appropriate commodity market"* (Article 4). This supplement includes into "associates" practically every form of hybrid coordination, which, in our opinion, is an unjustified expansion of the concept of an "economic firm" for anti-trust regulation purposes. Moreover, with extremely great reserve this definition can be considered true for any two companies entered into contractual relations, as by definition execution of a deal brings benefits to its participants in comparison with the situation when the deal would have not been effected (or in comparison with those companies which did not effect this deal).

More concerns are triggered by the fact that such a definition of associates practically coincides with the definition of agreements and agreed actions given in the same Article 4 of the draft law: *"...operations of an economic agent on the commodity market, the economic effect of which corresponds to interests of the said economic agent only if other economic agents.... act accordingly"*. Despite the fact that from the point of view of the new institutional economic theory, as was stressed hereinabove, there exist grounds for such approach, it is evidently inoperative from the point of view of requirements of application of the anti-trust legislation.

While preserving qualifying attributes (taking into account the reference hereinabove) the draft law expands the list of regulatory provisions based on representation of associates as an economic firm. Particularly, Article 25 of the draft law dealing with governmental control of economic concentration deals establishes:

"[With preliminary consent of the anti-monopoly authority shall]

An entity (group of entities) acquire voting shares in the authorized capital of a joint-stock company, thus the entity (group of entities) becomes entitled to administer more than 25% of the said shares, provided prior to such acquisition such entity (group of entities) was not entitled to administer shares of the said joint-stock company or administered less than 25% of the voting shares in the authorized capital of such joint-stock company...;

An entity (group of entities) acquire voting stake in the authorized capital of an economic agent, thus the entity (group of entities) becomes entitled to administer more than 50% of the said stakes, provided prior to such acquisition such entity (group of entities) was not entitled to administer stakes of the said economic agent or administered less than 50% of the voting stakes in the authorized capital of such economic agent...;

An entity (group of entities) which is administering not less than 25% and not more than 50% of voting shares in the authorized capital of a joint-stock company acquires voting shares in the authorized capital of the said joint-stock company and as a result of such transaction such entity (or group of entities) becomes entitled to administer more than 50% of the said shares;

An entity (group of entities) which is administering not less than 50% and not more than two thirds of voting stakes in the authorized capital of an economic agent acquires voting stakes in the authorized capital of the said economic agent and as a result of such transaction such entity (or group of entities) becomes entitled to administer more than two thirds of the said stakes;

An entity (group of entities) which is administering not less than 50% and not more than 75% of voting shares in the authorized capital of a joint-stock company acquires voting shares in the authorized capital of the said joint-stock company and as a result of such transaction such entity (or group of entities) becomes entitled to administer more than 75% of the said shares".

Thus redistribution of property rights inside the group of entities representing an economic firm is removed from the sphere of governmental anti-monopoly control of transactions. In comparison with the applicable anti-trust legislation which requires agreeing transactions which involve redistribution of shares from one legal entity to another the draft law introduces a radical innovation.

From the economic point of view this innovation is supported by a clear-cut logic. Actually, if the rights of control over an economic agent are transferred from one legal entity to another inside the same group, this transfer represents nothing else but an inter-company transfer, i.e. transformation of the corporate structure. As the anti-monopoly legislation does not provide for preliminary agreeing of corporate architecture transformations and decision-making process, such requirements shall not apply to associates.

Nevertheless application of this provision coupled with the ambiguous classification of associates as a group of entities which entered into agreement to obtain certain advantages creates the danger of second type of errors: companies are interested in classifying themselves as associates (to avoid costs connected with the preliminary agreeing of transactions), even if they actually behave themselves in the market as independent "economic firms".

There exist several ways to avoid problems emerging in this situation. The first one is to narrow the associates definition to the aggregate of companies united through property-based controls. The second one is to request market participants to fully disclose the information regarding structural links inside the group of entities in case they consider that the deals executed by them are outside economic concentration control regulations. Meanwhile an obligation has to be imposed on the companies to continue being viewed as associates for the anti-monopoly legislation purposes unless the data are submitted regarding significant control redistribution. To a certain degree such approach constitutes introduction of the regime of voluntary notification of associates similar to voluntary notification of agreements. In our opinion, the first approach should be used to improve the law "Concerning Competition Protection". The second method to avoid mistakes in application of the anti-monopoly legislation requires rather huge expenses to be incurred by the anti-monopoly authority.

Finally, irrespective of the chosen way application of regulations regarding associates necessitates development of a number of regulatory documents designed for anti-monopoly authority internal use as well as for market participants.

8. Conclusions and proposals regarding the use of the "associates" definition

The major prerequisite to efficiently use the "associates" definition is to guarantee rights of ownership, including private property rights which are the necessary condition for improvement of transparency during allocation of rights of control over the companies including physical persons.

Methods to provide an "associates" definition as well as to apply it may negatively as well as favorably affect competition and, in particular, effectiveness of the anti-monopoly legislation. The overly wide and excessively narrow interpretation of the "associates" notion may create unjustified expenses in applying the anti-monopoly legislation and both for anti-monopoly authorities and immediate market participants.

In our opinion, to avoid similar problems it is appropriate to undertake the following measures:

1. To establish that the "associates" and "affiliates" notions be defined separately in the anti-trust, tax, corporate and other legislations. Recognition of the aggregate of

- companies as associates for anti-monopoly legislation purposes should not, in general, lead to their automatic recognition as "associates" for tax legislation purposes.
2. To narrow down and specify the associates definition in the Russian anti-monopoly legislation. It is proposed to use the "associates" definition similarly to the European anti-monopoly legislation, i.e. as an aggregate consisting of company X, those companies which may control X company as well as the companies which are controlled by X company and the company which is the parent company in relation to it.
 3. To provide the anti-monopoly legislation (at the level of a law) with the definition of control (possibly, in the definition of associates similarly to the definition existing in the European anti-monopoly legislation);
 4. To include into the anti-monopoly legislation and its application practice the regime of the voluntary notification of the associates structure and to develop certain information disclosure standards;
 5. To supplement the anti-monopoly legislation with the definition of an "instrumental" company and to specify that the "instrumental company", unlike the companies which exercise control over it and physical persons, can not be treated as a legally capable entity.
 6. To develop methodological recommendations to identify "associates" for internal use by the anti-monopoly authority staff;
 7. To develop explanations to the "associates" concept used to keep the anti-monopoly legislation current in the interests of market participants;
 8. To introduce changes into the Russian governmental system of collection and processing of enterprise data to establish a system of statistical monitoring of groups of companies.