

INVESTOR PROTECTION TO ENCOURAGE INVESTMENT CLIMATE IN INDONESIA

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Abstract

The issue of widespread corruption in Indonesia is harmful for its investment climate. The government should have been aware with such phenomenon and need to take immediate action, otherwise the devastating impact will affect many sectors such as weaken business environment, unemployment and poverty. Many factors might support the corruption climate in Indonesia, in this paper the investor protection is widely discussed so that it might be helpful to eradicate the corruption in Indonesia.

Keyword : investor, investor protection, investment climate, law instruments, public company

1. INTRODUCTION

Indonesia may have been known for its widespread corruption as stated by the Political and Economic Risk consultancy in the website of <http://www.globalpolitician.com>. According to Henderson & Kuncoro [2004] *corruption in Indonesia spread on average over 10% of costs and over 10% of management time in smoothing business operation with local officials. But the extent of corruption varies enormously across local jurisdictions, with, for example, the average of bribes to costs ranging from 56% to 31% across localities*. This widespread and costly corruption case has been a big issue for years and terrifyingly become the number one threat for business climate in Indonesia.

Facing such a fact, Indonesia should have been aware since the subsequent effect will then harm Indonesia's investment climate. Investors will avoid investing and refuse to involve in such a risky transaction. The biggest responsibility might be in government's hand. Government should take an action to provide comfort business and convenient investment climate; otherwise the real sector in Indonesia may never rise. As a consequence, poverty and unemployment will never be reduced. This is a challenge for government to establish law that can protect investors so its image as always engage with corruption culture will be vanished. Thus, I would like to see this phenomenon from law perspective. How the law of investment protection in Indonesia has been established?

My discussion about investor protection will focus on law of public company that trade in stock exchange. The organization of this paper is as follow. In the first section I will discuss the general legal characteristic of company law in Indonesia and make a little comparison with

what has been explained in the book *The Anatomy of Corporate Law* by Kraakman et al [2009]. In the second section I will discuss the instrument law to protect investor as explained in Kraakman et al. The third section explains the specific law that ruled how investors are being protected in Indonesia. Finally, the summary of this paper will be concluded in the fourth section which tries to describe how the general condition of business climate in Indonesia.

2. PRIVATE COMPANY AND PUBLIC COMPANY IN INDONESIA

Running business in Indonesia shall comply with Indonesia corporate law which is established by Indonesian government for the very first time in 1995. Furthermore, the law was renewed in August 2007 and has been enacted as company law no.40 of 2007 (hereafter refer to as CL no.40). Whereas, trading in stock exchange in Indonesia is ruled under Capital Market Law No.8 of 1996.

According to CL no.40, article 16, point 2 and 3 Limited liability companies or private companies in Indonesia are named PT (Perseroan Terbatas). The minimum authorized capital to establish a PT is IDR 50,000,000 or approximately equal to EUR 4,237. However, certain type of companies might be ruled differently under government's law as long as not less than IDR 50 million. Of the authorized capital, at least 25% must be issued and paid up in full.

PTs whose shares are exercised to public offering in the field of capital market are called PT.Tbk (the term Tbk is added after the name of the PT), the word Tbk refers to "terbuka" which mean open for public or go public. To convert from PT to PT.Tbk, the minimum requirement of number of shareholders and the amount of

paid up capital must be fulfilled. Due to provisions and legislation in the field of capital market (UU Pasar Modal) to be listed in stock exchange and start the public offering, the minimum number of shareholders is 300 with minimum paid up capital is IDR 3 billion or approximately equal to EUR 255,000.

Characteristic of Business Corporation in Indonesia's companies compared to the five characteristics in Kraakman et al [2009]

All five company's characteristics as explained in Kraakman. et al [2009] are recognized in Indonesia's business. However, the application might not exactly the same. Below is succinct explanation regarding the five characteristics in Indonesia's CL no.40 of 2007.

1. Legal Personality

This characteristic shows that there is clear separation between the company as a distinct legal person and any of its members (eg. shareholders, directors, etc). Kraakman et al. [2009] stated that that there are two major rules in this characteristic. The first is priority rule which pledge firm's assets automatically as security for all contractual liabilities entered into by the firm. The second is a rule of liquidation protection which prohibits the shareholders to withdraw their share of firms' assets.

Some rules in CL no.40 reflect this characteristic. For example CL no.40. a.35 stated that *"shareholders and other creditors having receivables against the company may set off their receivables against the payment obligation to pay up the share price they have subscribed, with the approval from the General Meeting of Shareholders (GMS)"*. It is seen that a claim to firms' assets only possible subject to approval by GMS. This rule permits a firm to serve as a single contracting party that is distinct from other individual either managers or owners of the firm.

Furthermore, in case of liquidation, protection is also provided to the creditors as an advantage of the 'legal personality' as stated in a.49 point 1.c that *Liquidator's obligation in performing settlement of the Company's assets during the process of liquidation shall cover the implementation of payment to creditors.*

2. Limited liability

Limited liability characteristic is set up to protect the firms' owners personal assets from the creditors' claim. In Indonesia, limited liability term is governed under CL no.40 a.3. This rule said that *the company's shareholders are not personally liable for agreements made on behalf of the com-*

pany, and are not liable for the company's losses in excess of their prospective shareholding. However, if they are proven to exploit the company for their personal interest or involve in illegal actions, their responsibility become unlimited. In addition, this law does not give clear guidance of the separation of assets among companies' subsidiaries or lines of business so the assets associated to each venture cannot conveniently be pledged to the creditors who deal with that venture.

3. Transferable Shares

Securities Exchange rules that the transfer of Securities must consider general practices in the Capital Market. The "transfer of Securities" also refers to the transfer of entitlements. In Indonesia shares are not fully transferable. There should have been approval from GMS before transferring the shares.

4. Delegated management

Business Corporation in Indonesia is distinguished by a board of structure which adopt the two tier model. The highest power is in general Meeting of Shareholders' [GMS'] hand while the board of directors [direksi] fully responsible for the operational and management of company. CL no.40 a.5 requires direksi to carry out its duties in the best interests of the company. Each member is personally liable for any misconduct or negligence in carrying out these responsibilities. The two tier character is recognized as the presence of supervisory board or known as board of commissioner (dewan komisaris) which its main task is to supervise and advise the directors to run the company. However, in practice this Board of commissioner is usually idle and neglect his duty.

5. Investor ownership

CL No.40 clearly rules the right of investor to control the firm and to receive the firms' net earnings. For example in CL no.40 a.52 (1) which said that *shares provide rights to their owners to attend and cast vote in the GMS; receive dividend payment and the remainder or assets from liquidation; exercise other rights under this Law.* More about investors' right will be explained in the next section.

3. LAW INSTRUMENT TO PROTECT INVESTORS

Kraakman et al [2009] defined investor protection as *legal support for investors in the public trading markets through, inter alia, committing listed (or registered) companies to measure,*

ranging from mandatory disclosure to governance reform and regulatory constraint.

According to Kraakman et al. [2009] In order to protect investors, role of law can focus on the regulation of the action of firm and its insiders toward investors. The roles of law are by mandating the release of credible and reliable financial statement which provides valuable information to help investors in predicting future return of the shares. Another role is by limiting the insider trading to reduce information asymmetry in which some parties have information advantage over others.

Kraakman et al. [2009] explained that legal strategies in protecting investors are possible by applying three strategies which are the paradigmatic entry strategy: mandatory disclosure, the quality disclosure: governance and regulatory strategies and by providing some enforcement device namely private, public and gate keeper enforcement.

Mandatory disclosure is the main issue here since it is the most applicable instrument that allows firms to inform its financial position which later affect the share price in capital market. In complete and perfect market all information might available and accessible at all times. However, in real markets such condition is never met. Assuming that companies will not voluntarily disclose its information for whatever reason, justification for controlling mandatory disclosure is a necessity.

Legal strategies to protect investors are conjoined with the entry and exit strategy. Kraakman et al. [2009] stated that investor protection is possible to be designed by conditioning the entering requirement for each company desired to be listed in stock exchange and by obliging such companies to remain there. De-register or delisting law is also important to prevent company easily exit the market and then 'go dark' by abandoning their status as listed company.

4. APPLICATION OF INVESTOR PROTECTION IN INDONESIA

Considering what has been explained in the previous section, this section will discuss about the three law instruments of investor protection in Indonesia.

The paradigmatic entry strategy: Mandatory disclosure

There are some parts in Indonesia CL that specifically rule the disclosure obligation. For example, obligation to submit an audited annual report is ruled under CL no.40 a.68. Meanwhile, CL no.40 a.44 regarding capital reduction said that *the board of directors is obliged to notify the*

resolution of (capital reduction) to all creditors by announcing it in one or more newspaper. Even when member of directors (dewan direksi) or commissioners (dewan komisaris) or any of his/her families held any shareholding interest, this information must also be disclosed. The direksi shall comply with CL.no.40 a.50 (1) requiring company to organize and maintain a register of shareholders and special register containing information regarding the shareholdings of member of the direksi and komisaris and their families in such company and/or in other companies and the dates such shares are acquired and disposed.

Next to the Indonesia Company Law, the second major regulatory framework is found in Capital Market Regulation (thereafter referred to as CAPM). Initially, Regulation Of capital Law in Indonesia was ruled under Law 15 of 1952, "*The Emergency Law on the Securities Exchange*". However, the Capital Market Supervisory Board (BAPEPAM) considered this law as inadequate to today's climate as not fully covered the disclosure requirement which is the essential part in supporting transparency in securities market. In addition, to move toward more efficient market and to accelerate with rapid development of economy and business globalization, new Law is established. Capital Market Law no.8 of 1996 is different from the previous since the essentiality of disclosing all information to investors play more important role. In chapter I a.25, CAPM requires public companies and every person who participated in the Initial Public Offering (IPO) to convey all material information regarding companies' transaction, finance, management and other business activities. Consequence of violating of such, Consequence of violating of such provisions due to inadequate disclosure or fraudulent in the disclosures which result in public losses will bring the person or the company to the court. Furthermore, the violators are subject to criminal sanctions.

Moreover, chapter X a.85 of CAPM explained that all listed companies in stock exchange must periodically submit its annual report to BAPEPAM. Companies are also obliged to make public material information regarding events that may affect the price of securities, not later than two working days after the event. not later than two working days after the event. The material information is including mergers, acquisition, consolidations or joint venture and distribution of stock splits/stock dividends.

Besides CL no.40 and CAPM Indonesia also have Code for Good Corporate Governance (GCG) which covers some areas which function is to be used as guidance and reference in implementing GCG in business processes.

Quality controls: Governance and regulatory strategies

According to Kraakman et al.[2009] *governance strategies include hard and soft laws that structure shareholders voting rights and nomination procedures, director tenure, the committee structure of boards, the conduct of proxy rights, and disclosure requirement.* The affiliation strategies suggest that regulatory control shall be tightened by regulating the entering and exiting public markets.

Specifically, in Indonesia such hard and soft law has been regulated in CL no.40 and CAPM. For example CL no.49 a.42 (1) regulates voting right in deciding the amount of issued and paid up capital which stated that *"The GMS resolution for the increase of issued and paid-up capital within the limits of the authorized capital shall be declared valid if the quorum attending of more than ½ (one half) part of the total number of shares with voting rights and approved by more than ½ (one half) part of the total votes cast, unless larger number is determined in the articles of association"*. Another rule in CAPM explained that General Meeting of Shareholders (GMS) has an authority to elect the board of directors and the board of commissioners after the candidates meet the requirement and are approved by BAPEPAM. However, the minimum percentage of shareholders attending and approving the nomination is not clearly regulated in the CL no.40.

Concerning regulatory strategies, the entering regulation in Indonesia Capital Market is well designed to prohibit unqualified companies trading in the market. The first requirement is to comply with minimum IDR 50,000,000 of the authorized capital which at least 25% must be issued and paid up in full. Next to minimum capital is 300 minimum numbers of shareholders. However, the exiting regulation is not sufficiently ruled which imply that delisting procedures in the Indonesia capital market are very less. Lack of exit regulation may harm investors as firms might easily attract investors with the implicit promise of full disclosure and without responsibility abandoning markets.

Enforcement of Investor Protection strategies

Kraakman et al.[2009] stated that *legal strategies are relevant only to the extent that they induce compliance.* Furthermore, in order to prompt the compliance it is necessary to generate an enforcement device. The most directly relevant enforcement is in the form of regulatory strategies such as rules and standards. The objective is to constraint the agents' behaviour which is assumed not sufficiently do their work unless they are enforced. On the other hand,

governance strategies mostly rely on principals' intervention to encourage agents' compliance. Three modalities of enforcement according to kraakman et al. [2009] are private enforcement, public enforcement, and gatekeeper enforcement.

To apply public enforcement, Indonesia's government enacted Law No.5/1999, Concerning the Prohibition of Monopolistic Practices the Prohibition of Monopolistic Practices and Unfair Business Competition. Enforcement of Law No.5/1999 is vested in board of Business Competition Supervisory Commission or *Komisi Pengawasan Persaingan Usaha* (KPPU)

The law is authorized to prosecute violations of the law. The KPPU has an authority to investigate alleged violations either formality is complained by business actor or it may open an investigation upon its own initiative.

According to Global Forum on Competition in the website <http://www.oecd.org> *within the nine-year period upon its establishment, KPPU has shown ever increasing outputs of law enforcement. This is evident from reports on merger, consolidation, acquisition, share ownership, dual position, monopsony, closed agreement, and so on.*

Meanwhile, gatekeeper enforcement in Indonesia is not really tight to the extent that number of audit firms brought to the court is low, however it seems increase recently. For example, according to Mayangsari. S & Sudibyo. B [2005] in Accounting National Symposium, *the numbers of audit firms in Indonesia that is threatened by sanction is increasing. Moreover there will soon be released The Public Accountant Act that permits everyone to sue auditor if he fail to appropriately modify his opinion on financial statements that are materially misstated.*

Other Set of Rules in Investor Protection

In order to encourage investment climate, other set of law also established. For example, law number 37 of 2004 on bankruptcy and suspension of obligation for payment of debts which objective is as one of the legal means of settling debt-related problems. Another law device is Investment Law number 23 of 2007 established by The Investment Coordinating Board or BKPM. The main purpose of this law is to attract foreign investor to support the investment climate in Indonesia. iNUSANTARA networks in their website www.inusantara.com.sg stated that *through this law BKPM want to reduce bureaucracy by coordinating the various government institution, providing tax incentives to generate an attractive return on investment and by inducing major investors to invest on capital market.*

5. CONCLUSION

With some set of rules and standards already established, Indonesia should have provided convenient climate for investors. For instance, it is seen that the device in mandating disclosure in Indonesia is quite well established. The company shall disclose material information through its annual report to shareholders as well as to BAPEPAM, the relevant stock exchange and the public in timely, accurate, understandable and objective manner.

The two tier structure boards should be applied by public companies in Indonesia in which voting rights are held by investors to elect the member of the boards. The entering regulation is quite well designed however; the exiting regulation is lack of rule. Furthermore some governance strategies have also been regulated in a set of rules.

Law enforcement to protect investors is in process of improvement. For example, with law no.5/1999 public or private party is possible to bring the case of monetary damage to the court. On the other hand, auditor liability is also regulated so it is possible to claim auditors in case of negligent or neglect their work. However, it seems that such regulation is not sufficient enough and need more attention from government and other parties who have interests in financial statement.

Moreover, according to the World Bank's 2004 Report on the Observance of Standards and Codes (ROSC) on Indonesia's compliance with the Organization for Economic Co-operation and Development's (OECD) in their website <http://www.estandardsforum.org> Indonesia has an elaborate system of corporate governance rules. World Bank admits that with CL.no.40, CAPM, and GCG, corporate governance in Indonesia should have been sufficient enough to protect investors and encourage investor climate in Indonesia. Moreover with law no.5/1999 to enforce good corporate governance, corruption should have been gradually eradicated. Unfortunately, this is not the case in reality. Probably the most crucial problem is because actual corporate governance practices in Indonesia often fall short of the regulation. The World Bank reported that business culture in Indonesia is based on relationships rather than rules and the ownership is highly concentrated in one or two parties. Moreover, the percentage of managers belonging to the controlling group is also high. Facing this phenomenon, government together with the society should realize that the most important thing is to improve the effectiveness of implementation and enforcement of legislation and regulations to improve the corporate governance framework.

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