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MEMORANDUM; ESTABLISHMENT OF OVER-THE-COUNTER MARKET IN INDONESIA

*Bureau for Private Enterprise
U.S. Agency for International Development*

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A MEMBER OF ARTHUR YOUNG INTERNATIONAL

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MEMORANDUM

TO: Gordon West
United States Agency for
International Development Mission,
United States Embassy, Jakarta, Indonesia

FROM: Melville S. Brown
Frank J. Wilson

DATE: September 18, 1987

RE: Establishment of Over-the-Counter Market in Indonesia

The Ministry of Finance of Indonesia and the Capital Market Executive Agency (Bapepam), the overseer of its capital markets, have expressed a desire to establish an over-the-counter market in Indonesia. The primary impetus for this movement appears to be the lack of a secondary market for the existing Indonesian Stock Exchange and its failure to attract new listings. In 1986, average daily trading volume was less than 5000 shares and thus far the 1987 volume shows no improvement. No company has made a public offering of its shares since 1984. The only bonds traded on the Exchange are several issues each for the government agencies which have financed toll road facilities.

The reason for the failure of the current exchange appear to be several. Not the least of these reasons is a taxation bias in favor of banks (interest on deposits is non-taxable and interest on loans are tax deductible while dividends and capital gains on shares are fully taxable) and what are considered to be stringent exchange listing requirements. To make a public offering, among other things, a company must have earned a profit for the previous two years and, for the latest year, profits must have

seen at least 10% of shareholder's equity. Also certified financial statements must have an unqualified audit opinion.

Recognizing the moribund condition of its stock exchange, the Ministry of Finance has indicated a willingness to establish a system for the trading of shares and bonds outside the stock exchange. This willingness has been evidenced by the promulgation of three decrees by the Minister (two of which we had drafts of but the final copies of which we have not yet seen)¹ and four implementation decrees issued by Bapepam (which we have not yet seen either in draft or final form). All the decrees have apparently now been issued and we are informed are in the process of being translated. Since we have not seen these documents, one or more of our recommendations conceivably may be addressed in them. Also, it is possible that they could cause a modification in our recommendations or even that we could take issue with parts of them.

The Ministry of Finance has further manifested its desire to create a market outside the Exchange by expressing its willingness to work with outside consultants through the United States Agency for International Development such as the authors of this memorandum. In this connection, Mel Brown will work on a two-year assignment with the Ministry of Finance on financial and capital market issues generally and, in particular, on the proposed over-the-counter market. Frank Wilson's assistance was solicited for a shorter period (a two week period in Jakarta and such other time as needed to review proposals as they come about) because of his experience with the NASDAQ system in the United States. We were both in Jakarta for the period of August

1/ Decree of R.I. Finance Minister on Emission of Shares and Its Trade outside Stock Exchange.

Decree of R.I. Finance Minister on Emission of Bonds and Its Trade outside Stock Exchange.

14th through August 29th. During that period we had the very able and effective assistance of Phil Brewer, a full-time employee of the USAID whose assignment is the capital markets of Indonesia. Phil arranged for and participated with us in the 20 or more meetings held with various potential participants in an over-the-counter market. We also met with other interested entities (the Ministry of Finance, Bapepam and the Bank of Indonesia). Meetings were held with potential issuers, underwriters, institutional investors, brokers, the Association of Money and Securities Traders (PPUE) (apparently the designated operator of the market) and others. The comments made herein reflect the findings and conclusions drawn from these meetings as well as other study of events and background materials available to the writers.

In sum, the overall structure presumed for the proposed over-the-counter market as outlined in the draft decrees we have seen appears to be basically sound and has, even in its skeletal form, many positive provisions such as: requirements for registration statements with pertinent disclosure to be filed with Bapepam; public access to registration statements; distribution of prospectuses to the public as part of the emission; preparation of financial statements in accordance with generally accepted accounting principals; apparent "due diligence" (assessment of the emittant) requirements on the part of underwriters for the discovery of pertinent facts which would be made public as part of the registration statement and prospectus; and apparent restrictions on "insider trading,".

Nevertheless, there are many policy considerations which we believe must first be implemented and, indeed, are imperative if there is to be a successful over-the-counter market in Indonesia. Any successful stock market system must address the primary and secondary aspects of the marketplace and all potential participants in the marketplace: issuer companies, investors, intermediaries, government agencies and the operator of the marketplace, and others.

With these preliminary statements in mind, therefore, the following observations and recommendations are made based upon the results of the referenced meetings and our knowledge of the proposals to date. As stated, modifications could be made as details of the decrees become known or further study is conducted.

Objective

A highly liquid and widely credible market for the offering and trading of securities (stocks and bonds) off the existing exchange.

To achieve this objective several factors must be considered:

- o primary (distribution) and secondary (aftermarket) aspects of the marketplace. This would necessarily include the activities of intermediaries and the supply (securities of companies) and the demand (investing public) without any of which there will be no marketplace.
- o regulation of the marketplace
- o operator and operation of the marketplace.
- o existing legal and other constraints to a successful marketplace.

By way of preliminary comment, we believe that at the outset regulation of the new market should not be so burdensome as to have a negative impact on its development; yet, it must be sufficiently defined and clearly publicized so as to build and enhance public confidence in the market. Abuses subsequently discovered can be addressed specifically as they arise. Actions such as manipulation and insider trading should be defined and emphasized from the outset as being absolutely prohibited.

Also, presently existing disincentives to the development of the marketplace must be eliminated and/ or incentives to its development must be created. This is most important because we believe certain existing factors, delineated hereafter, would effectively prevent the new market from developing.

Recommendations

Target Date - Establish immediately a firm target date for startup of the new market with interim milestones. This could be utilized as a vehicle for a public relations initiative to further dramatize and publicize the new marketplace.

High Level Working Committee - Establish immediately a high level working committee composed of the potential future participants in the market. This Committee's purpose would be to design specifically how the market would be constructed, how it would be operated and how it would be regulated. Full-time staff would be needed to assist the Committee. This also could be the subject of a public relations initiative.

Since it has been proposed that PPUE would be the operator of the new marketplace, the Committee should probably be chaired by the Chairman of PPUE.² The remainder of its composition should be high level representatives of the other participants in the marketplace: issuers, underwriters, banks and non-banks financial institutions, market makers, brokers, the Bapepam Chairman or his designee and perhaps some other members of the PPUE Board. Its size should probably be no more than seven to nine people. It is important that the people appointed be at a high level in their own organizations (decision makers) and have an expertise in the area they are representing. Given Mr. Brown's perceived role as an advisor in the area, he should be a member or ex officio member of this Committee in a consulting role.

The System - A computerized system to operate the marketplace should be established from the outset. The system would preferably be a competing multiple

2/ Although it is realized that Mr. Sereh as Chairman of PPUE is also the Director of Danareksa, this should not present a problem since, as per our recommendations, Danareksa would have no special or privileged position in the new market.

market maker system. At the very least, every effort should be made toward creating a multiple market maker system thus encouraging the competition necessary to enhance the development of a liquid market with sufficient depth to encourage trading.

A computerized system would enable instant dissemination of all market information (quotations of market makers, transaction prices, volume and such other information as is desired), to all participants in the system on a real time basis, and to the public as desired. The computerized system conceptualized would be small at first, involving perhaps only Jakarta, but very shortly after start-up it should go outward to branches of financial institutions throughout other parts of the country. Thus, up-to-the-minute stock and bond information would be available to all parts of the country. This visibility and continued publicity will generate increased interest as time goes on.

The dissemination of information is important to creating an interest (buyer demand) in the secondary market and enhances its creation. Without such dissemination, chances are there will be no secondary market. Buyers and sellers must be brought together and to do so they must have knowledge of the market and develop a confidence therein.

The operator of the market is very important to the success of the new market system. Since it is envisioned to be a private company, it would have to be financed in one way or another. In this connection, financing for its working capital requirements could be accomplished through membership fees, government seed money, government and/or international development loans and/or grants, bank borrowings and from fee income derived from the provision of other services offered by PPUE.

Because of its small size and recent development, the Stock Exchange of Singapore's SESDAQ system should be utilized as a model. Therefore, it is suggested that consultation with the officials of the Singapore Stock Exchange be held by the Committee during the development process to draw on their very recent experience in

is still in its infancy. Currently, there are only five stocks listed on SESDAQ but more are expected. Officials of the Hong Kong Stock Exchange should also be consulted. They have a computerized screen system but do not operate a competing market maker system, it being an order matching system. The technical considerations are the same, however. NASDAQ, of course, will offer continuing advice.

A name should also be developed to distinguish the new market from the existing exchange market and to emphasize its automated nature. It is also recommended that the new market not be referred to as the "over-the-counter market". It should be called the automated dealer market. The name INSDAQ is suggested, meaning Indonesian Securities Dealers Automated Quotation System. This seems logical and would associate the new Indonesian market by name at least with other automated computerized dealer market systems, NASDAQ, SESDAQ and the SEAQ system of the London Stock Exchange. Also, other countries are thinking about developing similar computerized markets. It was stated in the Asian Wall Street Journal recently that Malaysia is looking into the development of a dealer market.

Clearly Identify the Primary Regulator/Operator of the Marketplace - This is a must. The regulator/operator must be unmistakable and receive full legal authority to do the job. Preferably it should be a private sector, self-regulatory type organization. Bapepam would act as be the government overseer with ultimate regulatory authority. If PPUE is to be the operator, as apparently is the intent, it must make a firm commitment to do the job. This would include a financial commitment on its part and the part of its members to fund a full-time, highly professional staff and to develop and operate the system. It is important that its ability to operate and develop not be tied with government red tape or duplication by the government through yet another government agency.

Relationship of New Market With the Exchange - The new market must be completely separated from the existing exchange and there should be complete discretion

in the issuer as to whether it wants to be traded in the new market or on the current exchange. A company in the INSDAQ market that subsequently meets the listing requirements of the stock exchange should not be required to list on that exchange. During our meetings we heard this concept advanced as the intent at one point. To require such an "upgrade" would automatically put the new marketplace in a second class status before it has begun. This would seem ironic in view of the fact that this new market is being created for the purpose of supplementing the existing market which has not proven workable. Also, if an exchange listed company wants to delist and be traded on the new market, there should be no prohibition to it doing so. In fact, there should be specific provisions enabling such a move. Actually, it seems rather redundant to create a new market system as a solution to the problems which have caused the existing stock exchange to decline into its present moribund state. Many of the provisions in the new proposed regulations could and should be applied to the existing stock exchange in an effort to revive it as well. In fact, the new system could even be designed to replace the exchange.

Identification of Companies - As Committee work toward design of the marketplace moves forward, a list of companies, state and private, which potentially would go public should be identified. Thereafter a meeting or series of meetings should be initiated and held with them by Committee members, a sub-committee or staff. Attempts should be made to match these potential issuers with potential underwriters. Subsequently, however, the Committee should step out of any negotiations, other than to keep abreast of what is going on, and let negotiations go on between the underwriter and the issuers directed toward an offering to the public. In other words, let them do the deal.

It is suggested that several companies should be prepared and ready to go public as of and on the day the new market opens or on successive days or maybe even a

week apart. Perhaps even a partially privatized government company could be one (or more) of such issuers. The privatization of a government company would provide a dramatic impact on the commencement of the new marketplace by showing the government's commitment to the project. This would in turn enhance public confidence.

Eliminate Disincentives/Create Incentives - There are issues which we realize have possibly broader political and/or economic ramifications than those which relate to the creation of a new marketplace. Nevertheless, we believe they must be addressed by the government and certain modifications to existing conditions and structures made if an efficient secondary market with liquidity and credibility is to be developed. These issues impact upon both the supply and demand sides of the market equation. In this connection, the following recommendations are made:

a) The bias in favor of bank deposits must be eliminated. Currently interest paid on bank deposits is tax-free and interest charged on bank loans is tax deductible while dividends paid and capital gains on stock sales are fully taxable. Interest on bank deposits are also at extraordinarily high rates, (approximately 18%). This structure is a deterrent to investors investing in the stock market, on the one hand, and to company growth on the other. That company growth is deterred is evidenced by the existing system in which companies must attempt to match and exceed bank interest rates with comparable dividend payments irrespective of actual corporate profits. We learned of instances of dividends being paid when the company had actually incurred significant operating losses for the year. This kind of activity necessarily deters company growth in that they are unable to build up surplus and reserves to be invested in additional plant and equipment. Capital expansion to this type would create additional job opportunities.

This bank bias therefore restricts the supply of securities and negates investor demand. It could be corrected either by imposing a tax on interest on deposits or by exempting dividends and capital gains from stock sales from taxation. Another

approach would be to eliminate the tax on dividends and capital gains and phase-in a tax program for both types of financial instruments over a period of several years. This second approach would have a more positive impact on the creation of the new market.

b) Inherent inefficiencies in the tax system has led to a reluctance on the part of many companies to disclose accurate, audited financial statements for fear of increasing their tax burden. The necessity of publishing audited financials deters companies from going public. These inefficiencies should be eliminated through a more efficient taxing system, in which companies would pay their proper taxes in any event

c) Simplify the clearance process for issuing securities. The number of government agencies which must review offerings to the public must be reduced to one. The existing system is a disincentive to companies going public because of the additional time, expense and annoyance which result from having to get clearance from a number of government agencies.

d) Do not require the government, or PPUE, to review substantive merits of a company, its management, credit worthiness, prospects, etc. The new market must be based solely on a full disclosure concept and review should be directed only to whether full disclosure of all material aspects of the company has been made, good as well as bad.

e) Eliminate the requirement that the most recent year's financial statements of an issuing Company have an unqualified auditors opinion. If the opinion is qualified, a company could still go public, but the marketplace would then determine the issue price and the issue acceptability.

f) Eliminate the restriction which limits an underwriter's fee to 4%. Allow all fees and commissions to be worked out in arms length negotiations between the company and the underwriter.

g) Eliminate the restriction on daily movement of a stock price on the Exchange of 4% and do not impose it on the new market. Let the market find its own level as a result of investor demand. If such is done, the possibility of growth expectation would eventually be added to the existing yield expectation of Indonesian investors and the market price would reflect such.

h) Clarify the role of Danareksa and its involvement in and dominance of the market by eliminating its preferential status, i.e., its right to purchase 50% of an offering. This Government Agency should not have a preferential status in the new market, and its dominant status as to the Stock Exchange should be eliminated on a gradual basis. Danareksa should act solely as a mutual fund and not as the government's vehicle for market intervention. When it participates in an offering as an underwriter/investor, the net effect is that its investment is at a lower offering price than other investors because it receives an underwriting fee. We also understand Danareksa exerts pressure to keep the offering price low. This should not be permitted. The offering price should be the subject of negotiations between the underwriter and the issuing company taking into consideration the company, its prospects, market conditions and other matters they deem pertinent.

i) Encourage rather than discourage foreign ownership of securities. The actual percentage of foreign ownership allowed in any particular company or industry could be established.

j) Allow foreign financial intermediaries to participate in all aspects of the market. This includes foreign banks currently operating in Indonesia.

k) Allow foreign underwriters to at least partly participate in distributions.

l) Allow foreign listings on the Stock Exchange and in the new system.

m) Expand the types of securities that can be issued. In addition to stocks and bonds allow convertible bonds, floating bonds, options, warrants, and other financial instruments which the market itself may propose.

n) Provide tax relief to companies that go public in a manner similar to that which existed before 1984. Such incentive is considered a necessary incentive to encourage more companies to go public.

Privatization - Consider privatization in whole or in part of some government operated companies and coordinate this with the start up of the new market. In addition to encouraging private ownership of stock, this would clearly put the government's stamp of approval on the new marketplace. A significant percentage of the companies to be privatized should have been profitable in recent years. If only unprofitable companies are privatized, investors' interest and confidence will not be engendered. After privatization, management should be permitted full discretion in management of the company. Unfair restrictions should not be placed on their management activities by the

government. An offering of shares in a state bank, or possibly Garuda Airlines, at the outset of the new market would be very beneficial to its development.

Operation of the Market - INSDAQ

a) Non-Government Entity As Operator/Regulator — Operation of the market should be by a non-government, legal entity established as a self-regulatory membership organization - probably PPUE. It should develop a fee structure and methods of generating income and operate pursuant to a budget. The funding and budgeting process should commence immediately by PPUE, simultaneously with Committee planning. In other words, while policy recommendations are being discussed and resolved at the Committee level, internal planning at PPUE concerning its future operations should be actively pursued. Such planning must encompass development of an overall organizational structure, personnel skills needed, hiring, office space requirements, computers and other equipment costs as well as the myriad of other details attendant to the startup of any organization.

It must be emphasized that PPUE must have clear legal authority to develop and operate the market and to establish and enforce ethical and operating rules and mechanisms. It must have a full-time, trained professional staff to be taken seriously and to assure its creditability. It must also have the legal authority and organizational ability to impose sanctions of censure, fine, suspension, and expulsion as to firms and individuals which are part of its membership. Without all of these things, it cannot be successful.

It must be responsible, in terms of regulatory oversight, to BAPEPAM which would have ultimate regulatory responsibility. Bapepam would approve PPUE's rules. Thereafter, PPUE would implement them. Bapepam would not intervene in the

daily operation of PPUE on the market. It would act in a manner similar to the SEC in the United States.

b) Membership - Membership requirements should be set by PPUE not the government. The membership should be composed of banks, non-bank financial institutions, broker/dealers, underwriters, market makers, other participants in the market making and distribution aspects of the market, and persons associated with them. Also, foreign intermediates should be permitted membership if the government allows them participation in the Indonesian capital market.

Underwriters - PPUE should establish the requirements and obligations of underwriters, not the government. Permits should not be required to be issued by BAPEPAM before a firm can be an underwriter as is the situation at present. If a firm meets PPUE's requirements, it should be permitted to be an underwriter. The government should have no part in the selection of an underwriter, or be permitted to influence the selection, as appears to be the case today. This should be solely determined by the issuing company as long as the underwriter meets the basic requirements as set by PPUE.

The underwriter's fee should be permitted to be negotiated by the underwriter and the issuing company as specified in the Decree within the bounds of reasonableness. There should not be a maximum underwriter's fee of 4% as is the case today.

If considered desirable, the underwriter or underwriters should be required to be market makers for a period of time, 6 months, 1 year, or 18 months. However, a price at which a market is to be made should not be specified or pre-determined. Ideally, there

should not be a requirement that the underwriter be a market maker. This action is usually by agreement between the company and the underwriter. Business reasons would also dictate that the underwriter continue his involvement with the company by being a market maker. However, given the lack of secondary market activity in Indonesia, and the need to establish the new market with an assurance of a place for an investor to sell his shares if he so desires, it would probably be desirable for the new market to require market making by underwriters, at least for the first several years.

The underwriters should, as stated by the Decree, be required to conduct an assessment of the issuer (due diligence).

Government review (Bapepam) of a registration statement should be only for the purpose of assuring full disclosure of all material factors about the company and not, as seems to be suggested by the Decree, a evaluation of the company's future viability among other things such as evaluation of management capability. A situation should not be created where the government would duplicate the underwriter's work. This is not necessary, would be time-consuming and would be a disincentive to a company going public as well as to a firm's willingness to be an underwriter.

The registration statement and prospectus should contain audited financial statements. This appears to be provided for in the Decree. The current requirement for an unqualified auditor's opinion should be eliminated. Distribution of the prospectus to prospective investors should be required.

Market Makers - Market makers are essential to liquidity and, hence, the success of the market. PPUE should establish the requirements and obligations of a market maker. All who meet them should be permitted to make a market.

A market maker must make a two-sided market. That is, he must be obligated when asked to do so to purchase/sell for or out of inventory an established minimum amount of securities at its posted bid/asked price, or better, or the best bid or offer (BBO) if several market makers are publishing quotations.

A firm should be permitted, within guidelines, to commence, or cease making a market as desired by itself (with the possible exception of underwriters). A market maker should be prohibited from going in and out of the market as a market maker without restriction. If he doesn't live up to his commitments, penalties should be provided for.

Movement of the market in a security should not be restricted to 4% per day as on the exchange today. The market should be permitted to seek its own level based upon investor demand.

Brokers, market makers and underwriters should be required to distribute periodic information about a company, such as, periodic financial statements, annual reports and reports of material developments. Public companies should be required to file and make such reports available to the public and intermediaries for distribution. It is our understanding that accurate information on public companies is currently difficult to obtain.

Education/Training - This is an extremely important part of development of the new market. It must include all existing and potential market participants as well as the public. This exercise should be commenced on several different fronts as soon as possible. Thus, PPUE should develop at an early date a structured educational program directed to all aspects of the marketplace and its participants. Initially, its staff must be educated and they in turn must educate traders, underwriters, broker/dealers, potential issuers and investors. The market should be promoted throughout Indonesia.

Education of PPUE personnel should commence immediately. They should be sent to other marketplaces such as Singapore, Hong Kong and NASDAQ for at least part of their training and education.

Qualifications Program - As to the personnel of intermediaries in the securities business, within two years of start-up, a system of qualification examinations for market participants should be instituted.

CONCLUSION

The ultimate objective is a highly liquid and widely credible marketplace.

Credibility will be difficult to achieve without regulation for the protection of investors but regulations cannot be so burdensome as to be a disincentive to the market's potential participants. After experience with a minimum level of regulation, additional rules could be adopted as needed to correct problems but regulation simply for the sake of regulation or based upon a misconceived attempt to "protect investors" when abuses have not been shown should be avoided.

Credibility will also be difficult to achieve without liquidity, and visa versa. The components of a liquid market are investors, securities for them to buy and sell, underwriters to provide for the distribution of the securities, market makers to provide a continuing ability for investors to buy and sell securities, brokers, and dissemination of trade, quotation and other market information so as to attract investors and enhance the credibility of the market.

Potential market participants will not participate in a market unless there is a positive rationale for them to do so in relation to other investment alternatives and the risk involved. A reason for participation is usually profit for the investors and intermediaries and efficiency and reasonableness of cost of financing as to issuer companies. Assuming a potential for profitability, intermediaries and investors will assume the risk involved in participating.

The present structure of the capital market in Indonesia is such that participation is greatly deterred as to various potential corporate participants. Investors can do better by investing in certificates of deposit virtually without risk so little incentive exists for them to participate in the capital market. Without them there is no market. Thus, all aspects of the existing market must be analyzed and disincentives eliminated and/or incentives created to encourage renewed participation. Without some of the basic changes suggested above being first undertaken, a liquid credible marketplace will not be possible and the proposed new over-the-counter market is doomed to failure in much the same manner as the existing Stock Exchange.