

DEMUTUALIZATION OF INDONESIA STOCK EXCHANGE  
AS A STRATEGIC MEASURE AND A MEANS TO IMPROVE  
EFFICIENT TRADING

A THESIS



بِسْمِ اللَّهِ الرَّحْمَنِ الرَّحِيمِ

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INTERNATIONAL PROGRAM

DEPARTMENT OF LAW

FACULTY OF LAW

UNIVERSITAS ISLAM INDONESIA

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EFFICIENT TRADING**

A BACHELOR DEGREE THESIS



By:

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**INTERNATIONAL PROGRAM**

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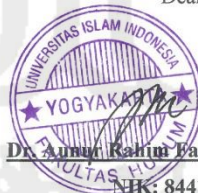
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*Bismillahirrahmanirrahim*

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Demikian, surat pernyataan ini saya buat dengan sebenar-benarnya, dalam kondisi sehat jasmani dan rohani, dengan sadar serta tidak ada tekanan dalam bentuk apapun oleh siapapun.

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Pada tanggal : 27 September 2016

Yang membuat pernyataan



Achmad Dion Ragil Kusuma

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## MOTTO

How can you be polished to shines, if every rub irritates you.

(Jalaluddin Rumi)



## DEDICATION

I dedicated This Bachelor Degree Thesis For:

1. Allah SWT and Prophet Muhammad SAW who continues to provide extraordinary favors and ease me in writing this bachelor degree thesis;
2. My parents Kasidjianto (alm) and Sutarni (almh);
3. My big family, person who always supported me, my advisors, my lectures, my relatives, my friends, and all of you students both in regular and international program class Faculty of Law Universitas Islam Indonesia thank you all for your love and care to me.







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In accomplishing the research, the writer feels indebted to a lot of people for their guidance, assistance, and help. Therefore, the writer would like to express his special gratitude to:

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Finally, the writer recognizes that this bachelor degree thesis is still far from being perfect, so the writer wants the reader to give some criticism and

suggestions. However, the writer expects that this thesis will be useful for anyone who reads this thesis.

*Wassalammu'alaikum. Wr. Wb*

Yogyakarta, 31 Agustus 2016

The Writer

Achmad Dion Ragil Kusuma



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## ABSTRACT

*The purpose of establishment of Indonesia Stock Exchange is to run the securities trading which orderly, fair and efficient. The demand for the implementation of good corporate governance is one of the issues to attract the interest of potential investor on capital market in a state. Driven from article 8 of law number 8 of 1995 that the member of Indonesia Stock Exchange is also the shareholder of the stock exchange. By that, many possibilities of problems may occur such as crime in the form of fraud, manipulation of market, and insider trading. The problem statements are: Has the structure of Indonesia Stock Exchange nowadays implemented the Good Corporate Governance principles in order to create orderly, fair and efficient trading exchange?; Why is demutualization necessary by Indonesia Stock Exchange to create orderly, fair and efficient trading exchange?. Method of research which is used is comparative normative approach. Method of collecting the sources is by literature research, it is examining the books, literatures, and related materials which supporting the problem of this research. The result of this research shows that the implementation of good corporate governance principle is not well implemented yet due to the conflict of interest between existing structure owners and the legal status of Indonesia Stock Exchange is not in accordance with the Law Number 40 of 2007 about Indonesia Limited Liability Company Law. And demutualization is considered as a solution to increase the quality of corporate governance, for instance, in the issue of conflict of interest by separating the ownership from the membership and trading rights so that it can lead into proper running of the stock exchanges which is orderly, fair and efficient trading. This research recommends the amendment of article 8 of Law Number 8 of 1995, and conducting the demutualization in the form of establishing a holding company.*

*Keywords : Demutualization, Indonesia Stock Exchange, orderly fair and efficient trading.*

# CHAPTER I

## INTRODUCTION

### A. Context of Study

The capital market<sup>1</sup> plays significant role in the national economy. It mobilizes funds from people for further investments in the productive channels of economy, activating idle monetary resources and put them in proper investments.<sup>2</sup> Capital market unites the fund suppliers with the fund users in the purpose of *middle-term investment* and *long-term investment*. Capital markets consist mainly equity and debt instrument, it provides an avenue for raising the financial needs of business through equity and long-term debt by attracting investors with kinds of investments.<sup>3</sup>

Stock exchanges are pillars of a nation's economy.<sup>4</sup> Stock exchanges<sup>5</sup> have been viewed as an important catalyst of economic growth. They provide an organized market for the trading of securities to individuals and organizations which intend to invest their saving or excess funds through the purchase of securities. This market is regulated by established rules that promote and maintain fair, efficient, secure and transparent market and facilitate the orderly development of the stock exchange.<sup>6</sup> A fair and

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<sup>1</sup>According to Rosenberg: Capital Market is *"the place through which the buying and selling of stock for the purpose of profit for both buyers and sellers of the security take place"*.

<sup>2</sup>[http://www.finance.gov.pk/survey/chapter\\_12/06-CapitalMarkets.pdf](http://www.finance.gov.pk/survey/chapter_12/06-CapitalMarkets.pdf) page 81 accessed on 22nd October 2015 at 10.23pm.

<sup>3</sup>*Supra note* at 2, page 81.

<sup>4</sup>Subhashish Saha, *Stock Exchange Demutualization and Self Regulation*, Securities and Exchange Board of India Mumbai, Preliminary Draft, September 5, 2015, page 2.

<sup>5</sup>According to Rosenberg: Stock Exchange is *"the organization that provides a market for the trading of stocks and bonds"*.

<sup>6</sup>Arwa M. Morsy, *The Impact of Demutualization on the Performance of Stock Echanges*, Maastricht School of Management, 2007, page 7.



efficient performance of a stock exchange is a substantial benefit to the public.

Stock exchange plays several roles in the economy. Some of the various roles that stock exchange fills are; raising capital for businesses, mobilizing savings for investments, facilitating company growth, redistribution of wealth, corporate governance, creating investment opportunities for small investors and raising capital for the government to enable for carrying out development projects.<sup>7</sup>

In Indonesia, the capital market<sup>8</sup> also play a significant role alongwith banking institution, this is due to the contribution of capital markets which contribute to Indonesian economy as one of the financing in business and investment area.<sup>9</sup> The capital which is traded in capital market is in the form of commercial paper or in the financial terminology is known as securities.<sup>10</sup> The term of securities can be defined as promissory notes, commercial paper, shares, bonds, evidences of indebtedness, mutual fund of collective investment contracts, futures contracts related to securities and all derivatives<sup>11</sup> of securities.<sup>12</sup>

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<sup>7</sup>*Role of the Exchange in the Economy, Nairobi Stock Exchange.* Available from Nairobi Stock Exchange website (accessed October 2015).

<sup>8</sup>Based on Indonesian Law Number 8 of 1995 specifically on article 1 poin 13, Capital Market is "the activity of trading and offering securities to the pulic, the activity of a public company with respect to securities issued, and the activities of securities-related institutions and professions".

<sup>9</sup>C.S.T. Kansil, *Pokok-Pokok Hukum Pasar Modal*, Jakarta: Pustaka Sinar Harapan, 2004, page 1.

<sup>10</sup>M Paulus Situmorang, *Pengantar Pasar Modal*, Mitra Wacana Media, Jakarta, 2008, page 4.

<sup>11</sup>"Derivatives" refers to rights that are derived from either debt or equity Securities, such as Options or Warrants."

<sup>12</sup>Article 1 poin 5 of Law Number 8 of 1995 about Indonesian Capital Market.

The structure of Indonesia Stock Exchange<sup>13</sup> is different from the most of structure of Stock Exchange in the world, for example, London Stock Exchange, Hongkong Stock Exchange, New York Stock Exchange whereas a process of continuing an organization from its mutual ownership structure to a share ownership structure which is known as *Demutualization*.<sup>14</sup> The members of mutually owned exchanges that are, Broker-Dealer dealers with “seats” on the exchange are also its owners, with all the voting rights conferred by ownership.<sup>15</sup> In contrast, a demutualized exchange is a limited liability company owned by its shareholders. Trading rights and ownership can be separated; shareholders provide capital to the exchange and receive profits, but they need not conduct trading on the exchange. And as discussed later, although demutualized exchanges will continue to provide many if not most of the same services, they will have different governance structures in which outside shareholders are represented by boards of directors.<sup>16</sup>

Demutualization, in the strictest sense, refers to the change in legal status of the exchange from a mutual association with one vote per member

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<sup>13</sup>The structure of Indonesia Stock Exchange is non-profit mutual organization.

<sup>14</sup>Arwa M. Morsy, *Op.Cit.*, page 8.

<sup>15</sup>For more discussion on ownership issue, see, for example, Report of the Technical Committee of the International Organization of Securities Commissions, *“Issues Paper on Exchange Demutualization.”* 2001 and Jennifer Elliot, *“Demutualization of Exchanges – The Regulatory Perspective.”* 2000, International Monetary Fund Technical Note.

<sup>16</sup>Reena Aggarwal, *Demutualization and Corporate Governance of Stock Exchanges*, Washington D.C. McDonough School of Business Georgetown University, 2002, page 6.

and possibly consensus-based decision making, into a company limited by shares, with one vote per share with majority-based decision making.<sup>17</sup>

Since the demutualization by the Stockholm Stock Exchange which took place in 1993 with the change of its organizational form from a non-profit to a for profit, publicly listed organization, a significant number of stock exchanges have experienced similar changes.<sup>18</sup> For example, the Australian Stock Exchange became one of the first stock exchanges that went public and became a listed company. In the same way, the London Stock Exchange, the Deutsche Borse, alongside with other major European stock exchanges also become public companies. In Americas, the Toronto Stock Exchange demutualized in 2000, followed by its owner, the TSX Group, which went public in 2002. In Asia, both of the most important stock exchanges: Hong Kong Stock Exchange demutualized in 2000 and Singapore exchange in 1999. The only significant and important stock exchange which did not list its share (despite the fact that it demutualized in 2001), is the Tokyo Stock Exchange. Also the United State, the Chicago Mercantile Exchange demutualized in 2000. In 2003 CME conducted a later initial public offering (IPO) and listed its shares on the New York Stock Exchange. Also, India, Pakistan, Brazil, the Philippines, and some other

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<sup>17</sup>Shamshad Akhtar, *Demutualization of Asian Stock Exchanges – Critical Issues and Challenges*, in *DEMUTUALIZATION OF STOCK EXCHANGES: PROBLEMS, SOLUTIONS AND CASE STUDIES*. Asian Development Bank, 2002, page 4.

<sup>18</sup>Saadia Altaf, *Demutualization of Stock Exchanges, A Case Research: London Stock Exchange and Hong Kong Stock Exchange*, Master Degree Project in Economic and Finance, University of Skovde, 2009, page 12.

countries' stock exchanges announced in 2005 their plans to demutualize and to their shares.<sup>19</sup>

According to the data of the World Federation of Exchanges, the weight of mutual dropped out dramatically from 40% in 1999 to only 25% in 2003. And the same period of time, the number of demutualized stock exchanges rose from 10% in 1999 to 25% in 2003.<sup>20</sup> The fact that almost all major exchanges have undergone demutualization and became public companies is showing the necessity of having a structure that will allow the exchange to be able to respond to the industry challenges.<sup>21</sup>

Technology improvements, increasing economic competition, and the associated costs led stock exchange to revise their entrepreneurial strategies. As an answer, a large number of stock exchanges have demutualized.<sup>22</sup> Besides, the increasing conflicts in the stock exchanges member's interests and tough competition led to a reduction in the stock exchanges wealth. As a result, this led to a change in the stock exchanges governance structure or saying it otherwise to demutualization.<sup>23</sup> At the beginning, stock exchanges were conducted as non-profit firms with significant membership fees being charged for the access to trading floors. The rise of electronic trading system (ETS) allowed a reduction of the marginal cost close to zero for accepting a new member which at its turn is

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<sup>19</sup>Saadia Altaf, *Loc.Cit.*, page 13.

<sup>20</sup>*Ibid.*

<sup>21</sup>Otchere, I. & Abou-Zied, K, *Stock exchange demutualization, self-listing and performance: The Case of Australian stock exchange*, Journal of Banking & Finance Vol. 32, issued April 4' 2008, page 512.

<sup>22</sup>Reena Aggarwal, *Loc.Cit.*, page 106.

<sup>23</sup>Serifsoy, B, *Essays on stock exchange efficienct*, Business Models and Governance, 2006 <http://www.wiwi.uni-frankurt.de/schwerpunkte/finance/wp/1360.pdf>

a motive for demutualization. In addition, many of large institutional traders have developed capabilities to “internalize” a large volume of trade wherein they can match the buy and sell orders without going to the exchange.<sup>24</sup> These developments have strained the traditional organizational structure of stock exchanges. Alongside with other factors that fastened up the demutualization, for example, such initiatives as the Single European Market, and the Big Bang<sup>25</sup> reforms in the United Kingdom, made securities trading much more competitive.

The spirit of capital market itself is on the disclosure principle. This disclosure principle is one of the main principles which shall be enforced in capital market, in the case of “trust crisis” or “un-trust” from investor towards capital market and financial, therefore the investor will draw out their capital from the market. By the consequences that the market and financial will collapse either partly or in wholly.<sup>26</sup>

Disclosure principle is main component and very important in the capital market all over the world.<sup>27</sup> In example that there was happened un-trust of investor towards the capital market in the United States of America,

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<sup>24</sup>Saadia Altaf, *Loc.Cit.*, page 15.

<sup>25</sup>The reforms changes concerning the stock exchanges that came into effect in UK in 1986, were to be usually called in the literature to as the “Big Bang”. Fixed commission charges were abolished, leading to an alternation in the structure of the market, and the right of member firms to act as market makers as well as agents was also abolished.

<sup>26</sup>Bismar Nasution, *Keterbukaan dalam Pasar Modal*, Universitas Indonesia, Program Pasca Sarjana, Jakarta, 2001, page 31.

<sup>27</sup>Thomas Lee Hazen, *The Law of Securities Regulation*, West Publishing Co., St. Paul Minnesota, 1990, page 85.

specifically on 1929-1934, which caused the investor drew out their capitals from America's capital market.<sup>28</sup>

By the disclosure, people will not only know several activities conducted by certain parties, because there had been information which provided, but by disclosure, it is expected the existence of a public control towards certain activities.<sup>29</sup>

At least there are three functions of disclosure principle in the capital market, those are:

1. Disclosure principle has a function to maintain the public trust towards the market. The absence of disclosure in capital market causes investors distrust towards the market mechanism. Because the disclosure principle has an important role for investors before taking decision to conduct investment, the disclosure will be used to formulate judgments towards investment, so that the investor optimally able to determine their choices. The clearer of information, will impact towards the decision of investors to invest their capital.<sup>30</sup>

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<sup>28</sup>Bismar Nasution, *Keterbukaan dalam Pasar Modal*, Universitas Indonesia, Program Pasca Sarjana, Jakarta, 2001, page 32.

<sup>29</sup>What investors fear the most is having their money expropriated. Whether the company is private or public, expropriation of minority shareholders may be achieved by selling products or assets below-market price, buying products or assets at above-market prices, taking business opportunities away from the company and issuing loans at preferential rates. In many countries with legal protections, clever entrepreneurs can devise ways to deny fair to investors while remaining within the law. The International Bank for Construction and Development/World Bank, *Doing Business in 2005: Removing obstacles to Growth*, the World Bank, the International Finance Corporation and Oxford University Press, 2005, page 51.

<sup>30</sup>Bismar Nasution, *Op.Cit.*, page 9.

2. Disclosure principle has a function to create an efficient market mechanism. This philosophy is based on giving of full information with the result of creating efficient capital market, that is the price of stock will fully reflected from whole information provided. By such conduct, the disclosure principle can play role in increasing the availability of real information in order to determine the price market accurately.<sup>31</sup>
3. Disclosure principle is important to prevent a fraud. Barry Rider argued that the more information provided, it will minimize the wrong conduct and miss-application. The function of disclosure principle to prevent a fraud is the oldest legal opinion.<sup>32</sup>

The demand for the implementation of *good corporate governance* is one of the issues to attract the interest of coming investor on capital market in a state.<sup>33</sup> Because the more implementation of the principle of *good corporate governance* is conducted, it will automatically give good impact for the sustainability of capital market in general and as an indication of good treatment towards shareholders.<sup>34</sup> It is agreed that the important of shareholder's rights to get accurate information and on time. And also became the responsibility of the company to conduct the disclosure

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<sup>31</sup>Bismar Nasution, *Op.Cit.*, page 10.

<sup>32</sup>Bismar Nasution, *Op.Cit.*, page 11.

<sup>33</sup>Ridwan Khairandy, Camelia Malik, *Good Corporate Governance Perkembangan Pemikiran dan Implementasinya di Indonesia dalam Perspektif Hukum*, Yogyakarta: Kreasi Total Media, 2007, page 1.

<sup>34</sup>Hamud M. Balfas, *Hukum Pasar Modal Indonesia*, Jakarta:PT Tatanusa, 2007, page 231.

accurately, on time and transparently regarding informations on company's performance, ownership, and stakeholder.<sup>35</sup>

A stakeholder is every party which has interest on the company's performance. Theoretically, stakeholder can be divided by two, which are:<sup>36</sup>

1. *Primary Stakeholder*, it is the shareholder, investor, staff, and manager, supplier, business partners, and society;
2. *Secondary Stakeholder*, it is government, business institution, social group of society, academic, and competitor.

*Corporate Governance* is a set of rules which regulate the relationship between shareholders, managers of the company, creditors, government, officers and the internal stakeholders or its external which related to their rights and obligations or in the other word is a system which regulates and manage the company.<sup>37</sup> From this definition, it can be concluded that *corporate governance* is a set of rules which urge or requires the existence of management over corporation in a good way.

According to Organization for Economic Cooperation and Development (OECD) formulation, at least there are four main principles

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<sup>35</sup>Ridwan Khairandy, *Op.Cit.*, page 2.

<sup>36</sup>Indra Surya dan Ivan Yustivandana, *Penerapan Good Corporate Governance: Mengesampingkan Hak-Hak Istimewa Demi Kelangsungan Usaha*, diterbitkan atas kerjasama dengan Lembaga Kajian Pasar Modal dan Keuangan (LPMK) dan Fakultas Hukum Universitas Indonesia, Jakarta: Kencana, 2006, page 67.

<sup>37</sup>See, *Tata Kelola Perusahaan*, Forum for Corporate Governance in Indonesia, jilid I edisi ke-2, 2001, page 3. Whereas according to Robert A.G. Monks and Nell Minow, *Corporate Governance*, edisi kedua, 2001, page 1, stated that "Corporate Governance is the relationship among various participants in determining the direction and performance of corporations."



of *corporate governance* which finally conclude to the disclosure, those principles are:

- a. *Fairness*. This Principle guarantee the rights protection of shareholders, including the rights of minority shareholder.
- b. *Transparency*. This Principle oblige the existence of disclosure information, on-time and clear, and can be compared which related the financial condition of the management of corporation.
- c. *Accountability*. This Principle requires explanation the role and responsibility, and supporting the effort to guarantee the balance of management interest and shareholder, as the supervision of the commissioner.
- d. *Responsibility*. This Principle is ensuring the compliance of the regulation.

Nowadays, capital market activities in Indonesia are run by Indonesia Stock Exchange Ltd. Initially, there were two Indonesia Stock Exchanges, those are Jakarta Stock Exchange and Surabaya Stock Exchange, but on December 2007 both are merged and since then it became Indonesia Stock Exchange Ltd. (IDX).

Stock Exchange is the corporation which carries out and provides system and or infrastructure to unite selling and buying offers of securities from other parties in purpose to trade those securities among them.<sup>38</sup>

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<sup>38</sup>Article 1 poin 4 of Law Number 8 of 1995.

Indonesia Stock Exchange was established in order to organize the securities trading with disciplinary, fairly and efficiently.<sup>39</sup>

The disciplinary principle means that a trading should be organized based on the clear regulation and consistently well-implemented. Thus, the price is reflecting the market mechanism based on the power of demand and offer, with the result that the price will be fair. The efficient market is reflected by fast and cheap settlement of transaction. The securities trading in the stock exchange happened electronically, not by hand in hand so that it puts easy the transaction process between investor and issuer.

Initially BAPEPAM was the authorized institution to supervise Indonesia Stock Exchange activity based on article 3 of Law Number 8 of 1995 on Capital Market, but nowadays its function, duty and authorization had been shifted to Indonesian Financial Authority (OJK) in accordance with article 55 of Law Number 21 of 2007 on OJK.

Along with Indonesia Stock Exchange, some parties which positioning theirsself parallel in the capital market structure, and assisting the execution of capital market in Indonesia are Trust-Agent (PT Kliring Penjamin Efek Indonesia as known as KPEI) and also Custodians (PT Kustodian Sentral Efek Indonesia as known as KSEI) which acts as *Self-Regulatory Organization (SRO)*.<sup>40</sup>

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<sup>39</sup>Article 7 poin 1 and its explanation of Law Number 8 of 1995.

<sup>40</sup>Sekolah Pasar Modal Bursa Efek Indonesia Level 1-A, *Pengenalan Pasar Modal Produk Investasi di BEI Investasi di Pasar Modal Analisa Fundamental bersama KPEI IDX dan KSEI*, page 6.

An SRO is a non-governmental entity responsible for regulating its members through the adoption and enforcement of rules and regulations governing the business conduct of its members.<sup>41</sup> Or in other word, SRO means that the institution has authority to regulate and to create regulations which are binding to every institution involved in its function.<sup>42</sup> But those regulations can only be enforced after the permission given by OJK. As the example, Indonesia Stock Exchange makes regulations which concerns on its membership, securities trading regulation, and listing securities regulation.<sup>43</sup> It reflects that Indonesia Stock Exchange as SRO, is also as the supervision body within the securities trading in capital market because this institution which makes its own regulation so that it held the authority to supervise the trading activities as well.

Article 8 of Law Number 8 of 1995 has specifically defined that the one which is able to be a shareholder of Stock Exchange is Securities Company which hold business license to conduct the activity as Broker-Dealer. Based on the explanation on article 8, the purpose of Stock Exchange is to provide system and or facility of securities trading and parties in which able to conduct securities trading in Stock Exchange are only Securities Company which are conducting activity as Broker-Dealer,

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<sup>41</sup>Christopher W. Cole, *Financial Industry Regulatory Authority (FINRA): Is the Consolidation of NASD and the Regulatory Arm of NYSE a Bull or a Bear for U.S. Capital Market*. 2006, 76 UMKC L. REV. 251, 255-56.

<sup>42</sup>Article 9 of Law Number 8 of 1995 is legal basic of Indonesia Stock Exchange as SRO institution.

<sup>43</sup>Tjiptono Darmadji dan Hendy M. Fakhruddin, *Pasar Modal di Indonesia Edisi 3*, Jakarta: Salemba Empat, 2011, page 34.

so that the shareholder is limited only to Securities Company which hold business license from OJK as the Broker-Dealer.

Besides that, article 1 point 2 of Law Number 8 of 1995 has stated that the Member of Stock Exchange is the Broker-Dealer who hold a business license from OJK and has right to use the system and or facility of Stock Exchange in accordance with the regulation of Stock Exchange. This reflects that the one which are able to be the member of Stock Exchange are the Broker-Dealer. Meaning that the member of the Stock Exchange is also the shareholder of the Stock Exchange.

This structure of Stock Exchange would be definitely causing problems. Because when the member of Stock Exchange is the shareholder, they conduct trading activities and also the Stock Exchange is SRO, it clearly means that in the first place they make the rules and they supervise themselves.

By that, many possibilities of problems may occurred such as crime in the form of fraud, manipulation of market, and insider trading.<sup>44</sup> The price manipulation is commonly done by collusion by some of the securities member or intermediaries. These intermediaries buy the low price and sell it to the higher price. So that the process of buying demand and selling offers that happens is not reflecting the power of the original market.<sup>45</sup>

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<sup>44</sup>Article 90 – 99 of Law Number 8 of 1995.

<sup>45</sup>Hamud M. Balfas, *Tindak Pidana Pasar Modal dan Pengawasan Perdagangan di Bursa*, Jurnal Hukum dan Pembangunan Edisi Januari-Juni 1998, page 16.

The mechanism of *Good Corporate Governance* will automatically lead to the development of *check and balance* in the surrounding of management specifically in the matter of giving attention towards the interest of shareholder and another stakeholder. Despitefully the protection of investor, the regulation also obliges the existence of a system which guarantees the transparency and accountability within the business transaction among the corporations which potentially raise a conflict of interest.<sup>46</sup> Therefore, another possibility is about the conflict of interest among the parties in the Stock Exchange's structure. As in mutual exchange, one of the main problems is imbalance of members-owners' interest and the the investors.<sup>47</sup> Just as stock exchanges become more and more sophisticated, the interests of various member groups began to diverge. This has led to tremendous tensions in the governance and decision making of stock exchanges. In some sense, demutualization can be perceived as a solution of conflict of interest by segregating the ownership from the membership and trading rights thus allowing a proper running of the stock exchanges' management. Also by transforming itself into a for-profit investor owned organization, the managers of the stock exchange are able now to focus on a single group, its owners. This simplification of governance structure allows for faster decision making.

Other than being alternative of investment done by investors and increasing the quality of economic development, the capital market has the

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<sup>46</sup>Ridwan Khairandy, *Op.Cit.*, page 6.

<sup>47</sup>Saadia Altaf, *Loc.Cit.*, page 16.

black side by the raising of *white collar crime*,<sup>48</sup> which is very bringing disadvantages for the societies generally and investors specifically. Even the *white collar crime* which is done in the capital market is not recognized by the related parties because it is done smoothly and perfectly, therefore, the victims are not feeling to be inflicted financial losses. The societies respond to the crime, and giving losses for them, as the results which shall be carried by them because the negative power of market, and part of the market mechanism whereas they unfortunately become the victim.<sup>49</sup> Thus, the crime which is done in the capital market usually is difficult to be proven because it is different with the commonly crime.

Ideally, the Stock Exchange should be the market for fair stock transaction mechanism. But the fair stock transaction mechanism is difficult to be achieved due to the conflict of interest and transparency in this structure. Simply saying, when the shareholder is the member of the Stock Exchange, this might cause a problem. When Stock Exchange as the corporation or Limited Company, it means that there are organs like the common company such as general meeting of shareholder, director, and commissioner. When the shareholders are the member of stock exchange, the conflict of interest would be happened. The concentration of control on

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<sup>48</sup>According to Hazzel Croall in his book *White Collar Crime is defined as the abuse of a legitimate occupational role which is regulated by law. Then the term white collar with fraud, embezzlement and other offences associated with high status employees.* In Hamud M. Balfas, *Op.Cit.*, page 459.

<sup>49</sup>*Ibid.*

a handful of shareholder, would lead to possibility in which the conflict of interest occurred.<sup>50</sup>

For Example, when crime happened in the capital market in which the subject is the member of the stock exchange, it is very possible that the stock exchange response or decisions regarding that particular case will be emphasizing on its own interest at the very the first place. Another example, in the general meeting of shareholder of Stock Exchange, the shareholders are the Broker-Dealer in which this Broker-Dealer is also doing business activities within its system. By this, during the general meeting of shareholder, the shareholders have right to determine the future action of stock exchange itself. When those happened, therefore basically there is no check and balances and well implementation of *good corporate governance* in Indonesia Stock Exchange.

Since there is no separation of the ownership of the share and memberships of Stock Exchange it will arise problem and disadvantages to the investors. This is very contradictive with the purpose of Law Number 8 of 1995 and to the legal certainty principle and investor protection.

## **B. Problem Statement**

Based on the explanation of background of this research, therefore the formulated problems of this research are as follows:

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<sup>50</sup>Indra Surya dan Ivan Yustivandana, *Op.Cit.*, page 4.

1. Has the structure of Indonesia Stock Exchange nowadays implemented the *good corporate governance* principles in order to create orderly, fair and efficient trading Exchange?
2. Why is demutualization necessary by Indonesia Stock Exchange to create orderly, fair and efficient trading in the Exchange?

### **C. Research Objective**

Based on the problem statement, therefore the objectives of this thesis are:

1. To know the implementation of *good corporate governance* principles in order to create orderly, fair and efficient trading.
2. To know the necessity of demutualization by Indonesia Stock Exchange to create orderly, fair and efficient trading.

### **D. Research Advantage**

1. As a referential literature for the development of legal studies.
2. As a consideration for all stakeholders related to this thesis.

### **E. Theoretical Review**

Starting in the early 1990s, stock exchanges around the world have been undergoing major organizational and operational changes. One of the most visible changes has been the trend toward demutualization—the process of converting exchanges from non-profit, member-owned organizations to for-profit, investor-owned corporations.<sup>51</sup> In 1993, the

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<sup>51</sup>Reena Aggarwal, *Loc.Cit.*, page 3.



Stockholm Stock Exchange became the first exchange to demutualize. It was followed by several others, including the Helsinki Stock Exchange in 1995, the Copenhagen Exchange in 1996, the Amsterdam Exchange in 1997, the Australian Exchange in 1998, and the Toronto, Hong Kong, and London Stock Exchanges in 2000.

Historically, the stock exchange has been established before the independence of Indonesia. The stock exchange has been established since the Dutch colonization which specifically on 1912 in Batavia. The Dutch colonization government established it for the interest of government's colonization or VOC. Notwithstanding stock exchange has been established on 1912, the development and growth of stock exchange did not run effectively, even in some of periods the stock exchange's activities were vacuum. Those were caused by some factors such as First and Second World War, the movement of government's authority from Dutch to Indonesian Government, and several conditions which caused the operation of stock exchange did not run well which had been expected before. The Indonesian Government re-activated the stock exchange on 1977, and the years after that stock exchange developed along with some incentives and regulations issued by the government.<sup>52</sup>

Since 1977 the Indonesian Government had tried to re-activated stock exchange which actually had been established before the Second World War. Until 1987 that the activities were sporadical, the amounts of

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<sup>52</sup><http://www.idx.co.id/id-id/beranda/tentangbei/sejarah.aspx> last accessed on 6th November 2015, at 15.53 WIB.

activities were very little, while the corporations which listed on the stock exchange were pushed to conduct foreign investment which requires the participation of domestic shares. Since 1998, the Jakarta Stock Exchange actively run and also was established the Surabaya Stock Exchange.<sup>53</sup>

Initially that in Indonesia were known that there were two stock exchanges those are Jakarta Stock Exchange (BEJ) and Surabaya Stock Exchange (BES), but since on December 2007 those two stock exchanges merged became Indonesia Stock Exchange (IDX).

Stock Exchange is the corporation which carries out and provides system and or infrastructure to unite the sell and buy offering of securities from another party for the purpose of trading that securities among them.<sup>54</sup>

The law Number 8 of 1995 has specifically defined that Indonesia Stock Exchange as the *Self-Regulatory Organization* (SRO). SRO means that the institution has authority to regulate and authority to create regulations which are binding to every institutions which are involved in its function.<sup>55</sup> But those regulations can be enforced after the permission given by OJK. As the example, Indonesia Stock Exchange makes regulations which concern on its membership, securities trading regulation, and listing securities regulation.<sup>56</sup> It reflects that Indonesia Stock Exchange as the SRO, is also as the supervision body within the securities trading in capital market

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<sup>53</sup>Sjahrir, *Analisis Bursa Efek*, Jakarta: Gramedia Pustaka Utama, 1995, page 25.

<sup>54</sup>Article 1 poin 4 of Law Number 8 of 1995 about Capital Market.

<sup>55</sup>Article 9 of Law Number 8 of 1995 is legal basic of Indonesia Stock Exchange as SRO institution.

<sup>56</sup>Tjiptono Darmadji and Hendy M. Fakhrudin, *Op.Cit.*, page 34.

because again, that this institution which makes its own regulation so that it has authority to supervise the trading activities too.

Article 8 of Law Number 8 of 1995 has specifically defined that the one which is able to be shareholder of Stock Exchange is Securities Company which hold business license to conduct the activity as Broker-Dealer. Based on the explanation on article 8, the purpose of Stock Exchange is to provide system and or facility of securities trading and parties which able to conduct securities trading in Stock Exchange is only Securities Company which conducting activity as Broker-Dealer, so that the shareholder is limited only to Securities Company which hold business license from OJK as the Broker-Dealer.

The job as intermediary of securities in the Exchange is conducted by accepting order to buy or sell the securities. For the securities which are listed the Stock Exchange, the investor shall communicate with Securities Company, who acts as the Broker-Dealer, in this sense is represented by its staff.<sup>57</sup> The term of Broker-Dealer has two senses:<sup>58</sup>

1. Intermediary or agent of securities, it means that acting as the intermediary in the selling and buying of securities' activity, because the investor is not allowed to conduct selling and buying of securities without passing the Broker-Dealer. By the service of intermediary, therefore the intermediary gets fee from investor.

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<sup>57</sup>Hamud M. Balfas, *Op.Cit.*, page 343.

<sup>58</sup>Tjiptono Darmadji and Hedy M. Fakhruddin, *Op.Cit.*, page 22.

2. Securities seller, it means that while acting as the intermediary so that the securities companies can also conducting activities of selling and buying of securities for the interest of that securities company.

The Securities Company and also its representative in term of conducting the activities shall get the license, which is issued by OJK.<sup>59</sup> By that, the Securities Company is permitted to conduct its activity such as acting as the Broker-Dealer. Therefore some of the obligations which owned by the Broker-Dealer can be defined as follows:<sup>60</sup>

- a. Prioritizing the investors' interest before conducting its own transaction for its own interest;
- b. In giving recommendation towards the investors to buy or sell the securities is obliged to consider the financial condition and purpose of investment from investors;
- c. Listing the time, day and date of all the orders of investors on the order's form;
- d. Giving a confirmation towards the investors before the end of day on stock exchange after transaction done;
- e. Issuing the receipt after accepting the securities or money from investors;
- f. Finishing the mandate of sell or buy from the principal;
- g. Providing the data and information for the investors' interest;

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<sup>59</sup>Article 30 poin 1 and acrticle 31 poin 1 of Law Number 8 of 1995.

<sup>60</sup>Sekolah Pasar Modal Bursa Efek Indonesia Level 1-A, *Loc.Cit.*, page 30.

- h. Helping in management of fund for the investors' interest;
- i. Giving a recommendation towards investors.

Meanwhile, the role, function, and duty of Securities Company are as follows:

- a. Supporting the existence of capital market, in term of smoothing the fund rotation and information;
- b. Supporting the system and Exchange's activities as part of capital market and business actor;
- c. Increasing the activities of capital market's investment to support the national economy.

The Securities Company has functions to:

- a. As intermediary the fund flow and information between investor to investor and investor to issuers;
- b. As one of the main player in the Exchange in developing the movement and investment volume.

And Securities Company has duty to:

- a. In recognizing the societies about capital market and increasing the societies' interest to invest within stock exchange as one of the investment's instrument;
- b. Helping to the mobilization of societies' fund by selling and buying the securities among either the investors to investors or issuers.

One of the elements of crime in capital market is the misuse of trust which is given to criminal. As the example is insider trading, this has element the utilization of information which owned by corporation by related parties (insider), before those information are published to public. Since the information is coming from the corporation, the parties which are very possible to misuse are the insider to gain the benefit.<sup>61</sup>

Transparency or disclosure is kind of investor or public protection. Substantially, transparency unable public to get access of information which is correlated with the company. A fair and efficient market is if all of the investors get information in the same time along with quality of information. Juridically, disclosure is a guarantee for public right to always get important access by the sanction for the barrier or dereliction which is done by the company.

## **F. Research Method**

The method of writing which is used in this research is as follows:

1. Object
  - a. The implementation of *good corporate governance* principles which can improve the efficient trading.
  - b. The necessity of demutualization done by Indonesia Stock Exchange as a measure to improve efficient trading.
2. Legal Sources
  - a. Primary Legal Sources

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<sup>61</sup>Hamud M. Balfas, *Op.Cit.*, page 461.

It is the sources which has legally binding, those are Law Number 8 of 1995 about Capital Market, Law Number 21 of 2011 about Indonesian Financial Authority (OJK), Law Number 40 of 2007 about Indonesian Limited Liability Company, Government Regulation Number 45 of 1995 about the Implementation of Activities in Capital Market, III-A Kep-00401/BEI/12-2010 about the Amendment of Regulation Number III-A about Exchange Membership by Indonesia Stock Exchange.

b. Secondary Legal Sources

It is the source which is not legally binding. In this matter, it is from the literatures and books.

c. Tertiary Legal Sources

It is supporting sources, such as Legal Dictionary and Economic Dictionary.

3. Method of Collecting the Sources

Literature Research, it is examining the books, literatures, books and related materials which supporting the problem of this research.

4. Method of Approach

Method of approach which is used is comparative normative approach; it is a method which examines the Law and regulation which are related to the Capital Market.

5. Data Analysis

Data analysis is done qualitatively, it means the data which are acquired then presented descriptively and analyzed qualitatively.

**CHAPTER II**  
**GENERAL OVERVIEW ON CAPITAL MARKET AND STOCK**  
**EXCHANGE, THE STRUCTURE OF INDONESIA CAPITAL**  
**MARKET, GOOD CORPORATE GOVERNANCE AND**  
**DEMUTUALIZATION**

**A. The Meaning of Capital Market and Stock Exchange**

The term of capital market is often treated same as money market. But actually those two markets have different substantial factors notwithstanding both are part of financial market system.<sup>62</sup>

Financial market is a meeting point between supply and financial assets. The financial asset as financial instrument is an asset or intangible assets which has characteristic that future benefit contains of claim in due date.<sup>63</sup> This financial asset has two functions. The first one is, to shift the fund from them who have more funds towards those who needs that fund for investment in the tangible asset. The second one is, to shift the fund by any ways, therefore, the risks that cannot be prevented, can be shifted and divided among them who needs the fund and able to supply the fund.<sup>64</sup>

Capital market in developed countries has grown significantly over the past three decades, experiencing a large boom in the 1990s. As a part of

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<sup>62</sup>Dahlan Siamat, *Manajemen Lembaga Keuangan*, Jakarta: Intermedia, 1995, page 365 in Ridwan Khairandy, *Hukum Pasar Modal I*, Yogyakarta: FH UII Press, 2010, page 1.

<sup>63</sup>Frank J. Fabozzi and Franco Modigliani, *Capital Markets* (New Jersey: Prentice-Hall, Inc, 1996) page 2.

<sup>64</sup>Frank J. Fabozzi, *Pasar dan Lembaga Keuangan*, translation, Jakarta: Salemba Empat, page 4.



this process, companies raised more capital in bond and equity markets, while both retail and institutional investors increased their participation in those markets.<sup>65</sup>

Capital Market is meeting point between parties who has more fund and party who needs fund by process of sale and purchase the securities. By this, the capital market can also be interpreted as market to sell and purchase the securities which have the long term more than one year, such as stock and bonds.<sup>66</sup>

The capital market is a financial market for the long term fund,<sup>67</sup> and in the narrow meaning as a concrete market. The money market deals with short-term fund financial instrument and as an abstract market. Money market is an infrastructure which provides the short-term defrayal.<sup>68</sup> The different is based on the securities or the instrument which is traded.

There are some of benefits due to the existence of capital market, those are as follows:<sup>69</sup>

- a. Providing the fund raising for the business activity and also allocating the fund raising optimally;
- b. Giving investment area for investors and also enabling the diversification effort;

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<sup>65</sup>Augusto de la Torre and Sergio L. Schumkler, 2007, *Emerging Capital Markets and Globalization*. Stanford University Press, and the World Bank, page 9.

<sup>66</sup>Eduardus Tandelin, *Portofolio dan Investasi*, Yogyakarta: Kanisius, 2010, page 26.

<sup>67</sup>Such as stock and bonds.

<sup>68</sup>Ridwan Khairandy, *Hukum Pasar Modal I, Op. Cit.*, page 9.

<sup>69</sup>Tjiptono Darmadji dan Hendy M. Fakhruhin, *Pasar Modal di Indonesia Edisi tiga*, Jakarta: Salemba Empat, 2001, page 2.

- c. Providing the leading indicator for country's trend economy;
- d. Enabling the expansion of ownership, disclosure, and professionalism and also creating the fair business activity;
- e. Creating the job field or interesting profession;
- f. Giving chances to own the health company and having future chance;
- g. Becoming the alternative of investment which giving the potential profit by risk which can be calculated by disclosure, liquidity, and investment diversification.

In fact, the capital market is closed to Stock Exchange or Securities Exchange. Exchange is a meeting place between seller and buyer in conducting transaction through intermediaries system. The instrument which is traded in capital market is securities such as stocks and bonds. Securities come from the notion that securities give guarantee that able to that securities.<sup>70</sup>

The term of Exchange is taken from *bourse* which means a meeting place between seller and buyer to trade their particular commodities which the implementation through the broker-dealer system.<sup>71</sup>

Generally, the definition of capital market is an abstract market which is also as a concrete market. As an abstract, capital market is a traded place of securities in the form of a long-term fund, it is more than one year.

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<sup>70</sup>Sumantoro, *Pengantar tentang Pasar Modal di Indonesia*, 1987, Jakarta: Ghalia Indonesia. page 10.

<sup>71</sup>*Ibid.*

Realistically speaking, the trading of securities happens in Stock Exchange.<sup>72</sup> Therefore, it can be said that capital market is an infrastructure which unites the seller and buyer of fund or capital. This place of offer and demand of securities is conducted based on the form of a legal institution called as Stock Exchange.<sup>73</sup> Stock Exchange is an organized system which unites the buyer and seller of securities conducted either directly or through the representatives.<sup>74</sup>

The authentic definition of capital market and stock exchange can be found in Law Number 8 of 1995. Capital market is a business activity which relates to the public offering and securities trading, public company which relates to its issued securities, and also institutions and profession which are correlated to the securities.<sup>75</sup> The capital market provides some of investments alternative for investors except another investments such as saving in bank, buying the gold, insurance, land and building, and etc.<sup>76</sup> Whereas stock exchange is a party which organizes and provides system or infrastructure to unite the sell offering and buying of securities from another party in order to trade the securities among them.<sup>77</sup>

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<sup>72</sup>Umaran Mansyur, *Teknik Perdagangan Efek di Bursa Efek Indonesia*, 1987, Jakarta: PT Aksara Kencana, page 9 in Ridwan Khairandy, *Op. Cit.*, page 4.

<sup>73</sup>*Ibid.*

<sup>74</sup>Dahlan Siamat, *Op. Cit.*, page 5.

<sup>75</sup>Article 1 point 13 Law Number 8 of 1995

<sup>76</sup>Rusdin, *Pasar Modal Teori Masalah dan Kebijakan dalam Praktik*, Bandung: Alfabeta, 2006, page 1.

<sup>77</sup>Article 1 point 4 of Law Number 8 of 1995.

The essence of stock exchange is a market, like the conventional market which unites the buyer and seller. If it is compared, there are various differentiations of conventional market and stock exchange as follows:<sup>78</sup>

1. In conventional market, the goods and product of service can be utilized directly to fulfill the need and get the satisfaction. It is different with that, in stock exchange that the object which is traded is the financial assets. The trading of securities is attached by transfer of physical evidence, it is stock portfolio, bonds, warrant, and etc. In the other trading way, it only gives consequence the transfer of stock ownership without transfer of physical evidence such as stock portfolio. From that illustration, it can be concluded that the sale and purchase is not intended to get direct satisfaction, but it is motivated by an effort to get bigger benefit in the future if the market value of the securities getting an increase.

2. In the conventional trading, the information matter has an important role. In the securities trading, the information has very dominant role and crucial. The instrument which become the trading commodities. The stock price is very depended on the supply and demand, but the process decision taking is very influenced by information which gotten from the performance and policy of issuer in its business activity. Therefore, the

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<sup>78</sup>M. Irsan Nasarudin dan Indra Surya, *Aspek Hukum Pasar Modal Indonesia*, 20014, Jakarta: Prenada Media, page 130-131 in Ridwan Khairandy, *Op. Cit.*, page 5-6.

quality, completeness, punctuality, and spread is very influencing the structure, competitiveness, and efficiency of stock exchange.

## **B. The Structure of Indonesian Capital Market**

The highest position of capital market in Indonesia is under Ministry of Finance which appointed Indonesian Financial Service Authority (here in after, OJK) which has duty to do management, regulating and daily supervision of capital market in the purpose of creating the capital market being orderly, fair, and efficient and also protecting the investor's interest.<sup>79</sup>

Therefore, it can be said that OJK as the center of all the activities in capital market, because from here that the beginning of capital market activities started. The company which wants to offer its securities to the public in the public offering shall beforehand start its process through this institution before can sell its securities to the public.

But, according to Law Number 21 of 2011 about OJK specifically on Article 55 point 1, that since the date of 31 December 2012, all function, duty, and regulatory authority and supervision financial service activities in the capital market, insurance, pension fund, fund raising institution, and others financial service institution moved from Ministry of Finance and OJK and Financial Institution to OJK. According to article 1 point 1 of Law Number 21 of 2011 about OJK, that OJK is an independent institution and free from any intervention from other parties, which has function, duty, and

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<sup>79</sup>Rusdin, *op.cit*, page 10.

regulatory authority, supervision, examination, and investigation as has been the purpose of the law. In which the function, duty, and authority of OJK are regulated in article 4 until 9 of Law Number 21 of 2011.<sup>80</sup>

As the purpose of OJK for all financial activities in the financial service which has been regulated by Law Number 21 of 2011 are as follows:<sup>81</sup>

- a. Running the financial service to be orderly, fair, transparency, and accountable;
- b. Enable to create financial system to be growing up sustainably and stable; and
- c. Enable protecting the consumers' interest and society.

OJK has function to provide in regulating system and integrated supervision towards all the financial service activities.<sup>82</sup>

To run its function, OJK has duty and authorities are as follows:<sup>83</sup>

- a. Financial service activities in Banking;
- b. Financial service activities in Capital Market; and
- c. Financial service activities in insurance, pension fund, fund rising, and other financial institution service.

To run it duty in regulating, OJK has authority as follows:<sup>84</sup>

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<sup>80</sup>Article 4-9 of Law Number 21 of 2011 about OJK

<sup>81</sup>Article 4 of Law Number 21 of 2011 about OJK

<sup>82</sup>Article 5 of Law Number 21 of 2011 about OJK

<sup>83</sup>Article 6 of Law Number 21 of 2011 about OJK

<sup>84</sup>Article 8 of Law Number 21 of 2011 about OJK

- a. Determining the implementation of regulation of this law;
- b. Determining regulations in financial service sector;
- c. Determining regulation and OJK's decision;
- d. Determining regulation about supervision in financial service sector;
- e. Determining the policy about implementation of OJK's duty;
- f. Determining regulation about procedure of writing order towards financial service institution and certain parties;
- g. Determining regulation about procedure of management of regulation in financial service institution;
- h. Determining structure of organization and infrastructure, management of wealth and obligation; and
- i. Determining regulation about sanction procedure in accordance with regulation in financial service sector.

To run its supervision duty, OJK has authority as follows:<sup>85</sup>

- a. Determining supervision operational policy towards financial service activities;
- b. Supervise the implementation of supervision duty which done by head of the executive;
- c. Conducting supervision, examination, investigation, consumers' protection, and another conduct towards financial

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<sup>85</sup>Article 9 of Law Number 21 of 2011 about OJK

service institution, subject, and or another supporting financial service activities;

d. Giving writing order towards financial service institution and or certain parties;

e. Conducting the appointment of management of regulation;

f. Deciding the user of management of regulation;

g. Determining administrative sanction towards parties who conduct violation of regulation in financial service sector;

h. Giving and or withdraw:

1) Business license;

2) Individual license;

3) The effectiveness of registration;

4) Letter of registered;

5) Approval of conducting business activity;

6) Validation;

7) Agreement or dismissal; and

8) Another determination which is in accordance with the regulation on financial service.

Direct licensing, approval or registration of professionals and capital market industry participants provides a mechanism to require such participants to have adequate financial and professional qualifications. Notwithstanding OJK is given authority to directly regulate all areas within its jurisdiction, in practice direct regulation was focused mainly on the disclosure process, licensing of market participants and professionals,



regulation of supporting institutions such as custodians, general regulation of the securities exchanges and investment funds, and certain broad operational principles which were relevant to all securities companies.

However, detailed regulation of exchange members, the primary institutions in the market, is the responsibility of the securities exchanges, through the principle of self-regulation. Self-regulation by the exchanges did not mean that OJK was not operative in this area, but that detailed rule making and supervision were delegated to these specialized self-regulatory bodies.

Self-regulation means that the government authorizes certain market participants to make and enforce the rules that govern their own activities. This rule-making power is delegated by law and with respect to two types of organizations: securities exchanges and clearing, settlement, and depository institutions.<sup>86</sup>

Article 22 of Decree 1548 required the securities exchanges to make rules on the following matters:

- a. Admission of members;
- b. Disciplining of members;
- c. Suspension and expulsion of members;
- d. Disclosure of information by listed companies;
- e. Surveillance of trading;

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<sup>86</sup>Putu Gede Ary Suta, *Foundations of Our Capital Market*, Jakarta: Yayasan Sad Satria Bhakti, 2000, page 169.

- f. Inspection of the financial situation of members;
- g. Dealing in securities on the exchange;
- h. Dealing in securities outside of the exchange;
- i. Listing of securities;
- j. Delisting of securities;
- k. Accounting procedures of members;
- l. Business practices of members;
- m. Clearing and settlement of trades on the exchange;
- n. Custody of clients' funds and securities by members.

Because stock exchanges must make rules on all these matters, exchanges were clearly self-regulatory organizations. Furthermore, the authority of an exchange to enforce these rules was plainly stipulated. An exchange could suspend and expel members for not complying with its rules. An exchange could delist the securities of issuers that did not follow its rules. Since its members, which are its shareholders and which elect its management, controlled an exchange, the exchange members regulated their own activities. In addition to the power to make rules, securities exchanges could also set their own fees and dues. The regulation which has been regulated and issued by securities exchange as SRO shall be approved by OJK as the highest authority in order that regulation can be enforced.<sup>87</sup>

## B.I Indonesia Stock Exchange

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<sup>87</sup>Tjiptono Darmadji dan Hedy M. Fakhruddin, *Pasar Modal di Indonesia Edisi 3, Op. Cit.*, page 34.

Historically, the capital market had come before the Indonesian independent. Capital market or stock exchange came since the colonialism era on 1912 in Batavia. The capital market on that era was established by Netherland Government for the interest of the colonial government or VOC. Even though capital market had come since 1912, the development of capital market did not run well as had been expected, even on some of periods the activities of capital market were vacuum. Those caused by some of the factors such as the first world war and second world war, the change of colonial government towards Indonesian Government, and other conditions which caused the operation of stock exchange could not run as well. The Indonesian Government re-activated the capital market in 1977, and a few years later the capital market experienced the development along with some of incentives and regulations which are issued by the government.<sup>88</sup>

(Table I) In briefly, the development of capital market in Indonesia can be seen as follows:<sup>89</sup>

December 1912	First stock exchange in Indonesia was established in Batavia by Netherland Colonial Government
1914 - 1918	Stock exchange in Batavia was closed during the First World War

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<sup>88</sup><http://www.idx.co.id/id-id/beranda/tentangbei/sejarah.aspx> seen at 26 December 2015 at 19.35 p.m.

<sup>89</sup>*ibid.*

1925 - 1942	Stock exchange in Jakarta (BEJ) was re-opened along with stock exchange in Semarang and Surabaya
In early of 1935	Due to political issue (Second World War), stock exchange in Semarang and Surabaya (BES) were closed
1942 - 1952	Stock exchange in Jakarta was re-closed during the Second World War
1956	The nationalization program of Netherland's company. The stock exchange did more not active
1956 - 1977	The trading in stock exchange was vacuum
10 August 1977	Stock exchange was re-officially activated by President. BEJ was run under OJK
16 June 1989	BES was operated and managed by Surabaya Stock Exchange Ltd.
10 November 1995	The government issued Law Number 8 of 1995 about Capital Market
2007	The merger between BES and BEJ, and changed the name become Indonesia Stock Exchange (IDX)

The trading of securities exchange as the important business activities, not everyone who holds the securities intend to hold it forever. Someone who owns the securities maybe nowadays has an important needs and he has no other fund resources so that in this condition the securities

which is owned as the alternative of his financial needs. In another situation, there is possibility an owner of securities does not have any needs to sufficient his needs but based on his analysis that the securities which he owned will be experiencing the decrease of its values, therefore, he has intention to sell his securities. Based on the needs of this securities trading, the Indonesia Stock Exchange as the market in trading activities. By doing this, the securities trading activities becoming faster and efficient.<sup>90</sup>

Stock Exchange as a party which runs and provides system or infrastructure to unite bidding and offering of securities by another parties in the purpose to commercialize the securities among them.<sup>91</sup> In another word, stock exchange as a market itself. Because of its function as a market, therefore the stock exchange is obliged to provide supporting infrastructure to run its business activities and also tools to conduct business supervision.<sup>92</sup>

Different with the common market, the access to enter in stock exchange is limited because only the members of stock exchange who are able to enter and conducting the commercial activities in stock exchange. To become the member of exchange so that having access to inner stock exchange trading system, other than it shall be the securities company so that the candidate of the member of stock exchange which has function as broker-dealer shall be the shareholders of stock exchange itself.<sup>93</sup> Those

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<sup>90</sup>Inda Rahadiyan, *Hukum Pasar Modal di Indonesia Pengawasan Pasar Modal Pasca Terbentuknya Otoritas Jas Keuangan*, Yogyakarta: UII Press, 2014, page 77.

<sup>91</sup>Article of 1 pont 4 Law Number 8 of 1995 about Capital Market.

<sup>92</sup>Article 7 point 2 and its explanation of Law Number 8 of 1995 about Capital Market.

<sup>93</sup>Article 8 of Law Number 8 of 1995 about Capital Market.

which are not the member of stock exchange can only entrust what is traded towards to members of stock exchange, which is the broker-dealer.<sup>94</sup>

Nowadays, there are one hundred and fifteen securities company which become the member of Indonesia Stock Exchange.<sup>95</sup> Whereas among of them there having function either as broker-dealer, underwriter or investment manager. Based on article 1 point 2 of Law Number 8 of 1995 has stated that the Member of Stock Exchange is the Broker-Dealer who hold a business license from OJK and has right to use the system and or facility of Stock Exchange in accordance with the regulation of Stock Exchange. This reflects that the one which is able to be the member of Stock Exchange is Broker-Dealer. Whereas the member of the Stock Exchange is also the shareholder of that particular Stock Exchange. In order to become the member of Indonesia Stock Exchange, there are requirements that shall be fulfilled by the candidates.<sup>96</sup>

Indonesia Stock Exchange is a limited liability company. Indonesia Stock Exchange has different characteristic compared to another company which is acknowledged by common. The main different is caused by Indonesia Stock Exchange has authority to regulate either for its members or another party related to itself. Authority to regulate is given to Indonesia Stock Exchange based on law which is clearly stated that Indonesia Stock

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<sup>94</sup>Hamud M. Balfas, *Hukum Pasar Modal Indonesia*, Jakarta:PT Tatanusa, 2007, page 13.

<sup>95</sup><http://www.idx.co.id/id-id/beranda/anggotabursaamppartisipan/profilanggotabursa.aspx> accessed on 27 December 2015 at 11.40 p.m.

<sup>96</sup>Amendment of Regulation Number III-A about Exchange Membership by Indonesia Stock Exchange.

Exchange is institution or organization which is given authority to regulate its implementation of its activities.<sup>97</sup>

The duties of Indonesia Stock Exchange as Self-Regulatory Organization are as follows:<sup>98</sup>

- a. Issuing regulation which is related to Stock Exchange's activities;
- b. Preventing the practice of prohibited transaction through its supervision function;
- c. The provision of Indonesia Stock Exchange has legally binding towards the actors in capital market.

## B.II Clearing and Guaranteeing (LKP)

After the trading has been done, therefore in order to finish all the rights and obligation which rise from that trading is established Clearing and Guarantee (LKP).<sup>99</sup> This Clearing and Guarantee Institution is run by PT Kliring Penjaminan Efek Indonesia (KPEI). This institution provides services on:<sup>100</sup>

- 1) Clearing and Finishing of Securities Exchange;

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<sup>97</sup>Inda Rahadiyan, *Op. Cit.*, page 78.

<sup>98</sup>Tjiptono Darmadji dan Hendy M. Fakhruddin, *Pasar Modal di Indonesia Edisi 3, Op. Cit.*, page 35.

<sup>99</sup>Based on Article 1 point 9 of Law Number 8 of 1995 about Capital Market has been stated that Clearing and Guarantee Institution is a party which operates clearing service and finishing guarantee of Securities Transaction.

<sup>100</sup>Tjiptono Darmadji dan Hendy M. Fakhruddin, *Pasar Modal di Indonesia Edisi 3, Op. Cit.*, page 35.

- 2) Guaranteeing the finishing of securities transaction. This guarantor has function to give a legal certainty the fulfillment of rights and obligation member of Stock Exchange (investor) which raise from securities transaction.
- 3) Borrowing the securities;
- 4) Another service in surrounding capital market, which is established in order to support clearing and guarantee function.

PT. KPEI was established based on Law Number 8 of 1995 about Capital Market in order to provide clearing service and finishing guarantee of transaction securities which is orderly, fair and efficient. The majority shareholders of PT. KPEI is Indonesia Stock Exchange with 100% was equal to 15 billion rupiahs. In the year of 2000, was implemented the Scrip less Trading System.<sup>101</sup>

The parties which can be the LKP's shareholders are Stock Exchange, Securities Exchange, Securities Administration Bureau, Custodian Bank, or other parties which has approval from OJK.<sup>102</sup>

### B.III Depository and Settlement (LPP)

Depository and Settlement were established based on Article 17 of Law Number 8 of 1995 about Capital Market. This Depository and Settlement is PT KSEI (Indonesian Central Securities Depository), as the

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<sup>101</sup><https://member.kpei.co.id/profile.aspx> last accessed on 4 December 2015 at 01.35pm.

<sup>102</sup>*ibid.*



institution which provides securities depository and another wealth which related to securities and such another services, including incoming of dividend, interest, and other rights, finishing the securities transaction, and representing bill holders which becoming its consumers.<sup>103</sup>

From those two institutions, both LKP and LPP are institution or company which run its function to determine and finish all the rights and obligation of the parties whose conducting the securities transaction.

Another structure within the capital market is Securities Company, Issuers, Investor and Supporting Institution in capital market.

#### B.IV Securities Company

The securities company in capital market has three main functions:

##### 1) Broker-Dealer

This term of Broker-Dealer has two meaning: The first one is, a broker in the trading of securities, it means that conducting as the broker in the securities trading activities, because the investor is not allowed to conduct trading activities directly without a broker. So in every transaction of trading shall be the existence of broker. For the broker's service, the broker will get fee from investor either on the buying or selling the securities. Secondly is Securities Seller, it means that while acting as the broker, the securities company is conducting securities trading activity for its own interest.<sup>104</sup>

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<sup>103</sup>Article 1 of point 8 Law Number 8 of 1995 about Capital Market.

<sup>104</sup>Tjiptono Darmadji dan Hendy M. Fakhruddin, *Pasar Modal di Indonesia pendekatan tanya jawab Edisi 1*, Jakarta: Salemba Empat, 2011, page 22.

Broker-Dealer has obligation as follows:<sup>105</sup>

- a) Prioritizing the consumers' interest before conducting transaction for its own interest;
- b) Giving recommendation to the consumers' to buy or sell the securities that oblige caring of the financial situation and the intention of investor;
- c) Providing the time, day and date upon all the consumers' order in the order form;
- d) Giving a confirmation towards the consumers before the closed day after the transaction;
- e) Issuing the letter of acceptance after accepting the securities or money from the consumers;
- f) Finishing the trading order from the order's giver;
- g) Providing the data and information for the investors' interest;
- h) Helping in management of fund for investors' interest;
- i) Giving advice to investors.

## 2) Underwriter

Based on article 1 point 17 of Law number 8 of 1995, Underwriter is a person who makes an agreement with an issuer to conduct a public offering, with or without the obligation to purchase securities that are not sold. The license for underwriter is also

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<sup>105</sup>Sekolah Pasar Modal Bursa Efek Indonesia Level 1-A, *Pengenalan Pasar Modal Produk Investasi di BEI Investasi di Pasar Modal Analisa Fundamental bersama KPEI IDX dan KSEI*, page 30.

effective for broker-dealer. Thus, Securities Company which has a license as underwriter can be conducting business activities as broker-dealer. But, the securities company which has a broker-dealer license is not automatically able to conduct business activity as underwriter.<sup>106</sup>

While the Representative of Underwriter (WPPE) is a person who hold a license from OJK through the procedure of capital market in acting as the representative upon the securities companies' interest for the activities related to the underwriter's duty.<sup>107</sup>

Theoretically, there are some of the securities underwriting in which it has been clearly stated in article 39 of Law Number 8 of 1995 that underwriter is obliged to comply with provisions in the securities underwriting, those some of the securities underwriting:<sup>108</sup>

- a) *Full Commitment*, it means that the underwriter purchases the entire offering from the issuer, and then resells it to investors.
- b) *Best Effort Commitment*, it means that Underwriter acts as a mere selling agent, receiving a commission on each securities sold.
- c) *Standby Commitment*, it means that unsold securities will remain with the issuer or will be taken by shareholders (standby buyers).

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<sup>106</sup>M Irsan Nasarudin dan Indra Surya, *Op. Cit.*, page 144.

<sup>107</sup>*Ibid.*

<sup>108</sup>*Ibid*, page 145.

d) *All or None Commitment*, it means that the underwriter will try to sell the securities, in order to be sold up, but if all securities are not sold up, therefore the transaction with the issuer will be cancelled.

### 3) Investment Manager

Based on article 1 point 11 of Law Number 8 of 1995, the investment manager is a person conducting activities in managing the securities portfolio for the consumers or managing the portfolio of collective investment for group of consumers, except the insurance company, pension fund, and bank which conducting their own business activities based on the applicable law.

This management of investment is based on the contract between the investment manager and its consumers. Therefore, the investment manager will get a fee from a certain percentage of the fund which has been managed.

### B.V Issuers

In capital market whereas the stock exchange as a market, while the issuer as a company which provides goods to be sold and purchased in the form of securities. As it has been clearly mentioned by article 1 point 6 of Law Number 8 of 1995, an issuer is a person who makes a public offering.

An issuer is a person or company who issues the securities in the form of stock or obligation and offered it to the public. After the securities issued by the issuer, then the securities will be traded in the stock exchange.

After the public offering of the securities, basically, the issuer does not have any longer relationship with the securities issued. In the sense that the issuer (in certain limitation) will not intervene upon the rise and fall of the securities price.<sup>109</sup> it is because the rise and fall of securities values is the interest of investor which conducting the sell and purchase of the securities. The obligation of the issuer is only to manage its business activities well and conducting its obligation as the issuer generally and specifically, and at the end, it will give effect on the price of the securities. The price of the securities is affected by the performance of the issuer but it is not caused by the intervention of the issuer in the market. The market (stock exchange) itself which is hoped to determine the price of securities and one of the components in the stock exchange is information, which is continually delivered by issuer due to its business activity.

#### B.VI Investor

The investor is a person who has more capital after the other of his fund has been used in consumption matter. In broadly, investor is a person who spends money with an expectation of earning a profit.<sup>110</sup> Or in another word that investor is a buyer of a security or other property who seeks to profit from it without exhausting the principal.<sup>111</sup>

There are some types of investors based on the purpose.<sup>112</sup>

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<sup>109</sup>Hamud M. Balfas, *Op. Cit.*, page 14 .

<sup>110</sup>Black's Law Dictionary 9th Edition, page 903.

<sup>111</sup>*Ibid.*

<sup>112</sup>Rusdin, *Pasar Modal Teori Masalah dan Kebijakan dalam Praktik*, Bandung: Alfabeta, 2006, page 35-36.

a) Investor who has purpose to get dividend

This type of investor is investing their capital in the very stable company. By this condition, this investor is getting a certainty by the existence of stable profit which will be given by the company.

b) Investor who has purpose to trade

The price of the stock in the stock exchange is not permanent; it can be raised or fallen down, depending on the power of demand and offer. The change of price is attracting this type of investor to be positioning himself as the trader of stock, by conducting sell and purchase of this stock in the stock exchange. The income is from the sell and purchase of the stock itself.

c) Investor who has interest in company ownership

For this type of investor is having interest on the participation of company ownership. They tend to choose company's stock which has been popular. The change of stock price is not really affecting, it does not make them worry to sell it.

d) Secular group

This type of investor, prefers on the company's stock which is not developing yet, and it is believed that the stock price will be always increasing.

## B.VII Supporting Institution in capital market<sup>113</sup>

### 1) Securities Administration Bureau

Securities Administration Bureau is a party based on the contract with issuer conducting the registry of stock ownership and distribution of rights related to the securities. The contract is specifically determining the rights and obligation of the issuer and securities administration bureau, including the obligation towards the stock holder. Finishing of the transaction through the book-entry settlement is the main job of Securities Administration Bureau.

### 2) Custodian

The custodian is a party which provides service on stock depository and the wealth related to securities and another service including dividend, interest, and other rights, finishing the securities transaction and representing the owner of bill account which becoming its consumer. This job is run by PT. KSEI, Securities Company or general bank which has a license of approval from OJK.

### 3) Trustee

Based on article 50 of Law Number 8 of 1995 clearly stated that business activities as the trustee can be done by general bank and another party which is determined by government regulation. The trustee is a party which represents the

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<sup>113</sup>M Irsan Nasarudin dan Indra Surya, *Op. Cit.*, page 171-176.

securities holder's interest by the characteristic of bond. Therefore, securities which characterized by the bond is a unilateral bond letter and the securities holders are spread, so in order to manage and represent them as the creditor, the trustee institution is established.

#### 4) Investment Advisor

An investment advisor is a party which gives an advice towards other parties concerning on the sell and purchase of securities by getting the fee from that service. The giving of an advice can be done orally or in writing, including the issuance on the mass media. Therefore in order to be able as the investment advisor, they must fulfill the requirement such as the skill of securities analysis.

#### 5) Securities Rating

The duty of Securities Rating is determining the rating of securities by using of certain symbol which can provide an imaginary concerning of his investment quality from a securities which is valued in correlation with default risk.

This institution is an institution which its performance quality is depending on the independency which can guarantee its credibility. The rating of securities which is issued by Securities Rating is very important information because it will be the decision from investor whether to buy the securities or not in the form of a bond.



### C. Good Corporate Governance

The legal basic of corporate governance is specifically mentioned in article 4 of Law Number 40 of 2007. The term “corporate governance” derives from an analogy between the government of cities, nations or states and the governance of corporation.<sup>114</sup> The precise term “corporate governance” itself seems to have been used to denote the structure and functioning of the corporate policy. The early corporate finance textbooks saw “representing government”<sup>115</sup> as an important advantage of the corporation over partnerships but there has been and still is little agreement on how representative corporate governance really is, or whom it should represent.

Corporate governance is a subject that is notoriously difficult to define in one sentence. Some view corporate governance in the narrow sense, dealing with the structure and functioning of the boards of directors, and their relationship to management. This narrow definition is the one often found in corporate governance codes. A broader definition includes a company’s relationship with shareholders, especially in organizations with concentrated ownership. Finally, academic studies dealing with governance broaden the definition to all

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<sup>114</sup>The analogy between corporate and political voting was explicit in early corporate charters and writings, dating back to the revolutionary origins of American corporation and the first railway corporations in Germany [Dunlavy, C.A. (1998), “Corporate governance in late 19th century Europe and the U.S: the case of shareholder voting rights”, in: K.J. Hopt, H. Kanda, M.J. Roe, E. Wymeersch and S. Prigge, eds., *Comparative Corporate Governance. The State of the Art and Emerging Research*, Oxford: Oxford University Press, page 5.]

<sup>115</sup>Mead, E.S. *Corporate Finance, 6th Edition*, Appleton, New York, London, 1928, page 31.

internal relationship within a business, including the issues raised by the conduct of shareholders, especially institutional investors, the functioning of the general meeting and the company's relationship with the financial markets.<sup>116</sup>

The Organization for Economic Co-operation and Development (OECD) Principles of 1999 defines the corporate governance as,<sup>117</sup> “*corporate governance involves a set of relationship between a company's management, its board, its shareholder and other stakeholder. Corporate Governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.*”

According to Jeremy Charles Vanderloo,<sup>118</sup> that “*corporate governance refers to those procedures established within a company's organization that allow director oversight of key officer decisions, provide disclosure of material facts to investors and other stakeholders, and allow for efficient and accurate decision making within the organization. Corporate governance describes the legal rules relating to the perspective powers and duties of directors, officers and shareholders.*”

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<sup>116</sup>Eddy Wymeersch, *Corporate Governance Codes and their Implementation*, Universiteit Geint, Financial Law Institute, 2006, page 1.

<sup>117</sup>Nikolai Lazarev, *on Certain Issues of the Modern Corporate Governance Reform in Russia*, International Company and Commercial Law Review, Volume 17 (15), 2006, page 143. In: Ridwan Khairandy, Camelia Malik, ... *Op. Cit.*, page 62.

<sup>118</sup>Jeremy Charles Vanderloo, *Encouraging Corporate Governance for the Closely Held Business*, Mississippi College Law Review, Volume 24, Fall 2004. In: Ridwan Khairandy, *Op. Cit.*, page 62.

An effective system of corporate governance shall provide sufficient incentive for commissioner and director in order to reach the purpose of the company for the sake of company's interest and its shareholders. This system shall also be capable to facilitate the existence of effective supervision; therefore it will push the company to utilize the company's resources efficiently.<sup>119</sup>

Good Corporate Governance is a system which regulates and manages a company in order to create the corporate value for all stakeholders. The concept of Good Corporate Governance in Indonesia can be understood as a concept of good management on corporation. There are two matters on this concept. The first one is about the importance of shareholders' rights to receive accurate information and on time. The second one is the obligation of company to conduct the disclosure accurately, on time, and transparency towards all information dealing with the performance of company, ownership, and stakeholders.<sup>120</sup>

Good governance both by public institutions and by private business is considered one of the building blocks upon which economic success is based. Hence the efforts undertaken by many international and national organizations and bodies to improve governance, especially by enacting rules, standards or recommendations, have to be respected and

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<sup>119</sup>Jeremy Charles Vanderloo, *Loc. Cit.*, page 40. In: Ridwan Khairandy, *Op. Cit.*, page 1.

<sup>120</sup>Ridwan Khairandy, Camelia Malik, *Good Corporate Governance, Perkembangan Pemikiran dan Implementasinya di Indonesia dalam Perspektif Hukum*, Yogyakarta: Kreasi Total Media, 2007, page 2.

serve as models against which directors of these institutions or business firms can measure their conduct.<sup>121</sup>

The capability of a country to attract foreign capital is very depending on the corporate governance system which they follow and what extend the management or the company respects and obey the rights of shareholders, lender, bondholders, and non-controlling shareholders. The investor will not decide to invest their capital towards a company which does not have effective corporate governance system.<sup>122</sup>

The demand for implementation on Good Corporate Governance is necessary and important issue towards foreign investors to enter into stock exchange in a country, and in order being capable on global competition. With the expected result that the better of a country implements the principles of Good Corporate Governance as the indicator of the implementation of good treatment towards investor.<sup>123</sup>

The implementation on GCG in company has strategic purposes as follows:<sup>124</sup>

- 1) Capable to increase and develop the company;
- 2) Capable to manage the resources and risks effectively and efficiently;

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<sup>121</sup>Eddy Wymeersch, *Loc. Cit.*, page 1.

<sup>122</sup>Jeswald W. Salacuse, *Coporate Governance in the New Country*, Company Lawyer, Volume 25 (3), 2004, page 69. In: Ridwan Khairandy, Camelia Malik, *Good Corporate Governance ... Op. Cit.*, page 1.

<sup>123</sup>Hamud M. Balfas, *Op. Cit.*, page 231.

<sup>124</sup>Munir Fuady, *Perlindungan Pemegang Saham Minoritas*, Bandung: CV Utomo, 2005, page 52. In: Ridwan Khairandy, Camelia Malik, *Good Corporate Governance ... Op. Cit.*, page 2.

- 3) Capable to increase the disciplinary and responsibility from the company's structure for the sake of shareholders and company's stakeholder;
- 4) In order to increase the company's contribution towards the national economy; and
- 5) Increase the national investment.

The implementation of GCG in capital market is intended to increase the protection of investor, especially for the investor of public companies. Despite the mechanism of GCG will push the growing of *check and balance* mechanism in management area specifically upon the giving a concern towards shareholders' interest and other stakeholders. Beside the protection of investor, the regulation also obliges the existence of transparency system and accountability in business transaction among companies which potentially rise a conflict of interest. The existence of obligation for gaining public approval in that transaction is a form of implementation on accountability principle.<sup>125</sup>

Concerning on the implementation of GCG, there are some of GCG principles which shall be noticed in order to be carried out:<sup>126</sup> Those principles are:

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<sup>125</sup>Mas Achmad Daniri, *Reformasi Corporate Governance di Indonesia*, Jurnal Hukum Bisnis, Volume 24, No 3, 2005, page 21. In: Ridwan Khairandy, Camelia Malik, Good Corporate ... *Op. Cit.*, page 6.

<sup>126</sup>Nindyo Pramono, *Hukum PT Go Public dan Pasar Modal*, Yogyakarta: Andi Yogyakarta, 2013, page 521.

## 1) Fairness

Based on OECD, the principles of fairness have two essences. The first one is the management shall protect the shareholders' rights. Generally, this principle admits the ownership of shareholders. Those shareholders have rights to involve their interest within company. And also admitting shareholders' rights in participating in making the important decision which done by the company, such as the election of director and delivering some of ideas due to the life of company.<sup>127</sup> The second one is concerning on the management of company shall ensure the equal treatment for the shareholders, including the minority shareholders.<sup>128</sup>

## 2) Transparency or Disclosure

The disclosure principle is important to prevent fraud. According to Barry A.K. Rider, "*more disclosure will inevitably discourage wrongdoing and abuse*". By the delivered information through this principle, therefore it can be anticipated the possibility of shareholders, investor or stakeholders do not receive any information or material fact which existed.<sup>129</sup>

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<sup>127</sup>Hasnati, *Peran Komite Audit dalam Organ Perseroan Terbatas dalam Kerangka Good Corporate Governance*, Yogyakarta: FH UII Press, 2004, page 56. In: Ridwan Khairandy, Camelia Malik, ... *Op. Cit.*, page 75.

<sup>128</sup>*Ibid.*

<sup>129</sup>Bismar Nasution, *Prinsip Keterbukaan dalam Good Corporate Governance*, Journal Hukum Bisnis, Volume 22, Nomor 6, Tahun 2003, page 6. In: Ridwan Khairandy, ... *Op. Cit.*, page 78.

The disclosure principle is one of the important element in implementation of GCG within the company and that implementation of GCG's principles within the company had been the absolute necessity upon the modern corporate practice.<sup>130</sup>

The disclosure is not only the absolute obligation of public company which will and has conducted public offering, but it is the rights of investor. Only by the disclosure, the protection towards investor can be conducted. By the existence of disclosure, therefore the investors can take a decision to invest in the company's securities, either to buy, sell, or hold that securities. Therefore, before the issuer conducting public offering, so the issuer shall conduct disclosure towards public due to every single thing about that company.<sup>131</sup>

### 3) Accountability

Accountability principle defines that management of company shall ensure the strategic guidance of company, effective supervision upon responsibility parties towards company and its shareholders. This principle has implication on the legal liability of director, which is to make relationship based on the trust towards shareholders and company. The director shall not have any self-interest in decision-making

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<sup>130</sup>Munir Fuadi, *Op. Cit.*, ... page 60. In: Ridwan Khairandy, ... *Op. Cit.*, page 78.

<sup>131</sup>Hamud M. Balfas, *Op. Cit.*, page 166. In: Ridwan Khairandy, *Op. Cit.*, page 78.

process and active action, and based on the accepted information wholly.<sup>132</sup>

#### 4) Responsibility

The responsibility principle encompasses the matter related fulfillment of corporate social responsibility as a part of society.

The company in fulfillment of its responsibility towards its shareholders and stakeholders shall in accordance with the applicable law.<sup>133</sup>

Despite the structure of corporation which functions as the supervisor shall ensure the effective supervision towards director who must be responsible due to his decision. The responsibility towards company is the important requirement which shall be upheld by director, because of by corporate opportunity which owned by director, so that the director has broad opportunity to shift the company's profit for himself.<sup>134</sup>

Therefore the check and balance shall be noticed.

#### **D. Islamic Perspective on Capital Market**

The purpose of capital market based on Islamic Perspective is creating the capital market which is having ethic and fair. All the transaction in capital market shall be done in accordance with Islamic ethic which has

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<sup>132</sup>Ridwan khairandy, Camelia Malik, *Op. Cit.*, page 82.

<sup>133</sup>*Ibid*, page 84.

<sup>134</sup>*Ibid*, page 85.



been regulated in syariah principle.<sup>135</sup> The which has Islamic values is an ideal capital market, which is fulfilling the element of "ethic" fair or transparency and the existing of efficient element". Obaidullah, cited Baruch Lev's point of view which is, the meaning of ethic and fair is the existence equal opportunity whereas all the parties in capital market get an access of information in the same and relevant to evaluate the asset.<sup>136</sup>

As the main sources of syariah capital market is Al-Qur'an and Al-Hadith. If in both of them cannot be found therefore an ijtihad can be conducted by DSN-MUI, after that issuing a fatwa which then can be used in running the syariah capital market. The sources in determining the syariah concept can be found in as follows:<sup>137</sup>

- 1) Qs. Al-Baqarah: 275, "...Allah has granted a halal toward sale and purchase, and proscribe the riba..."
- 2) Qs. An-Nisa: 29. "O who believe, do not take your treasures among you in a way that vanity, except to trade you the pleasure of each other. And do not you kill yourself, verily Allah is the Most Compassionate to you."
- 3) Qs. Al-Ma'idah: 8, " O who believe, you shall be people who always uphold (the truth) for Allah, bearing witness with justice. And do not let the hatred of a people, encouraging you to justice.

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<sup>135</sup> Muhammad in Diana Wijayanti, *Perspektif Hukum Islam terhadap Pasar Modal Syariah Sebagai Alternatif Investasi Bagi Investor, Jurnal Hukum IUS QUIA IUSTUM No. 2 Vol.20 April 2013, page 247.*

<sup>136</sup> Muhammad in Diana Wijayanti, *Perspektif Hukum Islam..., Ibid.*

<sup>137</sup> Muhammad dalam Diana Wijayanti, *Perspektif Hukum Islam..., Ibid.*

Apply justice: that is next to God-fearing. And fear Allah, verily Allah is aware of what you do.”

- 4) “Muhammad Prophet forbids sale and purchase which contains of excessive uncertainty,” (H.R al-Baihaqi from Ibnu Umar.

## **E. Structure of Demutualized Exchange**

Traditionally, stock exchanges operating as a “club of brokers” offered these services as monopoly operators serving largely under a mutual governance structure. In case a particular broker did not have an opposite buy or sell order he would approach other brokers to match his trade. Thus the stock exchanges were physical locations where the trade of securities took place because there was gathering of brokers at the exchange floor. These brokers were the members of the stock exchanges. The members of the club enjoyed rights of ownership, decision-making (one member, one vote), and trading. The need to conduct the transaction in person restricted the access to the exchange members which were the intermediaries for investor’s transaction, which gave the exchange member the market power. Since the members of the exchange had a better knowledge of the order flow and the prices of the securities, they started charging monopoly rents in the form of brokerage commissions.<sup>138</sup>

Stock exchanges are now increasingly changing their business model and restructuring themselves across the world due to the

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<sup>138</sup>Hazarika Sonali, *Governance Change in Stock Exchanges*, January 2005 FMA Annual meeting Chicago Illinois, available at [www.fma.org](http://www.fma.org)

simultaneous convergence of a number of powerful developments. Changes in the market structure can be primarily attributed to the advent of the electronic trading system. The most notable of these has been the rapid advancement and innovation in technology that has facilitated alternative trading system (ATS) including electronic communication network (ECNs) and growing partly by cross-border listing and portfolio flows.<sup>139</sup> In the current electronic trading environment, the buy or sell orders are placed onto a computer system which matches the orders on the basis of price-time priority or any other priority set by the administrator of the system. Thus in the current situation an erstwhile major function of matching the orders by the members have been taken up by the system.<sup>140</sup> Together these developments have eroded the significance of physical national stock exchanges and their trading floors.

Consequently, across the globe stock exchanges are now rethinking their business strategy and model in order to find ways of how best to survive. In the process, exchanges have evolved towards new corporate, legal and business model to strengthen governance and face the competition. This process of transformation from members' associations into for-profit corporations is referred to as demutualization.<sup>141</sup>

Demutualization in the strictest sense refers to the change in legal status of the exchange from a mutual association with one vote per member

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<sup>139</sup>Shamshad Akhtar, *Demutualization of Asian Stock Exchanges – Critical Issues and Challenges*, in *DEMUTUALIZATION OF STOCK EXCHANGES: PROBLEMS, SOLUTIONS AND CASE STUDIES*. Asian Development Bank, 2002, page 4

<sup>140</sup>Subhashish Saha, *Stock Exchange Demutualization and Self Regulation, ... Loc. Cit.*, page 2.

<sup>141</sup>*Ibid.*

(and possibly consensus-based decision making), into a company limited by shares, with one vote per share (with majority-based decision making). Demutualization makes sense if it induces a change in the exchange's objective from managing the interests of a closed member-based organization with a central focus on providing services for the benefit primarily of the members or brokers and keeping costs and investment limited to financing agreed by members, into a company set up with the objective of maximizing the value of the equity shares by focusing on generating profits from servicing the demands of their customers (brokers and investors) in a competitive manner.<sup>142</sup>

Since the demutualization by the Stockholm by the Stockholm Stock Exchange which took place in 1993 with the change of its organizational form from a non-profit to a for-profit, publicly listed organization, a significant number of stock exchanges have experienced similar changes, this process gaining a global scale (the data confirming this statement are shown in table 1).<sup>143</sup> For example, the Australian Stock Exchange became one of the first stock exchanges that went public and became a listed company. In the same way, the London Stock Exchange, the Deutsche Borse, alongside with other major European stock exchanges also become public companies. In Americas, the Toronto Stock Exchange demutualized in 2000, followed by its owner, the TSX Group, which went public in 2002. In Asia, both of the most important stock exchanges: Hong Kong Stock

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<sup>142</sup>*Ibid.*

<sup>143</sup>Saadia Altaf, *Demutualization of Stock Exchanges, A Case Research, ... Loc. Cit.,* page 12.

Exchange in 2000 and Singapore Exchange in 1999 are already listed companies. The only significant and important stock exchange which did not list its share (despite the fact that it demutualized in 2001), is the Tokyo Stock Exchange. Also the United States, the Chicago Mercantile Exchange demutualized in 2000. In 2003 CME conducted a later initial public offering (IPO) and listed its shares on the New York Stock Exchange. On April 20th, 2005 New York Stock Exchange announced that it is planning a merger with a publicly listed electronic exchange Archipelago, the new company becoming a public listed for-profit organization. It is worth noting that NYSE is one the last major global exchanges that is undertaking such an organizational transformation. This tendency is evident both across different continents as well as across stock exchanges that trade different types of securities. Also India, Pakistan, Brazil, the Philippines, and some other countries' stock exchange announced in 2005 their plans to demutualize and to list their shares. While the largest derivative exchanges (CME, LIFFE, Eurex, International Securities Exchange and CBOT) are already publicly listed, others including the New York Mercantile Exchange (NYMEX) and International Petroleum Exchange have demutualized and are planning public listings. This seemingly unstoppable organizational transformation of exchanges from member owned mutual to join-stock companies is unparalleled.

(Table II). Year of Demutualization of Major Exchanges<sup>144</sup>

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<sup>144</sup>Reena Aggrawal and Sandep Dahiya, *Demutualization and Public Offerings of Financial Exchanges*, McDonough School of Business, Georgetown University, November 6, 2005, page 16.

	Year of Demutualization	IPO/ Listing Date
<b><u>Major European Exchanges</u></b>		
London Stock Exchange	2000	20-Jul-01
Euronext	2000	10-Jul-01
Deutsche Boerse	2000	5-Feb-01
BME Spanish Exchanges	2001	No plans
Swiss Exchange	2002	No plans
Borsa Italiana	1997	No plans
OMX Group	1993	1-Jan-93
Oslo Bors	2001	28-May-01
Hellenic Stock Exchange	1999	28-Jul-00
<b><u>Major North American Exchanges</u></b>		
NYSE	2006 likely	2006 likely
Nasdaq (including AMEX)	2001	1-Jul-02
Toronto Stock Exchange	2000	12-Nov-02
Instinet	NA	18-May-01
Archipelago	NA	12-Aug-04
Chicago Mercantile Exchnage	2002	6-Dec-02
CBOT	2005	19-Oct-05
CBOE	2006 likely	2006 likely
International Securities Exchange	2002	8-Mar-05
<b><u>Major Asian/ Oceania Exchanges</u></b>		
Tokyo Stock Exchange	2001	2006 likely
Osaka Stock Exchange	2001	2-Apr-04
Hong Kong Stock Exchange	2000	27-Jun-00
Australia Stock Exchange	1998	14-Oct-98
Taiwan Stock Exchange	No plans	No plans

Korea Stock Exchange	No plans	No plans
Singapore Stock Exchange	1999	16-Nov-00
Bursa Malaysia	2004	18-Mar-05
New Zealand Stock Exchange	2003	4-Jun-03
Philippines Stock Exchange	2001	15-Dec-03
Sydney Futures Exchange	2000	16-Apr-02

The restructuring involves moving from an entity in which ownership of a share or “seat” in the exchange confers a right to trade on, and have some influence over the management of, the exchange, into an entity where ownership rights and trading rights are separate, and where the right to trade confers no ownership or management right.

The conventional rationale for public companies is limited by shares of profit maximization. It has been said that the single overriding objective shared by all listed public companies, whatever their size or type of business, is the preservation and the greatest practicable enhancement over time of their shareholders’ investment. A public company is able, and under some pressure, to distribute profits to its owners. For-profit enterprise is said to respond to a changing environment quickly, engender a proprietarily sense in shareholders and holders of stock options.<sup>145</sup>

Public companies are disciplined by competition from other companies and it is this competition which forces the creation of mechanism to efficiently monitor the performance of management. Ownership is seen

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<sup>145</sup>William Pearson (Director, Corporate Finance, Securities and Futures Commission, Hong Kong China), *Demutualization of Exchanges – The Conflicts of Interest*, Hong Kong, page 86.

as a key factor in determining the ability of a company to respond to market and regulatory developments. Under a mutual governance structure, the exchange is focused primarily on how its operations affect the personal or business interests of each member stockbroker. External ownership of a public company enables it to focus on the requirements of the exchanges a business and increase its capacity to make the difficult business decisions required by changing markets, technology and international and domestic competition.<sup>146</sup>

Demutualization is seen as facilitating a response to market and regulatory developments by:<sup>147</sup>

- (i) Separating rights of ownership from rights to trade and rights to manage;
- (ii) Removing certain inefficiencies and conflicts of interest which impaired the decision-making process; and
- (iii) Facilitating capital raising and alliances or mergers between exchanges.

The decision to demutualize has far-reaching consequences both for the exchange and the traditional manner of its operation and for the regulatory framework for securities and futures markets.

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<sup>146</sup>*Ibid.* page 87.

<sup>147</sup>*Ibid.*



**CHAPTER III**

**THE IMPLEMENTATION OF GOOD CORPORATE  
GOVERNANCE AND THE NECESSITY OF DEMUTUALIZATION  
CONDUCTED BY INDONESIA STOCK EXCHANGE**

**A. The Implementation of Good Corporate Governance**

The globalization of the marketplace has led in an era which quality of corporate governance is a crucial component of corporate survival. The compatibility of corporate governance practices with global standards has also become an important part of corporate success. The practice of good corporate governance has therefore become a necessary prerequisite for any corporation to manage effectively in the globalized market.

The purpose of establishment of stock exchange is to run the securities trading which orderly, fair and efficient.<sup>148</sup> It means that a trading is organized based on a clear regulation and consistently conducted. Thus, the price which appears in the market is reflecting market mechanism based on the power of supply and demand. The efficient trading of securities is reflected on the transaction settlement in quickly and a cheap cost. Therefore the basic purpose of stock exchange is to provide a sense of security and an adequate level of protection for investor.

Traditionally, stock exchanges operated in the form of non-profit mutual or membership organizations. And this condition happens to

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<sup>148</sup> Article 7 point 1 of Law Number 8 of 1995

Indonesia Stock Exchange nowadays. To the extent market power was not curtailed by competition or regulation, mutual governance gave specialist or market maker members of an exchange control of price, quality and range of services produced by the exchange. Exchange profits were returned to broker and dealer members in the form of lower access fees or trading profits. Further, exchanges have long operated as self-regulatory organizations (SRO) with members contributing their time to governance and self-regulation to make exchanges more effective and more profitable.<sup>149</sup> As the legal status of Indonesia Stock Exchange as SRO had raised a big question because this is seen unusual or contradict towards the legal system.

While theoretically the establishment of company is basically for profit-oriented and there shall be an organ inside such as General Meeting of Shareholders, Board of Directors, and Board of Commissioners.<sup>150</sup> As has been defined by Article 1 point 1 of Law Number 40 of 2007 about Limited Liability Company that company is a legal entity constituting a capital partnership, established based on an agreement, conducting business activities with all of its authorized capital being divided into shares, and meeting the requirements stipulated in the law and its implementing regulations. Some elements that must be owned by company including the

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<sup>149</sup> Roberta S. Karmel, *Turning Seats Into Shares: Implications of Demutualization For The Regulation of Stock and Futures Exchanges*. Center for the Research of International Business Law, Brooklyn Law School, 2001. Page 2.

<sup>150</sup> Article 1 point 2 of Law Number 40 of 2007.

separation of ownership; specific purpose (profit-oriented); own interest; and the existence of well-organization.<sup>151</sup>

Because of Indonesia Stock Exchange is SRO which is non profit motive and independent. The question is there any company which is non-profit motive based on Indonesian legal system. If the concept of company based on Indonesian Limited Liability Company Law whereas the purpose of company is to gain profit, if it is applied to the condition of Indonesia Stock Exchange, thus, Indonesia Stock Exchange may obviously have purpose to gain profit. As SRO, Indonesia Stock Exchange provides the securities trading shall be independent, whereas as the mediator is not allowed to double functioning himself as an intermediary and also the market player.<sup>152</sup> As long as Indonesia Stock Exchange which theoretically is a non-profit oriented, this is very difficult for him to keep his objectivity and independency to supervise, control and involving himself to the securities activities.

A loss of faith in capital market discipline based on a diagnosis that the markets had failed to detect the major corporate frauds. As a result, there shall be an increased willingness to rely on command and control regulation. Indonesian policy-makers have to believe that strong measures are needed to restore investor confidence in the integrity of the markets (stock exchange). The major underlying targets of reform were conflict of interest,

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<sup>151</sup> Nindyo Pramono, *Hukum PT Go Public dan Pasar Modal, Op. Cit.*, Page 33.

<sup>152</sup> Nindyo Pramono, *Menyibak Masa Lalu, Menggapai Masa Depan Pasar Modal Indonesia Menuju Milenium III*, Capital Market Law Journal, number 25 vol. 11, 2004, page 10.

ranging from the well-known but intensified agency problems of corporate boards.

Some researchers have found better performance results for companies that measure highly on overall corporate governance indexes, it appears that the key elements of these indexes that account for better performance are related to the level of shareholder rights, a matter that was not part of the reform agenda. Also, many have questioned theory as to how independent directors could increase performance, given the limited effectiveness of part-time directors primarily dependent on information supplied by management. Many have contended that the independent director reforms must be seen as part of a package of reforms that restored “integrity” to the market and thus the willingness of investors to participate.

The implementation of Good Corporate Governance makes the management of company more focus and clearer concerning on the distribution of duties, responsibilities, and also supervision. Good Corporate Governance has a very significant role on the developing company performance wholly.

The right implementation of Good Corporate Governance as primary principal in order to get a trust from other parties, such as investor, the candidate of investor, and all the stakeholders.<sup>153</sup> Therefore the principles of Good Corporate Governance shall be achieved by using the high standard in order to support the purpose of business, whether the

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<sup>153</sup>Ridwan Khairandy, Camelia Malik, *Good Corporate Governance Perkembangan Pemikiran dan Implementasinya di Indonesia dalam Perspektif Hukum, Op. Cit.*, page 140.

growth of business, profitability, the value added for stakeholders, and also increase the capabilities in order that the long-term business can be achieved.

One of the problems is that it is difficult for an exchange to regulate its broker-dealers more strongly than the broker-dealers want as long as the members of stock exchange whose functioning themselves as shareholder of stock exchange, therefore, they have more bargaining position on this matter. If the exchange is controlled by broker-dealer members this is almost a harmful. If the members do not face external pressure to behave appropriately, they will not want strong exchange regulation that constrains how they behave toward their customers.

### **A.1 The implementation of Good Corporate Governance Principles in Indonesia Stock Exchange:**

#### **1. Fairness;**

Since the parties who are able being the shareholder of Indonesia Stock Exchange are only Broker-Dealer. Whereas based on Article 8 of Law Number 8 of 1995 has specifically defined that the one which is able being the shareholder of Stock Exchange is Securities Company which hold business license to conduct the activity as Broker-Dealer. Based on the explanation on article 8, the purpose of Stock Exchange is to provide system and or facility of securities trading and parties which are able to conduct securities trading in Stock Exchange is only Securities Company which are conducting activity as Broker-Dealer, so that the shareholder is limited only

to Securities Company which hold business license from OJK as the Broker-Dealer. Until now, at least there are 103 Securities Companies that become the member of Indonesia Stock Exchange, particularly which functioned as Broker-Dealer.<sup>154</sup>

This type of relationship may lead to a non-favorable situation in the enforcement of membership regulation and the other capital market regulations, in which at the very first place that the role and purpose are to protect the public interest. Due to the nature of the relationship between on the one hand that the securities company is a shareholder of stock exchanges, and on the other hand he is a member of the stock exchanges, it becomes difficult. This relationship is indeed very possible causes the conflict of interest between these two statuses. Because in one side that the board of exchanges must protect and respect the shareholders, which have great power, but on the other side the board of exchanges also must have the courage to undertake disciplinary action on members which violate the regulations.

Despite of Indonesia Stock Exchange is a limited liability company but the element of membership is existed because there must be a separation of status as in between shareholder and member. Thus in one side that the securities company as the member of stock exchanges and also in other side as the shareholder of the exchanges.<sup>155</sup> Consequently, if the Securities Company is no longer becoming the member of stock exchange

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<sup>154</sup><http://www.idx.co.id/id-id/beranda/anggotabursaamppartisipasi/profilanggotabursa.aspx> last accessed on 22nd of June 2016 at 9pm.

<sup>155</sup>See Point II of Regulation III-A about the Membership of Stock Exchanges

because he has no longer fulfill the requirement anymore, therefore that Securities Company is automatically not becoming the shareholder of stock exchange and within three months that Securities Company shall sell his share to another Securities Company which still as the member of exchange.<sup>156</sup> As if that selling of share is unsuccessfully done, meaning that no one is buying the share, therefore the stock exchange will sell it by auction within three months later, if this is unsuccessfully again, hence the stock exchange will buy it with the normal price.

The provision which regulates on annual budget plan of stock exchange and the use of Stock Exchange's profit shall be arranged in accordance with the provision that determined by OJK and reported to him in order to get approval, Indonesia Stock Exchange is forbidden to distribute dividend toward his shareholders from the profit that have been gained and those profits shall be used for the interest on the development of company, it is set up as the form of limitation on that sense of profit oriented.<sup>157</sup> Automatically, as the consequence of this provision that this will lead to a contradiction between Capital Market Law and the Indonesian Limited Liability Company Law. Whereas based on Article 52 point 1 (a) has been defined that a share gives rights for its shareholders for accepting a dividend. Theoretically that Indonesian Limited Liability Company Law as the *umbrella act* from all the legal cases concerning on the company's problem, therefore this will lead to a question which one should be prioritized whether

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<sup>156</sup> Nindyo Pramono, *Menyibak Masa Lalu, Menggapai Masa Depan Pasar Modal Indonesia Menuju Milenium III*, Loc. Cit., page 11.

<sup>157</sup> Nindyo Pramono, *Menyibak Masa Lalu, Menggapai Masa Depan Pasar Modal Indonesia Menuju Milenium III*, Loc. Cit., page 12.

Indonesian Limited Liability Company Law or Capital Market Law. Shall there be a principle of *lex specialis derogate legi generalis* in here. Based on Article 127 of Law Number 40 of 2007 about Indonesian Limited Liability Company has stated that for a company which runs its activity in capital market field that this provision is valid for him. But, seeing that the stock exchange's activity is different with others, therefore the possibility to open a special regulation for him is possible. But again, this is still unclear enough because this company is dealing with the public interest because of Indonesia Stock Exchange as a market place. Whereas stock exchange has more bargaining position on this situation if it is compared to public due to its function, therefore the possibility to misuse its position is very possible enough.

As an SRO, stock exchange has to face the fact that there shall be two interests who should be highlighted; those are the investors' interest and the issuers which listed its securities in the stock exchange's market. If the stock exchange is unable to do its job properly, the misuse of power is very potentially conducted by stock exchange by involving itself partially in the market mechanism.

For self-regulation to work properly, SRO's must be oriented towards serving their members and users. Its goal should be to provide efficient services that will improve the business prospects of its constituents. For example, if there is a problem with lost securities, stock exchanges take initiative and devise appropriate procedures and rules. The question is raised



as to how exchange management may impose sanctions on exchange members if they are elected by the members themselves.

There are three principals that must be observed if self-regulation is to work properly.<sup>158</sup> First, the rules proposed by exchange management must have the support of the majority of the membership. Without this support, the exchange management does not have the necessary authority to enforce the rules. Second, the exchange may not establish rules which although supported by its members, are contrary to the interests or investors and market development. Third, if an exchange is unwilling or unable to enforce a rule against a powerful member, the government regulator may have to supplement exchange action.

Equal treatment by Indonesia Stock Exchange towards all of its shareholders including the members which are broker dealer which participate in the trading floor, the form of equal treatment can be as same fee for every transaction, because each of the broker-dealer up until now still compete with lowest fee transaction between one to others broker which it can lead to the unfair competition. Therefore Indonesia Stock Exchange shall make a strict regulation concerning this issue to implement the fairness principle.

The ownership structure in Indonesia Stock Exchange whereas the members as the shareholders might lead to a non-favorable situation in the enforcement of membership regulation and the other capital market regulation, in which the very first place that the role and purpose are to

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<sup>158</sup> I Putu Gede Ary Suta, *Foundations of Our Capital Market, Op. Cit.*, Page 174.

protect the public interest. In one side that the board of exchange shall protect and respect the shareholders, which have great power, but on the other side the board of exchange also must have the courage to undertake disciplinary action on members which violate the regulation.

## **2. Transparency or Disclosure;**

Indonesia Stock Exchange is non-profit motive, while theoretically, the purpose of common company is for-profit motive. This shall be clarified and evaluated deeply, on which part that Indonesia Stock Exchange shall be non-profit motive; however the Indonesia Stock Exchange still gain profit from its activities by organizing the securities trading activities. Moreover the function as a marketplace which gives a responsibility to supervise the market mechanism directly, this is difficult for Indonesia Stock Exchange to keep its objectivity, independency and uphold the transparency to public.

The characteristic of Indonesia Stock Exchange as SRO has not answered the question whether that company is actually non-profit motive or not. Because those characteristics cannot be strongly being used to argue that the company is non-profit motive. Speaking of the fact that from the listing fee and transaction fee can be collected profit therefore that stock exchange as SRO's company cannot be said as non-profit motive, based on the Government Regulation Number 45 of 1995 about the Activities in Capital Market has been clearly admitted that the existence of profit within

that company.<sup>159</sup> Consequently, this answers a question that stock exchange is basically for profit oriented and in accordance with the Indonesian Limited Liability Company Law.

The problems above can be analyzed based on the practice whereas there shall be a problem inside, it might be caused by gap interest between the shareholders as the owner of company and the board of company as the agent. Shareholders have an interest in order that their fund which had been invested gives a maximum return. While the board of company has interest toward the incentives gained from the fund management of shareholders.<sup>160</sup>

This conflict of interest naturally will happen in the ownership structures consist of two types, which are dispersed ownership towards outside investors and ownership structures with the control on some concentrated ownership.<sup>161</sup> When the ownership structures of company with the control on some concentrated ownership, this is what happened in Indonesia Stock Exchange nowadays, in which the shareholders of company are only controlled on some members. As has been clearly stated by Regulation Number III-A about Exchanges Membership on the requirement of exchange member point II.2. defined that the securities company which want to be the member shall own the exchange's share. This condition causes a conflict of interest and a lack of disclosure during the decision making process by the boards of company, because there is no necessity

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<sup>159</sup> Nindyo Pramono, *Menyibak Masa Lalu, Menggapai Masa Depan Pasar Modal Indonesia Menuju Milenium III*, Loc. Cit., page 12.

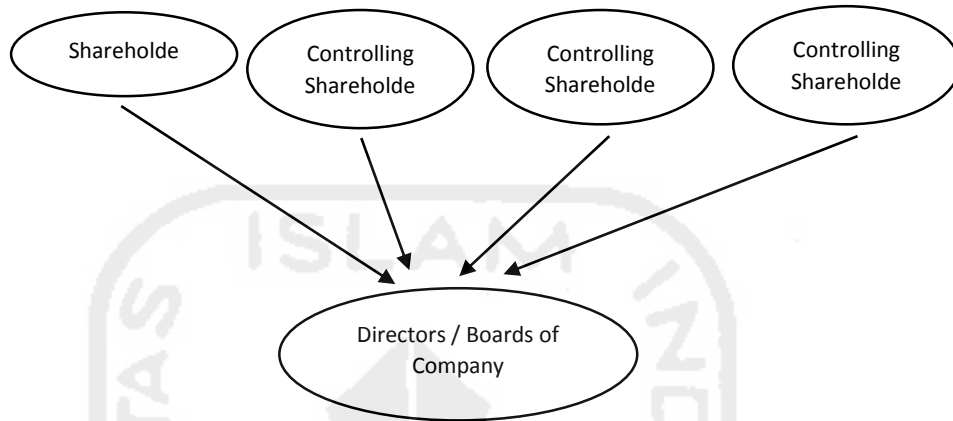
<sup>160</sup> Antonius Alijoyo dan Subarto Zaini, *iKomisaris Independen*, Jakarta: PT Indeks, 2004, page 7.

<sup>161</sup> Indra Surya dan Ivan Yustivandana, *Penerapan Good Corporate Governance: Mengesampingkan Hak-Hak Istimewa Demi Kelangsungan Usaha*, Op. Cit., page 3.

towards the outside investor and well implementation of Good Corporate Governance.<sup>162</sup>

(Table III), Ownership Structures with the control on Concentrated

Ownership:



Corporate Governance deals with the issue which is arisen from separation between the owner of corporation and its supervisors which run the company.<sup>163</sup> Corporate Governance focuses its attention on the directors' policy, the issue is developed from the audit committees and report from boards of company towards shareholders and also the management supervision conducted by commissioners. When the ownership of company is separated from its managers, consequently it is needed a system which can be as an intermediary for all the problems, and that is Corporate Governance.<sup>164</sup>

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<sup>162</sup>*Ibid.* Page 4.

<sup>163</sup> Tambunan, P. July, "Pentingnya Good Corporate Governance dalam Dunia Bisnis," *Business News*, 16 Agustus 2000, page 1.

<sup>164</sup> Misahardi Wilamarta, *Hak Pemegang Saham Minoritas Dalam Rangka Good Corporate Governance*, Jakarta: Program Pascasarjana FHUI, 2002, page 45.

In most of the countries, rights of share ownership consist of two types. Firstly, the shareholders gain a right from the company profit based on the percentage of share which is owned (*cash flow rights*). Secondly, the shareholder can use the control upon the company assets by using the vote rights which is owned (*control rights*). The percentage level from those two rights will underlie the difference of the financial system or corporate governance system which is followed by most of the countries; those are *outsider system* and *insider system*.<sup>165</sup>

*Outsider system* is followed by United State and England. Some countries that follow *outsider system*, the structure of ownership from the company is based on *dispersed ownership*. The principle of ‘one share one vote’ is used on the establishment of *corporate governance* to distribute the voting rights between the shareholders. Theoretically, by using the voting rights that the shareholders may appoint the boards of company or even express their interest on the company’s policy plan.

The characteristics of *outsider systems* can be further explained below:<sup>166</sup>

1. The share ownership is dispersed to public;
2. The existence of company law which protects the shareholder's interest;
3. The pressure on the implementation of regulations on capital market for the minority shareholders;

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<sup>165</sup>Indra Surya dan Ivan Yustivandana, *Penerapan Good Corporate Governance: Mengesampingkan Hak-Hak Istimewa Demi Kelangsungan Usaha, Op. Cit.*, page 13.

<sup>166</sup>*Ibid*, page 14.

4. The strict provision regarding on the disclosure information.

*Outsider system* has similarity with the *market-based systems*. This *outsider system* has characteristic by using the legal approach and regulation focusing on the protection of capital market and designed to establish the trust among the *non-controlling investors*. This legal pattern in countries that follows this system has clearly supported the rights of shareholders on controlling and making the company more accountable.<sup>167</sup> The existed regime in those some countries, from the past had established based on the assumption that the ownership of company dispersed towards the investors which is interrelated one to others and they need trusted information and the flow information reasonably available, which will be used in the decision making process. Since long time ago, the structure of regulation which is made provides all information required by investors and giving a fair treatment to all investors in getting access to information to protect their interest.

Furthermore, this system is described as a system which relies on the disclosure. Some countries which follow market-based systems had conducted elaboration on some regulations in order to prevent concentrated shareholders, particularly the shareholders which have the controlling power to use the material information which are not disclosed to public yet.

On the other hand, some countries which follow the *insider systems* will have a pattern which concentrating of share ownership on some of

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<sup>167</sup>*Ibid*, page 15.

individuals. Those parties have *control rights* beyond the *cash flows rights* in company. The examples of countries which follow this system are Germany, France, and Italy. Control of company by some of individuals often happens in Asia included Indonesia, the state also has a role to control the company.<sup>168</sup>

The pattern of company funding from *insider system* usually is dominated by banking and the high of *debt/equity ratios*. Bank seems like has a very complex relationship and has a long period of time with their debtors. While the capital market loses to develop compared to the advance of capital market which achieved by the countries which follow the *outsider systems* such as the United States.<sup>169</sup>

Unlike *outsider system* which has a strict regulation regarding on the disclosure, *insider system* gives an ease on exchange information which is not disclosed yet to public. The regulator's policy also tends to make some provisions which prohibit speculative transactions rather than how to encourage the quality of disclosure.<sup>170</sup>

In the development of Indonesian capital market, it is admitted that one of the causes of companies' vulnerability in Indonesia towards the turmoil in law and economy is a weak implementation of Good Corporate Governance in organizing the company itself. That condition is marked by the standard of the report, no independence director and being doubt

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<sup>168</sup> *Ibid*, page 16.

<sup>169</sup> *Ibid*.

<sup>170</sup> Stipon Nestor and John K. Thompson, "Corporate Governance Patterns in OECD Economies: Is Convergence Underway," This paper was presented on Corporate Governance Seminar in Asia: A Comparative Perspective, Paris: 2001, page 25.

towards independency of boards of company. Besides that, the mechanism of which push the company to obey the rules and upholding the law is still less than enough. The sanction for them which violates the regulation is not sufficient, especially when the condition of law and economy are weak.

Liu and Zu<sup>171</sup> did a research on GCG and one of the GCG's level appraise is presented by Top Share, major shareholders that become controlling shareholders. The existence of major shareholder that becomes controlling shareholder will cause expropriate to minor shareholder. Some of the Corporate Governance Report shows that the bigger dispersion of a company's ownership will make GCG applied better in the company. Claessens<sup>172</sup> proves that a concentrated ownership especially a single owner will cause GCG application in the company worse.

Concerning on the share ownership of Indonesia Stock Exchange, the insider system which is applied nowadays is considered less maximum on upholding the disclosure principle. Because Indonesian capital market loses to develop compared to the advance of capital market which achieved by the countries which follow the outsider system, one of the reason is because outsider system which has more strict regulation regarding on the disclosure, while the insider system gives an ease on stock exchange information which is not disclosed yet to public.

### **3. Accountability;**

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<sup>171</sup> Liu, Q., and Z. Lu, *Corporate governance and earnings management in the Chinese listed companies: A tunneling perspective*, *Loc. Cit.*, page 885.

<sup>172</sup> Claessens. S., Djankov, *The separation of ownership and control in East Asian corporations*, *Journal of Financial Economics* 58, page 81.



Concerning on the appointment of directors and commissioners of stock exchange, this kind of appointment is also different with common company. As has been regulated in Regulation Number III.A.3 about the requirement of director candidates and commissioner candidates of stock exchange and BAPEPAM chairman decree Number: Kep-04/PM/1996, 17<sup>th</sup> of January 1996, had been defined that the name of directors and commissioners candidate can be proposed in one package of director or commissioner candidates by a group of shareholders which have been fulfilled certain requirement based on the total frequency and trading value in the stock exchange. Those directors and commissioners candidates shall be proposed first to OJK in order to get an approval, at least twenty one days before the general meeting of shareholders.

Beside that functioning as supervisor upon the directors' deed, the board of commissioners also shall be consisted from the representative of several parties which has direct interest with the organization of stock exchange, those are issuer, representative of stock exchange's member, representative of investor and representative of government.<sup>173</sup> This kind of appointment may lead to a conflict of interest between those parties because they may have their own interest at the very first place. Therefore mechanism of appointment shall be evaluated such as the parties may not come from the direct interest with the organization of stock exchange.

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<sup>173</sup> Nindyo Pramono, *Menyibak Masa Lalu, Menggapai Masa Depan Pasar Modal Indonesia Menuju Milenium III*, Loc. Cit., page 12.

The corporate governance structure specifies the roles of different participants in the organization. It provides a mechanism through which the objectives of the company are set, and for attaining those objectives and monitoring performance. Good Corporate Governance is an important step in building market confidence and encouraging more stable, long-term domestic and international investment flows. The corporation is viewed as an increasingly important driver of wealth creation. To serve this wealth creating function, corporate must operate within a framework that keeps them focused on their objectives and accountable for their actions.

Klein<sup>174</sup> found that board of commissioner from independent side can be more effective in supervising action. Cornet<sup>175</sup> also stated that operation performance and stock return is getting better as independent commissioner increase. Chen<sup>176</sup> also found out that characteristic of the board is similar to independency, a number of meetings and period of executive board charges is related to the fraud level in a company. While then, Liu and Lu<sup>177</sup> stated that a board structure does not only act as a controlling mechanism in the process of making a financial report but also prevent controlling shareholder to do activities that can cause loss to the

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<sup>174</sup> Klein, *Audit committee, board of director characteristics, and earnings management*, Journal of Accounting and Economics 33, 2002, Page 375.

<sup>175</sup> Cornet, M.M., A.J. Marcus, *Corporate governance and pay-for-performance: The impact of earning management*, Journal of Financial Economics 87, 2008, page 357.

<sup>176</sup> Chen, G., Firth, *Ownership structure, corporate governance, and fraud: evidence from China*, Journal of Corporate Finance 12, 2006, page 424.

<sup>177</sup> Liu, Q., and Z. Lu, *Corporate governance and earnings management in the Chinese listed companies: A tunneling perspective*, Journal of Corporate Finance 13, page 881.

other shareholder. In Indonesia, Siregar and Utama<sup>178</sup>, system that exists in Indonesian's company uses two-tier system that consists of commissary board and direction board. The function of commissary board is to watch over the actions of direction board. To prevent loss of minor shareholder, Bapepam insists that 30% of commissary board must be independent and major shareholders.

Director Duality means someone acts as a director while at the same time, he/she is also the chairman of board. Director Duality existence will give chances to power concentration which can lead to management discretion. Split Director will do more effective monitoring. This will be different if Director Duality exists, which can make monitoring action less effective.

An Insider system which is applied by Indonesia Stock Exchange nowadays whereas only the member which can be the shareholder of stock exchange is considered less maximum. While the outsider system is considered more maximum because it has characteristic by using legal approach and regulation focusing on the protection of capital market and designed to establish the trust among the non-controlling investors. This legal pattern in countries which follows this system has clearly supported the rights of shareholders on controlling and making the company more accountable.

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<sup>178</sup> Siregar, S.V., and S. Utama, *Type of earnings management and the effect of ownership structure, firm size, and corporate-governance practices: Evidence from Indonesia*, International Journal of Accounting 43, page 1.

#### **4. Responsibility.**

Indonesia Stock Exchange at least has two responsibilities; those are towards its shareholder and towards its stakeholder. On its implementation, the responsibility towards its shareholder is considered well implemented by protecting their interest. But, responsibility towards its stakeholder including the public interest is not fully implemented yet because the performance of Indonesia Stock Exchange on running its function and duty to organize the securities trading activities in Indonesia is still questionable due to its objectivity and independency.

A fact that shall be faced by Indonesia Stock Exchange is there are two interests those are investors' interest and issuers which listed its securities in market. The role of exchange is very important on this condition, therefore each of the board of company and all the parties within the exchange shall uphold their responsibility. The implementation of fiduciary duties are considered less maximum due to the composition of board of company which come from the parties which have direct interest towards the organization of stock exchange.

#### **A.2 Fiduciary Duties as a mandatory to enforce and increase the quality of Good Corporate Governance**

Fiduciary duties adheres to every parties who have control towards the company, those are director, commissioner, and all the shareholders actively taking role on the process of decision making and its implementation. Besides that, fiduciary duties also adheres to the parties

who are not actively going along towards the decision making process but they have an access to know the policy planning and implemented it and the possibility to make company suffered generally by them.

In Law Number 40 of 2007 about Limited Liability Company, the existence of fiduciary duties is strongly admitted. The transplantation of fiduciary duties leads to juridical consequence that the implementation of fiduciary which regulates the fiduciary relationship between director and commissioner to company, and also the shareholders. Historically, this principle comes from the trust law. Whereas a fiduciary (director / commissioner) accepts the duty which is given by entrustor (company), therefore a fiduciary has rights which he is bound to exercise upon behalf of another or for the accomplishment of some particular purpose. In the fiduciary relationship, there are some parties such as fiduciary, entrustor, and the beneficiary.<sup>179</sup> Entrustor is as party which gives an object towards fiduciary. A fiduciary is as a party which manages that object for the interest of beneficiary. A beneficiary is as a party which accepts the benefit upon the management which is done by the fiduciary.

The implementation of fiduciary principle in the relationship of director as the board of company is that the director as a party which authorized to manage the company and all the resources owned by company. Therefore, it is very needed the legal principle which strictly limiting all the possibility the director's deed can use his position to access

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<sup>179</sup> Wahyu Kurniawan, *Good Corporate Governance Dalam Aspek Hukum Perusahaan*, Jakarta: Pustaka Utama Grafiti, 2012. Page 70.

the company for his own interest and all the parties which affiliated with him.

In every legal relationship leads to legal duty towards parties involved. Thus, the legal relationship between director as fiduciary from company also leads to legal duty which adheres to director. in which the duty of director is a fiduciary duties. As has been clearly stated by Carlin noted from Jean J. Du Plesis that “*fiduciary duties are imposed on person who stand in such a position of trust and power over another that the law requires to act in the latter’s best interest.*”<sup>180</sup>

If it is observed from two perspectives, fiduciary duties are seen from narrow perspective and broad perspective. Narrow perspective is fiduciary duties only boards of company towards the shareholders, while the broad perspective is that boards of company towards all the stakeholders.

Law Number 40 of 2007 asserts the non-existence of company may modify the fiduciary duties. The use of mandatory model in Indonesia is affected by empirical factor. The structure of share ownership in Indonesia indicates the centralized on one party or a group of certain party.<sup>181</sup> That share ownership is not only in the private company but also in the public company. Consequently, this centralized ownership is the majority shareholders dominate all the structure of company such as general meeting of shareholder, board of commissioner, and board of director. Another

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<sup>180</sup> Jean J. Du Plesis, *Research Guide: Director’s Duties, Deaking Topic 6: Director’s Duty to Act in Good Faith and in The Company’s Best Interest*, 2001, page 4.

<sup>181</sup> Zhuang, Juzhong; David Edwards and Virginita A. Capulong, *Corporate Governance and Finance in East Asia: A Research of Indonesia, Republic of Korea, Malaysia, Philippines, and Thailand*, *Asian Development Banking Working Paper*, page 17 in Wahyu Kurniawan, *Good Corporate Governance Dalam Aspek Hukum Perusahaan*, *Op. Cit.*, page 86.

consequences is the non-existence of check and balance system. Therefore, the role of state is urgently needed in this situation.

As has been known that fiduciary duties is regulated in Law Number 40 of 2007, that there are at least four points highlighted, those are duty to conduct in a good faith; duty to prevent the conflict of interest; duty to conduct any activities in the right purpose; and carefulness and diligence. Therefore, based on this legal perspective, that fiduciary as a mandatory which shall be well implemented in order to ensure the implementation of good corporate governance due to its importance. Since this mandatory model is able to give protection towards all the parties and may make a check and balance among them. As has been the purpose of the corporate law which is not only to protect the inner circle interest but also the external factors from it.

All the boards of company shall conduct their obligation based on the duty of loyalty and due care, since these are as the principal of fiduciary duties. Duty of loyalty and due care are different. Duty of loyalty emphasizes on regulation which pushes the director maximizes the prosperity to the authority giver than his own prosperity. While due care tends to give a direction towards director to be careful in certain condition during running his power and authority.<sup>182</sup>

Besides that, the good faith is also regulated in Law Number 40 of 2007 on article 97 point (1), (2), and (5)b. *“Director has obligation over all*

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<sup>182</sup> Hintmann, C.G, *You Gotta Have Faith: Good Faith in The Context of Directorial Fiduciary Duties and The Future Impact on Corporate Culture*, 2005, 49 Saint Louis Law Journal, page 578.

*the management of company. The management as intended by point (1), is compulsory conducted by every member of director by good faith and fully responsible. Board of director cannot be liable over the losses as long as he can prove that he has conducted the management by good faith and due care for the interest and appropriate with the purpose of company.”*

Duty to prevent the conflict of interest is regulated on article 97 point 5 Law Number 40 of 2007 whereas the members of director are not liable over the losses as long as he can prove that he does not have any conflict of interest neither direct nor indirect over the action of management which causes the loss of company. According to Bapepam Regulation IX.E.I has described that “*conflict of interest is the differentiation between economic interests of company with the economic interest of board of directors, . Board of commissioners, or majority shareholders which can lead the loss of company”*”.

In the recent development, conflict of interest spawned three doctrines which have its own focus. Those are the conflict rule; the misappropriation rule; and the profit rule of opportunity.<sup>183</sup>

The outline of conflict rule is about when director has loyalty towards another party and is not merely for company, there he is not allowed to conduct anything to represent the company during conducting the legal relationship towards the third party which is affiliated with director. As regulated in BAPEPAM Regulation IX.E.1 point 3a described that

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<sup>183</sup> Wahyu Kurniawan, *Good Corporate Governance Dalam Aspek Hukum Perusahaan*, Op. Cit., page 93.



*“transaction which contains conflict of interest shall be granted by independent shareholder or their representative in the general meeting of shareholder”.*

Whereas the misappropriation rule focuses on the misapplication of company property by the board of company. The legal concept of property itself is not only the tangible asset but also intangible asset. Consequently, the information is included as intangible asset. This misappropriation rule is commonly related to insider trading which often happened in the capital market practice.

While the profit rule opportunity has an outline about the fiduciary party is prohibited to use his position for his own profit because this form is a form of manifestation of fiduciary duties. Therefore, the director has to differentiate well between the profit opportunity for company and profit opportunity for himself.

The boards of company also have a duty to act in proper purpose, it has been regulated in article 92 point 2 of Law Number 40 of 2007. Therefore the board of company has to obey the article of association whereas there has been stipulated the purpose of company before they make a business decision policy.

Unlike the American company must have a minimum of two outside directors on its board of directors and appoint an independent, competent audit committee. The problems which appeared in this current situation is that the shareholders are parties which do not participate in the management of company, but in Indonesia Stock Exchange as a market place and SRO

whereas shareholders are also the member of Indonesia Stock Exchange therefore consequently shareholder is also participating the management of company by the role of supervision and the regulatory function. The effectiveness of self-regulation was called into question by this kind of structure because this strongly leads into abuse of power. The SRO has a natural tendency to protect members, and that the amount of control that exchange floor members exercised over exchange regulatory operations and governance ought to be reduced. Therefore this structure shall be evaluated deeply especially on the condition of the securities industry and the performance of SRO.

The system in Indonesia Stock Exchange nowadays as SRO had indicated that the system had failed to impose essential fiduciary standards on board of company included the securities companies which become the shareholder specifically on persons which responsibility it was to handle the purpose of capital market in Indonesia. Regulatory concerns are at the center of this Indonesia Stock Exchange as SRO. Since Stock Exchange plays decisive role in capital allocation and provide key infrastructure for a country's markets. Thus, Indonesian government shall establish a strict regulatory framework to safeguard the operation of stock market.

### **A.3. The Essence of Regulatory Role of Indonesia Stock Exchange should be like:**

1. Organizing a Market and Setting Its Rules

Indonesia Stock Exchange predate government agencies as regulators of equity trading markets, in fact, regulating the trading process was the primary goal behind the establishment of an organized stock market. Exchange constituted an attempt by a group of brokers to take control of trading in certain equities so as to offer more streamlined trading conditions through increased liquidity in exchange for a fee. As a result, setting out rules that define the operation of the market was inherent in the notion of an exchange. The aim of member regulation was to ensure that all market participants would be reliable trading partners. Thus, Indonesia Stock Exchange sought first to establish certain eligibility criteria to maintain a high-quality marketplace.

## 2. A Public Interest Role for Exchange

While rulemaking for members, listed companies, and trading processes has been a key feature of an organized marketplace, the central role exchanges play in the economy has lent an important public interest perspective to their regulatory function. The exchange is the main gateway through which corporate issuers access public financing, and thus their interest in maintaining a high-quality marketplace coincides with the public goal of more efficient allocation of resources. The exchange should provide liquid secondary markets, which are a precondition for effective primary markets. In addition,

exchange offers others functions that are also beneficial to the wider investing public. For example, by requiring ongoing disclosure about a firm's activities, exchanges reduce information costs for the wider public and contribute to the efficiency of the markets in assessing the true value of that firm's stock. Furthermore, by maintaining orderly markets, exchanges decrease the likelihood of serious market disruptions that could impose negative externalities on the larger economy.

The public interest objective of ensuring an efficient allocation of resources, coupled with exchanges' more concretely self-beneficial motivations to ensure market quality, formed the basis for the extensive use of self-regulation as a regulatory technique in the securities markets. In other words, policymakers noted the significant interest of exchanges in effectively organizing their markets and opted to take advantage of this dynamic to achieve the overarching goal of maintaining fair and orderly markets for investors and promoting market integrity.

### 3. Keep Its Independency and Strict on the Purpose

Stock Exchange as SRO shall keep its independency on running its function and duties, there shall be no intervention from other parties. Therefore, ensuring that directors and other board of company act in a company's best interest, as opposed to their own self-interest is a must.

The public interests in the responsibilities of the exchange are its regulatory role and its place as a part of the financial structure, thus it creates corporate governance needs. Particularly, the composition of the board and key committees (for example the regulation committees and the audit) should be carefully considered. In North America, the strong trend has been to move toward exchanges (and SROs) with 50% - 50% boards to have equal numbers of shareholder or industry representatives and independent non-industry representatives. This governance structure has been installed at the NYSE, NASDAQ, and Canadian exchanges.

When ownership structure of Indonesia Stock Exchange is centralized ownership, this will lead to monopoly control and less in the maximizing the implementation of good corporate governance principles, because it tends to lead the conflict of interest inside the company moreover the majority of boards of company come from the parties which has direct interest with the organization of stock exchange. Therefore its independency and integrity and also the fiduciary duties of the boards of company are really questionable. When the corporate governance is not well implemented yet by Indonesia Stock Exchange, this will become a barrier for him to run the capital market in Indonesia which is orderly, fair and efficient. And it is even also very difficult to compete with others capital market in the world. Therefore well implementation and a standard of good corporate governance principles is one of the keys to implement capital market in Indonesia in order to be better in the future.

From those explanation above, seeing the structure of Indonesia Stock Exchange nowadays which double functioned itself as marketplace and SRO while still the structure ownership on the centralized ownership, thus it is very difficult to keep its independency and integrity to run securities exchange activities in Indonesia and it is not in accordance with the purpose of company itself whereas gaining profit while Indonesia Stock Exchange stated himself that to not for gaining profit instead on the fact that still for gaining profit by the system which is established. Therefore the implementation of good corporate governance had been considered failed or not well implemented yet. Thus, will give an impact to the capital market activities which is it will not create orderly, fair and efficient trading.

#### **B. The Necessity of Demutualization Conducted by Indonesia Stock Exchange**

Financial markets have become increasingly reliant on complex, high-speed technological systems to facilitate trading, Stock Exchange is non-exception. Exchanges worldwide have used technological innovation to develop highly advanced trading systems, which are used to facilitate market transactions. Although the use of technology has benefitted markets and the investing public, markets have also experienced technological glitches that have caused major losses to investors and financial firms. Yet the exchanges that operate and profit from the complex, technological trading systems are immune from liability for any misconduct that may have

contributed to the malfunctions or the losses that ensued. This creates potential for moral hazard: exchanges are motivated by profits and are more likely to engage in risky behavior to maximize profits knowing that they are shielded by absolute immunity.

Underlying this moral hazard problem is the self-regulatory system of Indonesia Stock Exchange. Whereas indirectly the members of Indonesia Stock Exchange get immunity because they are as the owner of the marketplace, SRO will protect the interest of its shareholders by all the most appropriate measures conducted and unknown by external parties including government supervisory body. As same as the Indonesia Stock Exchange as an SRO has authority to issue the rules and supervise itself, in the daily securities activities that it is the one which knows what exactly been happening in the market mechanism.

Good Corporate Governance has become one of the most important parameters to measure the performance of company to increase its quality, this is not only for public company but also being used for limited company. By the condition of ownership structure in Indonesia Stock Exchange which does not implement well of Good Corporate Governance principle yet, therefore the ownership structure should be changed in order to create orderly, fair and efficient trading in Indonesian capital market. This happened in most of stock exchanges in the world.

Changes in the ownership structure of Stock Exchanges have compelled regulators around the world to reexamine the allocation of regulatory authority. Traditionally run as mutual membership organizations,

Stock Exchanges had developed rules for their members, listed companies, and trading processes. Most states had established systems of public oversight that took advantage of the benefits of self-regulation while mitigating the inherent conflict of interest. In the last decade, most Stock Exchanges “demutualized”: they abandoned their traditional non-profit mutual membership structure in favor of a for-profit corporate format. Some privatized Stock Exchanges took the additional step of listing their shares on their own markets.

Most exchanges justified their move to a for-profit structure in the basis of increasing the corporate governance quality and the need to raise to finance their infrastructure expenses.<sup>184</sup> Many corporate governance listing standard questions arise in the context of contests for corporate control. Demutualized exchange tends to have corporate governance provisions to prevent any shareholder from having more than a specified percentage stock ownership.

The introduction of electronic heightened competition among exchanges, both within national borders and internationally, and allowed the emergence of alternative, low-cost trade execution venues. Thus, when Indonesia Stock Exchange wants to increase its quality in order being able to compete with others stock exchange in the world, there shall an action being taken to react on this worldwide securities exchange industry. This is what the purpose based on Indonesian Capital Market blueprint.

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<sup>184</sup> Stavros Gadinis and Howell E. Jackson, *Markets As Regulators: A Survey*, Southern California Law Review, 2007, page 10.



As stated earlier, demutualization is the process of converting a non-profit, mutually owned organization to a for-profit, investor-owned corporation. The members mutually owned exchanges-that is, broker dealers with “seats” on the exchange are also its owners, with all the voting rights conferred by ownership.<sup>185</sup> In contrast, a demutualized exchange is a limited liability company owned by its shareholders. Trading rights and ownership can be separated; shareholders provide capital to the exchange and receive profits, but they need not conduct trading on the exchange. Therefore the demutualized exchange will have different governance structures in which outside shareholders are represented by boards of directors.

Demutualization will not affect the functions of the Exchange as a self-regulatory organization. Instead of shifting its function to more focus on its duty as rulemaking and regulatory body during the securities exchange activities. Demutualization is at least perceived to create a conflict of interest between the profit motive of an exchange and its regulatory function, there have been a number of major changes such as separating the function of SRO to focus on the regulatory function and then making the holding company for profit only thereby avoiding some of the conflicts of interest issues. Nasdaq has taken this approach. In April 2000,<sup>186</sup> the NASD started to demutualize and created two subsidiaries: NASD Regulation INC.

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<sup>185</sup>Reena Aggarwal, *Demutualization and Corporate Governance of Stock Exchanges*, Loc. Cit., page 6.

<sup>186</sup>*Ibid*, page 14.

(NASDR) was the regulatory arm and the Nasdaq Stock Market the commercial trading arm. This set-up reduces the conflict of interest issues.

Since the demutualization by the Stockholm Stock Exchange which took place in 1993 with the change of its organizational form from a non-profit to a for-profit, publicly listed organization, a significant number of stock exchanges have experienced similar changes, this process gaining a global scale. For example, the Australian Stock Exchange became one of the first stock exchanges that went public and became a listed company. In the same way, the London Stock Exchange, the Deutsche Borse, alongside with other major European stock exchanges also become public companies. In Americas, the Toronto Stock Exchange demutualized in 2000, followed by its owner, the TSX Group, which went public in 2002. In Asia, both of the most important stock exchanges: Hong Kong Stock Exchange in 2000 and Singapore Stock Exchange in 1999 are already listed companies. The only significant and important stock exchange which did not list its share (despite the fact that it demutualized in 2001), is the Tokyo Stock Exchange. The United States, the Chicago Mercantile Exchange demutualized in 2000. Also, India, Pakistan, Brazil, the Philippines, and some other countries' stock exchanges announced in 2005 their plans to demutualize and to list their shares.<sup>187</sup>

In this current situation whereas Asia as an emerging market, the case of Malaysia may become a reflection for Indonesia Stock Exchange to

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<sup>187</sup>Saadia Altaf, *Demutualization of Stock Exchanges, A Case Research: London Stock Exchange and Hong Kong Stock Exchange*, *Loc. Cit.*, page 12.

conduct demutualization. In Malaysia, there is Kuala Lumpur Stock Exchange (KLSE) as a marketplace of securities exchange. KLSE is a public company limited by guarantee incorporated in 1976 under the *Companies Act 1965*.<sup>188</sup> It has no shareholders and no share capital, only members, its membership comprising of two classes, voting and nonvoting, as defined in article 1 of the KLSE's *Articles of Association*.

Voting members are made up of companies that carry on the business of dealing in securities, which are stock broking companies. Nonvoting members may either be dealing members or non-dealing members. Dealing members refer to executive directors of the member companies, which hold a dealer's representative license, while non-dealing members include individual and corporate shareholders and nonexecutive directors of the member companies.

The KLSE's *Articles of Association* provide that the composition of its board of directors shall not be fewer than six and not more than nine persons. Under section 8(3) of the *Securities Industry Act 1983* and article 9.2(a) of the *Articles*, the Minister of Finance may appoint no more than four persons to be on the board to represent the interest of the public. Under section 8(4) of the same *Act*, one of the four appointed board members shall be the executive chairman of the board.

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<sup>188</sup>Shamshad Akhtar, *Demutualization of Asian Stock Exchanges – Critical Issues and Challenges*, in *DEMUTUALIZATION OF STOCK EXCHANGES: PROBLEMS, SOLUTIONS AND CASE STUDIES*, *Loc. Cit.*, page 323.

The KLSE is a self-regulatory organization which governs the conduct of its members and member stock broking companies in securities dealings. KLSE regulates its member through its *Memorandum and Articles of Association (M&A)* and *Rules of KLSE*. The *Memorandum* sets out the objectives of a Company and the *Articles govern the internal affairs of KLSE* as well as regulate the KLSE's relationship with its members.

KLSE has monitoring and risk management systems, which incorporate internal procedures and principles to enable it to deal with default risk, settlement risk and major market disruptions. In this regard, KLSE has formulated specific rules for the purpose of managing risks, which were developed in consultation with the Securities Commission.<sup>189</sup>

In February 2001, the Securities Commission released a *Capital Market Master plan (CMP)*, to provide the capital market with a blueprint development process for exchanges, the *CMP* recommended that given the increased dynamism and competitive pressures of the global market and to strengthen the regulatory framework, and also the efficiency market institutions.<sup>190</sup> A single Malaysian exchange be established through consolidation of all existing exchanges, and that the single Malaysian exchange should demutualize and list on the stock market by 2003. The Malaysian exchanges, like many in Southeast Asia, face serious competition for order-flow and listings from the more developed Singapore and Hong

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<sup>189</sup>*Ibid*, page 327.

<sup>190</sup>*Ibid*, page 329.

Kong exchanges and are struggling to find a niche for themselves. Finally on 2004 KLSE conducted demutualization and listed the company share.<sup>191</sup>

## **B.1 Reasons and forces that led to demutualization of Indonesia Stock Exchange**

### **1. Conflict of interests between the existing owners and affiliated parties;**

Driven from article 8 of Law Number 8 of 1995 defined parties which are allowed being shareholders of Indonesia Stock Exchange are members which hold business license as broker-dealer whereas this causes some problems presented above. Such quality standard of good corporate governance is not implemented well yet and still questionable.

In the mutual exchange such as Indonesia Stock Exchange, the main problem is the imbalance between members/owners' interest with the investor's interest. Just as stock exchanges become more and more sophisticated, the interests of various member groups began to diverge. This has led to tremendous tensions in the governance and decision-making of stock exchanges. In some sense, demutualization can be perceived as a solution of conflict of interest by segregating the ownership from the membership and trading rights thus allowing a proper

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<sup>191</sup> Serra Eren Sarioglu, *Changes In The Corporate Governance and Ownership Structure In Stock Markets*, *Annales Universitatis Apulensis Series Oeconomica*, 14(2), 2012, page 548.

running of the stock exchanges' management. Also by transforming itself into a for-profit investor owned organization, the boards of company of stock exchange are able now to focus on a single group, its owners. This performance improvement could be explained by the fact that self-listing is a perfect opportunity for the board of company of stock exchange to accept profitable projects that they would not have taken under the mutual structure.

Despite its advantages, demutualization is not without its distinct regulatory challenges, such as how to rationally divide governance of the demutualized exchange among other exchange, the government and other self-regulatory organizations. However, one of the most important regulatory challenges inherent in the demutualization of stock exchange is the management of conflict of interest. The for-profit nature raises the possibility that exchanges may be so preoccupied with profits that it might:

- (1) Abuse its position as both market participant and market regulator to its own advantage;
- (2) Sacrifice effective regulation in order to achieve the short term goal of maximizing shareholder profits.

Conflict of interest can be managed in a number of ways, notably by reorganizing the corporate structure of the exchange itself. Many demutualized exchanges have addressed conflicts

of interests by dividing their business branch from their regulatory branch. The legislation provides another means by which conflicts of interest can be managed. For example, the government may pass legislation limiting share ownership in a demutualized exchange so as to avoid giving a single shareholder undue influence over the affairs of the exchange, or may impose stringent reporting obligations on a demutualized exchange to ensure that it is in compliance with its supervisory obligations.

Therefore, by avoiding this conflict of interest, it will automatically increase the quality of corporate governance in the securities exchange activities especially on the stock exchange organization such as Indonesia Stock Exchange nowadays whereas good corporate governance standard has become a problematic issue.

## **2. Increasing role and competition from the alternative trading systems;**

The technological improvements from the last decade offered the possibility of conducting trades using remote connections and thus a number of alternative trading platforms have risen. This fact put a lot of pressure on the traditional stock exchanges in the way that they were pushed to adopt new and more efficient electronic trading systems. One interesting fact is that in Europe where the process of demutualization started

much earlier than in the rest regions of the world the weight of the Electronic Communication Networks (ECNs) is still very small and not significant. By following the demutualization path the European stock exchanges were able to gain more operational freedom. The new electronic trading systems which were adopted by stock exchanges allowed them to reduce the importance of regional location in the process of executing trades. In return, this put a lot of pressure on small regional exchanges because the liquidity began to move towards larger exchanges. As a result, the change in the organizational structure from mutual to publicly-listed companies opened for these exchanges the opportunity of undertaking mergers and acquisitions just to face this growing threat. Also by adopting the new technological developments the stock exchanges could thus integrate better their trading activities with clearing and settlement, which in turn also led to consolidation in the securities industry.

### **3. Mergers between financial exchanges around the world.**

Mergers and acquisitions also can be viewed as a factor that fastened the process of demutualization, because this gives the opportunity for stock exchanges to face the reality of the changes in the capital market environment, enhance available synergies and even to survive. From the most recent merger news, NASDAQ Stock Market declared that it is now in the last



stage of a definitive agreement with Philadelphia Stock Exchange concerning the acquisition of the later one.<sup>192</sup> Also alongside with Philadelphia Stock Exchange acquisition, NASDAQ was engaged in a deal with Borse Dubai concerning takeover of Scandinavian exchange operator OMX. On May 25, 2007 NASDAQ agreed to buy the Swedish-Finnish financial company that controls 7 Nordic and Baltic Stock Exchanges OMX for \$3,7 billion to form NASDAQ OMX Group. As of February 27, 2008, the deal has just been completed. This deal supposes that Borse Dubai after the acquisition of OMX will pass it to NASDAQ for 19,9% of the newly created company alongside with the 28% of NASDAQ for share in London Stock Exchange. Also during the recent years world's biggest futures exchange was created as a result of the merger of the Chicago Board of Trade (CBT) with Chicago Mercantile Exchange (CME). From other mergers plans, there were announced some rumors about a possible partnership of KLSE with CME. The possible partnership with KLSE is explained by the fact that KLSE at the moment is looking for new sources for expanding its business just in order to face the competition from Singapore Stock Exchange, its neighbor, which had a very high growth in options trading in the recent years.

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<sup>192</sup>Saadia Altaf, *Demutualization of Stock Exchanges, A Case Research: London Stock Exchange and Hong Kong Stock Exchange*, Loc. Cit., page 18.

The present tendencies show that the factors that have supported the demutualization of stock exchanges are going to be important in the future as well. The non-profit organization structure is in many aspects too limited and is frequently driving to decision blocking as competing interests influence the stock exchange. Most of stock exchanges have accepted this and already transformed themselves into for profit corporations.

**B.2 At least there are two types of demutualization that can be chosen by Indonesia Stock Exchange, those are:<sup>193</sup>**

- (1) **Direct Demutualization**, in this model of demutualization, each of SROs which will conduct demutualization each other by conducting public offering of share towards other parties;
- (2) **Holding company**, in this model of demutualization, the Stock Exchange organization, and existing SROs will establish the holding company as the majority shareholder of 100% and the SROs will be the sister company which runs the regulatory function of securities exchange activities. Holding company will conduct the public offering or become the public company, while the SROs and or some supporting services organization will be run by sister company.

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<sup>193</sup> Nindyo Pramono, *Menyibak Masa Lalu, Menggapai Masa Depan Pasar Modal Indonesia Menuju Milenium III*, Loc. Cit., page 15.

**Subsequently, a three-step process toward demutualization ensued:**<sup>194</sup>

- 1) Issuance of privatey placed stock;
- 2) Conversion into exchange status; and
- 3) Issuance of public stock.

**There are three distinct models for the division of regulatory responsibility for securities markets.**<sup>195</sup> These three models shaped the direction of post-demutualization reforms in each jurisdiction; countries in each cluster responded similarly to the challenges of stock exchange transformation. More specifically, countries in the “Government-led Model” (France, Germany, and Japan) provide central governments with direct channels of influence over securities markets regulation. These jurisdictions reacted to stock exchange demutualization by enhancing the efficiency of government supervision: they reshuffled the organization of their administrative agencies and increased their already strong regulatory powers. The “Flexibility Model” countries (the United Kingdom, Hong Kong, and Australia) traditionally relied heavily on market participants and granted them significant leeway in regulating many aspects of their activity. “For-profit” stock exchanges pose greater challenges for these jurisdictions. In response to demutualization, Flexibility Model countries curtailed the powers of SROs and enhanced oversight by administrative agencies. Yet, administrative agencies in these jurisdictions maintain a regulatory

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<sup>194</sup> Jaclyn Freeman, *Limiting SRO Immunity To Mitigate Risky Behavior*, *Journal on Telecommuniaction & High Technology Law*, 2014, page 9.

<sup>195</sup> Stavros Gadinis and Howell E. Jackson, *Markets As Regulators: Loc. Cit.*, page 4.

philosophy of cooperation with market participants, and typically issue guidance rather than mandatory rules. In the “Cooperation Model” countries (the United States and Canada), the regulatory power of stock exchanges extend over most issues, but are exercised under close supervision by government agencies. Instead of substantially limiting self-regulation, governments in the Cooperation Model developed mechanism to insulate stock exchange regulatory activity from the operation of the markets. Thus, under government influence, stock exchanges segregated their regulatory functions in a separate, independently-run subsidiary.

**(Table 2) Corporate Structure of a Mutual and a Demutualized Exchange:<sup>196</sup>**

<b>Area</b>	<b>Mutual Exchange</b>	<b>Demutualized Exchange</b>
Ownership	Members which trade on the exchange	Public shareholders, these may include members, but trading rights and ownership are separated
Aims of the Exchange	Usually to maintain: 1. An efficient, low-cost trading environment; 2. Risk-minimized settlement; and	Usually to: 1. Ensure and increase the corporate governance quality; 2. Maximize gains from shares;

<sup>196</sup> Shamsad Akhtar, *Demutualization of Asian Stock Exchanges – Critical Issues and Challenges*, in *DEMUTUALIZATION OF STOCK EXCHANGES: PROBLEMS, SOLUTIONS AND CASE STUDIES*, Loc. Cit., page 265.

	3. Quality regulatory framework	3. Grow earnings and dividends; 4. Improve product range and distribution; 5. Protect brand quality including by having a quality regulatory framework.
Composition of board and decision-making	1. The board usually comprises mostly or solely member representatives; 2. Decisions are usually made on one member, one vote basis; 3. Decision making power is vested in the board.	1. The board is usually more diversified; 2. Decision usually made on one share, one vote basis; 3. Decision-making power is vested in the board, but it is likely to be more strategic leaving management to operate the business.
Acquisitions and alliances	Not usually a priority.	Likely to be a priority, given a desire to maximize growth.
Capital management	Not usually a priority.	A key priority as management attempts to

		maximize shareholder share value.
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Demutualization in advanced capital markets appear to have been driven by business considerations rather than by regulatory concerns, although in cases such as the NASD/Nasdaq, increased security by regulators has resulted in a re-engineering of governance structure that is compatible with the changes necessary to a demutualization. However, in emerging market countries such as in Asia, regulatory concerns may be the impetus for demutualization which seem, more often than not, to be driven by the authorities in an attempt to wrest control of an institution that serves a public role and as regulator from a self-interested group of brokers, the traditional model fails to deliver an appropriate level of regulation or fails to sufficiently develop the capital markets because the exchange is controlled by the interests of the members which may not be the same interests as those of capital market as a whole.

Historically, securities regulation in advanced economy countries has tended to focus more on the regulation of public companies (disclosure) rather than on the market conduct of participants or marketplaces. This seems to have been due to the origin of exchanges, their special status under legislation and a general lack of innovation or change. The situation has changed enormously in recent years as SROs and exchanges have become a very great focus of securities regulators.

Thus, from the explanation above that the need of demutualization conducted by Indonesia Stock Exchange is very urgent due to the current situation happened in Indonesia Capital Market structure and also in the near future.



## CHAPTER IV

### CONCLUSION AND RECOMMENDATION

#### A. Conclusion

By some previous explanations, therefore it can be concluded as follow:

1. The purpose of establishment of Indonesia Stock Exchange is to run the securities trading which orderly, fair and efficient. It means that a trading is organized based on a clear regulation and consistently conducted. Therefore the basic purpose of stock exchange is to provide a sense of security and an adequate level of protection for the investor. A fair and efficient performance of a stock exchange is a substantial benefit to the public. The spirit of capital market itself is on the disclosure principle. This disclosure principle is one of the main principles which shall be enforced in capital market, in the case of “trust crisis” or “un-trust” from investor towards capital market and financial, therefore the investor will draw out their capital from the market. By the consequences that the market and financial will collapse either partly or wholly. By the disclosure, people will not only know several activities conducted by certain parties, because there has been information which provided, but by disclosure, it is expected the existence of a public control towards certain activities. The demand for the implementation of *good corporate governance* is one of the issues to attract the interest of potential investor on capital market in a state. Because the more



implementation of the principle of *good corporate governance* done, it will automatically give the good impact for the life of capital market generally and as the indication of the good treatment towards shareholders. Driven from article 8 of law number 8 of 1995 that the member of Indonesia Stock Exchange is also the shareholder of the stock exchange, this structure would be definitely causing problems. Because when the member of Stock Exchange is the shareholder, they conduct trading activities and also the Stock Exchange is SRO, it clearly means that in the first place they make the rules and they supervise themselves. By that, many possibilities of problems may occur such as crime in the form of fraud, manipulation of market, and insider trading. Another possibility is the conflict of interest among the parties in the Stock Exchange's structure. Because in the mutual exchange, one of the main problem is the imbalance between members/owners' interest with the investors' interest. The fair stock transaction mechanism is difficult to be achieved due the conflict of interest and transparency issue on this structure. Simply saying, when the shareholder is the member of the Stock Exchange, this might causes problems. When the ownership structure of Indonesia Stock Exchange is centralized ownership, it will lead into monopoly control and less optimum in the implementation of good corporate governance principles, because it tends to lead the conflict of interest inside the company. Even worse, when the majority of boards of company are came from the parties which has direct interest with the organization of stock exchange. Thus, the

independency, integrity and also the fiduciary duties of the boards of company are really questionable. When Good corporate governance is not yet being well implemented by Indonesia Stock Exchange, it will be a significant barrier to run the capital market in Indonesia accordingly to the principle of orderly, fair and efficient.

2. Demutualization can be considered as a solution to increase the quality of corporate governance, for instance, in the the issue of conflict of interest by separating the ownership from the membership and trading rights so that it can lead into proper running of the stock exchanges' management. Also by transforming itself into a for-profit investor owned organization, the managers of the stock exchange are able now to focus on a single group, its owners. This simplification of governance structure allows faster and credible decision-making process. Trading rights and ownership can be separated; shareholders provide capital to the exchange and receive profits, but they need not conduct trading on the exchange. Therefore the demutualized exchange will have different governance structures in which outside shareholders are represented by boards of directors. The move to a for-profit structure in the basis of increasing the regulatory framework or corporate governance quality and the need to rise to finance the infrastructure expenses. Demutualization will not affect the functions of the Exchange as a self-regulatory organization. Instead, it will only shifting its function to be more focus on its duty as rulemaking and regulatory body during the securities exchange activities. Demutualization is at least perceived to

create separating lines between the profit motive of an exchange and its regulatory function, there have been numbers of major changes such as separating the function of SRO to focus on the regulatory function and then making the holding company for profit only thereby avoiding and reducing some of the conflicts of interest issues.

## **B. Recommendation**

1. There should be an amendment of article 8 of Law Number 8 of 1995, whereas the structure of ownership should be changed in order to increase the quality of corporate governance and strengthening the regulatory framework. Thus it will automatically give a positive impact to create orderly, fair, and efficient trading in Indonesia Capital Market.
2. The demutualization conducted by Indonesia Stock Exchange in the form of establishing the holding company.
3. Indonesia Stock Exchange and other SROs shall obey the existing regulations either from the Government or set of regulations which are created by their self as SROs.

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