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Corporate Governance in Indonesian Listed Companies - A Problem of Legal Transplant

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Corporate Governance in Indonesian Listed Companies - A Problem of Legal Transplant

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Abstract

[extract] The purpose of this study is to examine the effectiveness of adoption of the OECD Principles of Corporate Governance by public listed companies in Indonesia. The author argues that the success of implementation of good corporate governance in Indonesia cannot be measured only by adoption of the principles in the code of corporate governance in each listed companies in Indonesia. Some thing was missing when a foreign legal system was adopted in Indonesia. This matter is called “legal culture”. It is an important variable for the success of adoption of a foreign legal system as well as a foreign code such as the Principles of Corporate Governance.

KEYWORDS: corporate governance, Indonesia, OECD Principles of Corporate Governance, South East Asian financial crisis

CORPORATE GOVERNANCE IN INDONESIAN LISTED COMPANIES - A PROBLEM OF LEGAL TRANSPLANT

*William E. Daniel**

Introduction

The South East Asian financial crisis has put Indonesia into the worst financial crisis in its history as a nation. The local currency, the rupiah, depreciated almost 80 percent due to the crisis. The banking industry then collapsed. The collapse of the banking sector was followed by the corporate sector. The crisis also triggered a political and social crisis.

There are many factors that can be blamed as the reasons for the financial crisis in Indonesia. Many studies in Indonesia showed that the most likely reason for the crisis was liberalization in the financial market.¹ This liberalization commenced in 1988 when the government reformed the banking regulations. The policy in the banking sector has increased the corporate sector's access to domestic and foreign private capital. As the government applied the free capital flow system, the private companies then borrowed foreign capital without any restrictions. As result, the bulk of the private capital in the form of borrowings came in through banking system and private sector.

External debt increased from US\$ 66.9 billion in 1990 to US\$ 138 billion in March 1998. About 52 percent of this external borrowing in March 1998 was owed by the private sector and nearly 90 percent of it was received by non-bank corporate entities.² The average maturity of this external debt is 1.5 years.³ Pursuant to the World Bank, a debt/gross-national-product (GNP) ratio of more than 80 percent is considered as high risk and a total debt-service/export ratio of 18 percent as the "warning" threshold.⁴ But the monetary authority gave no attention to the warning of the Word Bank by continuing its existing policy and did not conduct any preventive action to control the capital inflows. Actually, in response to capital inflows, the government established the Foreign Commercial Debt Management Coordinating Team (Team PKLN) in 1992. This team was

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1 Dr. Anwar Nasution, *Recent Issues in the Management of Macroeconomic in Indonesia*, the Asian Development Bank <<http://www.adb.org>>.

2 Ibid.

3 J.P. Morgan, Global Data Watch, 16 January 1998, p. 70.

4 Nasution, above n1.

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empowered to set ceilings on external borrowing of large public and quasi-public sectors projects. However, this team was not effective and the government was not consistent with its policy regarding capital inflows.

In this liberalization, the entry barriers in the banking sector were removed. This policy has increased the number of private banks in Indonesia from 65 in 1988 to 144 in 1997. However, removal of entry barriers in the banking sector was not followed by a strong regime in banking supervision and monitoring. The lax supervision and inadequate enforcement of prudential regulations contributed to the weakness of the financial system in Indonesia.

The weakness of the financial system in Indonesia can be related to the problems of the banking sector. Most conglomerates in Indonesia established their own banks. These banks served as a “cashier” that provided easy credit to other companies within a group.⁵ In many cases, the banks were acting as the prime source of funds for the group’s activities as they provided in-house lending.⁶ The attitude of conglomerates in Indonesia for their banks can be seen from the words of a director of Indonesia’s Dharmala Group:⁷

“We own a bank because what is the point of giving others the spread? ... Our Chairman thinks there is no sense in one division borrowing while the other has deposits...borrowing from someone else’s bank means giving them the interest margin.”

Another reason for the financial crisis is the high concentration of corporate ownership. Control by families has led to poor financing and investment practices.⁸ In-house lending from the private banks to members of their group companies is an example of this effect of high concentration of ownership.

Inherent instability in the international financial market, often stemming from herd mentality and contagion effects,⁹ has also contributed to the financial crisis in Indonesia. At the beginning of the crisis, the Indonesian economy tended to be influenced by the crisis in Thailand. As most of international lenders in Indonesia were not credible lenders, in the sense that they maintained only short term lending to the Indonesian corporate sector, the lenders then took the opportunity

5 Dr. Saud Husnan, *Corporate Governance in Indonesia*, the Asian Development Bank (2000), 37.

6 Michael Backman, *Asian Eclipse: Exposing the Dark Side of Business in Asia*, (2001) 64.

7 Ibid, 64-65.

8 Husnan, above n 5, 38.

9 Ill Chong Nam, Yeongjae Kang, and Joon-Kyung Kim, *Comparative Corporate Governance Trends in Asia*, Korea Development Institute, 1999, <<http://www.oecd.org/pdf/M000015000/M00015803.pdf>>.

to withdraw their lending out of Indonesia being influenced by the international lenders in Thailand who pulled-out their borrowings.¹⁰

Too much corruption in Indonesia is another reason for the crisis. It has been argued that corruption also contributed to the financial crisis.¹¹ Financial resources in many Asian countries were misallocated because of corruption.¹² A survey by independent organizations in this area shows the level of corruption and transparency in Indonesia. The Business International index ranks countries from one to ten, based on the degree to which transactions involve corruption or questionable payments. The rating of corruption in Indonesia, according to the Business International index is 9.5. It shows that amongst the survey countries in Asia, the level of corruption in Indonesia is the worst.¹³ The high level of corruption in Indonesia has also been shown by other organizations, such as the Global Competitiveness Report which placed it as 8.40 on the scale, while according to the Transparency International, level the of corruption in Indonesia is 8.28.¹⁴

In order to restore confidence in the economy, the government invited the IMF to come to Indonesia's assistance. Package programs for economic recovery were designed by the IMF to be implemented in Indonesia.¹⁵ The first package has been designed with the intention to (a) restore macroeconomic stability and economic growth, and (b) to remedy structural weakness in the economy by emphasizing short-run stabilization and medium to long-term structural reform, including rebuilding market infrastructure. This package outlines a broad macroeconomic policy, which includes cutting domestic absorption, and switching expenditures from imports to domestically produced goods and services.

The second package of the IMF program has broad economic reforms with the intention to remove impediments to market efficiency, to create a favorable climate for development, and to improve resource use efficiency. This package has structural reforms, which includes (a) bank restructuring, (b) removal of regulatory and price controls in the product and labor markets (c) efforts to tackle fiscal distress, (d) privatization of State owned enterprises, and (e) measures to

10 See Asian Development Outlook 1998, the currency crisis in Asia occurred in regional waves rather than in individual countries. This phenomenon has been metaphorically referred to as contagion.

11 Shang-Jin Wei and Sara E. Sievers, The Cost of Crony Capitalism in Wing Thye Woo, Jeffrey D. Sachs and Klaus Schawb (eds), *The Asian Financial Crisis: Lessons for a Resilient Asia* (2000), 91.

12 In their analysis in the cost of crony capitalism, Wei and Sievers try to define corruption as bribes from private sector parties to government officials.

13 Wei and Sievers, above n 11.

14 Ibid.

15 Package programs of the IMF for Indonesia have been accommodated in letter of intents between the IMF and the government of Indonesia. These can be seen in <<http://www.imf.org>>.

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improve market transparency. While the third package which was launched in April 1998 includes a framework for Government assistance in solving the private sector's external debt overhang and budget subsidies for the price of State-vended products.

From the first agreement with IMF, Indonesia received funding commitments with an amount of nearly US\$ 43 billion, US\$ 23 billion for first-line funding and nearly US\$ 20 billion for second-line resources. On 8 April 1998, Indonesia reached an agreement with IMF on a new package of economic reforms with specific target and timetables. It was called the "IMF Plus" because it was based on Mexico's Ficorca program and includes the IMF commitment to help solve the US\$ 72.5 billion private sector external debt.

The financial crisis has destroyed the financial system in Indonesia. Most banks and corporations were experiencing financial distress.¹⁶ Domestic financial institutions such as the banking sector and capital market are unable to inject corporations with fresh funds to deal with the shortfall in cash flow. According to Miskhin, the financial system of a country such as Indonesia, should be restarted so that it can resume its job of channeling funds to those with productive investment opportunities¹⁷. The big problem for Indonesia's financial system is that it requires international investors to supply funds.

The financial crisis in East Asia, including Indonesia, has brought corporate governance issues to the attention of the investors. Prior to the crisis the domination in commercial sector by overseas Chinese and the involvement of Chinese families in most of their commercial activities support the use of relationship-based (*guanxi*) in their financial and business system in Indonesia.¹⁸ The suppliers of capital reacted to the use of relationship-based system in corporate governance by shortening the term of investment or borrowing. The suppliers of capital who come from arm's length systems are aware that in relationship-based systems, capital can be misallocated when presented with large external capital inflows.¹⁹

16 As a condition to the IMF's assistance, the Government of Indonesia has liquidated 49 banks and put most of banks into supervisory of Bank Indonesia and the Indonesian Banking Restructure Agency (IBRA).

17 Frederic S. Miskhin, *Lessons From the Asian Crisis*, NBER Working paper 7102, 1999.

18 See Gordon Walker : "Corporate Governance in East Asia: Evidence and Justification". In this paper, Walker discussed *guanxi* system in East Asia and he also analyzed the distinction between relationship-based and arms-length financial system.

19 Raghuram Rajan and Luigi Zingales, 'Which Capitalism? Lesson From the East Asian Crisis' (1998) 11 (3) *Journal of Applied Corporate Finance*, 40.

A relationship-based system has implications for corporate governance in some forms of corruption, cronyism, self-dealing and high concentration in ownership. During the boom market in Asia investors ignored these circumstances. The most rational reason for this phenomena was advanced by Rajan and Zingales in 1999 that a relationship-based system works well in normal times in jurisdictions where contracts are poorly enforced and capital scare but is excessively susceptible to shocks.²⁰

A study in corporate governance by the Asian Development Bank supported the view that poor corporate governance was one of the major contributors to the build-up of vulnerabilities in the East Asian countries, including Indonesia, and that finally led to the financial crisis.²¹ This study suggested that weakness in corporate governance appeared to owe much to a highly concentrated ownership structure, excessive government interventions, under-developed capital markets and the weak legal and regulatory framework for investor protection.²²

The financial crisis has awakened investors to the fact that they need protection for their investment. In this matter, studies by La Porta et al show some relationship between legal protection and the existence of corporate governance. La Porta et al concluded that legal protection and large investors are complementary in an effective corporate governance system.²³ La Porta et al also concluded that common-law countries generally have the strongest, and the French-civil-law countries the weakest legal protections of investors, with German and Scandinavian-civil law countries located in the middle.²⁴ In this case, Indonesia is included in the French-civil law countries, which is historically inaccurate.

For other study of La Porta et al shows the relevance between investor protection and corporate governance. In this study, La Porta et al stressed the "law matter" thesis that:

"the legal approach to corporate governance holds that the key mechanism is the protection of outside investors...through the legal system, meaning both laws and their enforcement."²⁵

Investor protection becomes very important in Indonesia, as there is potential and actual expropriation of minority shareholders and creditors by controlling shareholders. In Indonesia, investors in public listed companies are minority

20 Ibid.

21 The Asian Development Bank, *Corporate Governance and Finance in East Asia*, 2.

22 Ibid.

23 Rafael la Porta, Florencio Lopes-de-Silanes, Andrei Shleifer, and Robert Vishny, 'Corporate Ownership Around The World' (1999) 54 (2) *The Journal of Finance*, 769.

24 Ibid.

25 Ibid.

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shareholders which are very powerless compared to the majority shareholders. Another issue relating to investor protection and corporate governance is that investor protection encourages the development of financial markets.²⁶ If this argument is correct, investor protection will increase the development of a capital market. The equity market in Indonesia is underdeveloped with only 320 public listed companies. Finally, La Porta et al argue that investor protection influences the real economy.²⁷

The theory that laws matter is relevant for Indonesia. Investor protection and lax law enforcement have led to the reluctance of foreign investors to act as lenders of last resort for the recovery of financial system in Indonesia.

The need for domestic financial system to be injected by foreign capital on the one hand and the importance of protection to the foreign investors on the other has attracted the concern of the IMF. As part of the IMF program, Indonesia is requested to apply good corporate governance in all sectors, especially for listed companies, banks and stated owned enterprises. The OECD Principles of Corporate Governance have been suggested to be adopted. The government then established the Indonesian Corporate Governance Committee. This committee has introduced the Indonesian Code for Good Corporate Governance.

The purpose of this study is to examine the effectiveness of adoption of the OECD Principles of Corporate Governance by public listed companies in Indonesia. The author argues that the success of implementation of good corporate governance in Indonesia cannot be measured only by adoption of the principles in the code of corporate governance in each listed companies in Indonesia. Some thing was missing when a foreign legal system was adopted in Indonesia. This matter is called “legal culture”. It is an important variable for the success of adoption of a foreign legal system as well as a foreign code such as the Principles of Corporate Governance.

Overview of Listed Companies in Indonesia

The capital market in Indonesia has a long history. It began on December 14, 1912 when the Dutch established *Effectenbueurs* as a branch of *Amsterdamse Effectenbueurs* in Batavia (Jakarta).²⁸ In Asia, this stock exchange was the fourth established after stock exchanges in Bombay, Hong Kong and Tokyo.²⁹ This stock exchange was named as *Vereniging voor de Effectenhandel* and had thirteen active members. At that time the stocks traded were shares and bonds of the

26 Ibid.

27 Ibid.

28 The Indonesian Capital Market Supervisory Board (Bapepam), *History of Indonesian Capital Market*, <<http://www.bapepam.go.id>>.

29 Ibid.

Netherlands firms or plantations located in Indonesia, bonds of the government, securities certificates of American companies issued by the administrative offices in Netherlands, and other the Netherlands firms.³⁰

As the exchange grew very fast, two stock exchanges were established in Surabaya city on January 11, 1925 and Semarang city on August 1, 1925. Unfortunately, due to the political situation in Europe, in early 1939, the stock exchanges in Indonesia were centralized in Jakarta. Finally, as an effect of the World War II, on May 17, 1940, all stocks trading was closed and a rule was issued stating that all stocks ought to be deposited in banks appointed by the Netherlands-Hindie government.³¹

After the Dutch colonialism, the stock exchange was not active until the creation of the Capital Market Executive Agency in 1977 and reopening of the stock exchange. During 1977-1988, the development of the stock exchange was very slow. At that time only 24 companies listed their shares on the stock exchange. After that, together with liberalization in banking and financial sector, the government also started to liberalize capital market. The number of listed companies then increased and trading activities and market capitalization grew over the years together with the development of financial market and the private sector.

As the growth of the stock market was very high, the demand for professional management in the stock market was increased as well. To anticipate the market, in 1990, the government established Surabaya Stock Exchange and finally in 1991, the government decided to privatize the Jakarta Stock Exchange. As the Capital Market Executive Agency did not manage the stock exchange, in 1992 it changed its function from the Capital Market Executive Agency into Capital Market Supervisory Agency or *Bapepam*. The management of the Jakarta Stock Exchange was given to Jakarta Stock Exchange, Inc (JSX) and brokerage companies become shareholders of JSX.

In acting as supervisory agency to the Indonesian capital market, Bapepam plays the dominant role in the regulatory area and is very powerful as it is a part of the government. Bapepam is not independent of the government's influence as it is a division of the Ministry of Finance. Bapepam reports directly to the Minister of Finance with its task of development, regulation and supervision of the capital market.³² It has functions equivalent with the Securities and Exchange Commission (SEC) in the United States. The functions of Bapepam in Indonesian Capital Market are:³³

30 Ibid.

31 Ibid.

32 Art 3 (1) and (2) of Capital Market Law No. 5 of 1995.

33 Art. 3 Minister of Finance Decree No. 503/KMK.01/1997 concerning Organization of Capital Market Supervisory Agency.

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- Drafting Capital Market rules and regulations;
- Guiding and supervising any person granted a business license, approval, registration from Bapepam and other person related to capital market;
- Establishing disclosure principles for issuers and public companies;
- Settlement of the appeals by persons on whom sanctions by stock exchange, clearing guarantee corporation and central depository have been imposed;
- Establishing capital market accounting standards;
- Protecting technical implementation of Bapepam's function based on the law.

As a consequence of Bapepam's position, the stock exchanges in Indonesia seem to be controlled by the government. This can be seen from the involvement of Bapepam in the day-to-day management of the stock exchanges, especially in budgeting. This situation brings many difficulties for Bapepam in (i) setting principles and allowing market-driven self-regulatory organizations to operate within those principles, and (ii) basing its rulings on consultations with users (as legally required).³⁴

The position of Bapepam as the extension of government power has been unsatisfactory in the privatization of the state owned companies. In Indonesia the Minister of Finance formally holds stakeholders in all of the stated owned enterprises in Indonesia.³⁵ When these enterprises offer their shares to the public, Bapepam will review a registration statement as a requirement for the initial public offering. If the shareholders of the state owned enterprises, in this case, the Minister of Finance has approved the intention to go public officially. Bapepam will have no power to reject the public offering.

After the collapse of the banking sector in Indonesia, the capital market became very important as a source of funds. Most of the debt restructuring settlements required the debtors to utilize the capital market in Indonesia to raise funds for the repayment of debt. Although the Indonesian capital market is not developed yet, it may attract new companies for listing. In mid-1997 there were 282 companies listed on JSX. During the financial crisis 32 companies were de-listed because of their inability to perform listing requirements. Some of them were de-listed because of financial insolvency due to the financial crisis and the others because of failure to submit their financial reports. After the financial crisis there were 40 new companies listing their shares in JSX and by the end of 2000 the number of listed companies were 290.

34 Stephen Wells, *Moving Towards Transparency: Capital Market in Indonesia*, the Asian Development Bank (2001), 74.

35 Since the establishment of the Ministry of State Owned Enterprise in May 1998, a function of the Minister of Finance in monitoring the state owned enterprises has been delivered to this new ministry.

The listed companies in Indonesia generally only listed about 30 percent of their total shares. The founder's family group normally controls the remaining 70 percent. For state owned enterprises, the government maintains a golden share, as a kind of privileged share which entitles the government to nominate and appoint a member of the board of directors and board of commissioners. In the state own enterprises other shareholders are unable to appoint their representatives in those two boards although they hold a majority of shares. About 80 percent of investors in public companies are foreign investors. They play a significant role in the activity of capital market in Indonesia, but in fact, as a minority, their rights were not protected.

Since 1988 the government relaxed regulation of the capital market by allowing foreign investors to buy up to 49% of the stock of a public listed company. This new regulation has caused the foreign investors to dominate daily trading. The volume of transaction increased from Rp. 8 trillion in 1992 to Rp. 120.4 trillion in 1997.

In September 1997 the limit of foreign ownership was changed. The foreign investors may buy up to 100 percent of the shares of listed companies. After the financial crisis the foreign investor become more critical of the standards of corporate governance. But the need for sound corporate governance is still ignored by the companies in Indonesia. This condition caused the foreign investors to liquidate their investment in listed companies in Indonesia, except for the blue chips companies or some companies which have implemented good corporate governance practice.

Generally, the equity market in Indonesia is more developed than the bond market. Equity transactions on the Jakarta Stock Exchange are quite active compared to trading of bonds, because for investors in Indonesia, equity is an attractive finance option. The cost for debt financing is expensive, while equity offers a cheap source of capital and assists the nascent venture capital industry by providing a market for small-company equity and an exit route as well.³⁶

The Problem of Corporate Governance in Public Listed Companies in Indonesia

From the financial point of view conditions in most listed companies in Indonesia are very bad. *Firstly*, almost all listed companies in Indonesia are overvalued.³⁷ The market value has been determined to be 90 percent by the growth expectation

³⁶ Ibid, 75.

³⁷ McKinsey & Co, *Listed Companies in Indonesia*, <<http://www.mckensey.com>>.

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and only 10 percent based on current earning stream or the ability of the company to generate a net profit.³⁸

Secondly, the healthiness of the financial structure of listed companies is not quite good. Most of the listed companies outside of banks rely on debt financing with debt to equity ratio at 10:1. In normal financial conditions the debt to equity ration should be less than 5:1. This kind of financial structure has resulted from the effects of the financial crisis and caused listed companies to experience financial insolvency. The financial crisis has caused their assets to become insufficient to cover the debts.

In addition, there are some other problems that may affect implementation of corporate governance in Indonesia such as the following:

Concentration of Ownership in Few Families

Ownership of the corporation is one of key features for implementation of good corporate governance. The problem facing sound corporate governance in Indonesia is the concentration of ownership, either in private or listed companies or the government control over the state owned enterprises. A survey of the Asian Development Bank in corporate management and control of public listed companies and conglomerates in Indonesia showed that concentration of ownership in most of public companies is in the hands of several families.³⁹ About 67.3 percent of listed companies were family held while only 6.6 percent were widely held.⁴⁰

The Indonesian Capital Market Directory records that prior to the crisis, between 1993 and 1997, about two thirds of public listed companies' outstanding shares were owned by corporations which were directly or indirectly controlled by groups of families.⁴¹ After the crisis there were some changes in the concentration of ownership resulting from the financial restructuring conducting by the Indonesian Banks Restructure Agency (IBRA). But this change does not affect the control of certain groups in the major corporations in Indonesia.

The dominant conflict in the implementation of corporate governance is between controlling shareholders and minority shareholders. In Indonesia, since the controlling shareholder or families control the management, the position of

38 For comparison, market value of listed companies in developed countries is determined 30 percent from the growth expectation and 70 percent from the current earning stream.

39 Husnan, above n 12, 18.

40 Claessens, Djankov and Lang, *Who controls East Asian Corporations*, World Bank Workingpaper (1999), <<http://worldbank.org>>.

41 The Jakarta Stock Exchange, *The Indonesian Capital Market Directory* (2001).

minority shareholders then becomes very bad. Expropriation of minority shareholders' right always happens as the management ignores their rights in the listed companies.

Pyramiding

All group companies in Indonesia establish a holding company with the purpose of holding several sub holding companies. Each of these sub holding companies then controls several operating companies in various sectors, such as banking, management, services, manufacturing and other activities. This kind of structure assists the founding family in obtaining a clearer picture of their business, but often without any transparency.⁴²

Tax benefits have been claimed as the main reason why the group companies in Indonesia use a pyramiding structure. Under income tax law, distribution of dividends to a holding company is not subject to withholding tax.⁴³ There is also no requirement for group companies to list their holding companies, sub-holding companies and subsidiaries companies on the stock exchange. It is very common in Indonesia that a holding company, as first layer, lists its shares in the stock markets, together with its second layer and third layer of companies. All of these companies use the same financial statement figures and data for listing.

Cross Shareholdings

The other fundamental problem of corporate governance in Indonesia is cross shareholding practices. There is no restriction in Indonesia for cross-shareholdings transactions. Restriction is applied only for cross-ownership between the holding and subsidiaries companies. Prior to enactment of the new Indonesian Company Law in 1995, cross-ownerships was very common in practice. One company subscribes to shares of the other company and in return, this company receives shares of the first company. As this kind of transaction had increased assets and capital of a company without any fresh fund injected into the company, restriction was then applied.

Cross-shareholding in Indonesia has a negative impact on fair business treatment as it may create a monopoly in certain areas of business. Some people in Indonesia are reluctant to apply good corporate governance if this will have the consequence that the benefits such as monopoly of the companies with cross-shareholding will be missing.⁴⁴

42 Backman, above n 4, 48.

43 Art. Income Tax Law No. 7 of 1984 as amended.

44 Anti monopoly law has just been introduced in Indonesia but in practice this law is

The Lack of Independent Director

Basically, Indonesia adopts a two-tier board system:

“the Board of Commissioners, equivalent to the supervisory board or non executive board in common law countries. This board performs supervisory and advisory roles with the duties (i) to supervise the performance of the board of directors and policies, and (ii) to provide advice to the board of directors.⁴⁵”

“the Board of Directors (Direksi) or executive board that perform an executive role with the duties (i) to manage the company in the interest of the company, consistent with the objectives of the company, and (ii) to represent the company before the courts. ⁴⁶”

In practice, the existence of these two boards is ineffective. As the families control the listed companies, the separation of power between the owner and manager is very little. The board of directors in many cases is only acting in the best interests of the controlling shareholders. Members of families appoint themselves as directors. Thus, at the same time controlling shareholders are also acting as directors. In this circumstance, there is no independence of the directors.

This situation also exists for the board of commissioners. They have been regarded as ineffective due to the fact that many of them lack the required competence and fail to maintain their independence, especially, when their remuneration is designated by the board of director or the majority shareholders.

Corruption and Cronyism

One of the reasons for the failure to deal with the effects of the financial crisis in Indonesia is the heavy practice of corruption, cronyism, collusion and nepotism. A Survey by independent organizations in this area shows that the level of corruption and transparency in Indonesia is the worst.⁴⁷

Regulatory Weakness

Another condition, which may affect implementation of corporate governance in listed companies, is the weakness in capital market regulations to provide

not effective.

45 Articles 1 (5) and 97 of the Indonesian Company Law.

46 Articles 1 (4) and Article 82 of the Indonesian Company Law.

47 See Wei and Sievers, n 11.

protection to minority shareholders. This weakness can be seen from the lack of implementation of administrative sanctions for breach of protection to minority shareholders. There is no case in Indonesia where a breach of the minority rights is the subject of a criminal penalty. The Capital Market Law only provide civil remedies for any person who suffers loss as result of any contravention of the legislation or its implementing regulations to claim damages individually or in class action against any person who is responsible for the contravention.⁴⁸

Lack of Law Enforcement

An example of the lack of law enforcement in Indonesia can be seen from the Bank Pikko case. Manipulation of Bank Pikko shares by certain brokers in April 1997, which caused a huge loss for many investors, shows the weakness of the law enforcement in Indonesia. During January-March 1997, its shares price was fluctuating within a range of Rp. 800 – 1,050. In April 1997, its share price increased sharply from Rp. 1,300 to Rp. 4,050. within about 204 minutes of trading.

Basically, Bapepam has a power to undertake a criminal investigation to a person who has been committed wrongdoing or breach of capital market regulation in accordance with the Criminal Procedure Code.⁴⁹ The Capital Market Law entitles Bapepam to appoint its employee as investigator with wide powers to obtain information, call and examine witnesses, as well as to freeze accounts.⁵⁰ Investigations of Bapepam are then delivered to the Attorney General's Office. This office will prosecute the matter in the court.⁵¹ However, until this time, Bapepam has never delivered the report of its investigation to the Attorney General's Office for further enforcement. In cases such as the Bank Pikko, Bapepam has only imposed administrative sanctions upon individual investors and masterminds of this transaction.⁵² The persons behind this case have been fined by administrative sanction Rp 1 billion and Rp. 500 million respectively for allegedly masterminding the attempted manipulation in Bank Pikko shares.⁵³

Reception of Corporate Governance

The existence of corporate governance in Indonesia is not based upon voluntary reception, as a result of awareness of the companies about the function of

48 Article 111 of the Capital Market Law.

49 Article 101 (2) of the Capital Market Law.

50 Article 101 (3) of the Capital Market Law.

51 Article 101 (3) and (5) of the Indonesian Capital Market Law.

52 Bapepam is an Indonesian Capital Market Supervisory Board which control and monitor the implementation of capital market in Indonesia.

53 Bapepam news, <<http://www.bapepam.go.id>>.

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corporate governance. There are some factors which influence the implementation of corporate governance in Indonesia such as (i) pressure from the IMF and donor agencies as “legal conditions” for their economic assistance, (ii) pressure from foreign investors in their position as the last resort to finance Indonesia financial system, (iii) as an effect of globalization, for instance, the ASEAN Free Trade Agreement will be effective by year 2003 and this has caused companies in Indonesia to comply with international practices, and (iv) as an effort to attract investors to purchase equity or debt instruments in the domestic stock market due to the collapse of the domestic capital market. Involuntary implementation of a new code such as corporate governance in Indonesian listed company will obtain negative reactions from the majority of shareholders if this implementation reduces their control over the companies.

The OECD Principles of Corporate Governance and Their Adoption in the Indonesian Code of Corporate Governance and Formal Regulations

In 1996, the Organization for Economic Cooperation and Development (OECD) formed the Business Sector Advisory Group and a task force to refine a set of basic principles of good corporate governance. According to the report of this advisory group, to achieve good corporate governance, it is required to have combination of regulatory and voluntary private actions. This advisory group noted that government interventions in corporate governance are the most effective if consistently and expeditiously enforced. The interventions of the government should focus in the following issues:⁵⁴

- (i) Fairness: protecting shareholders rights and ensuring the enforceability of contracts with resource providers;
- (ii) Transparency: requiring timely disclosure of adequate information on corporate financial performance;
- (iii) Accountability: clarifying governance roles and responsibilities and supporting voluntary efforts to ensure the alignment of managerial and shareholder interests, as monitored by a board of directors-or in certain nations, a board of auditors-with some independent member;
- (iv) Responsibilities: ensuring corporate compliance with other laws and regulations that reflect society’s values, including a broad sensitivity to the objectives of the society in which corporations operate.

This report highlighted that voluntary actions of corporations in setting up codes of conduct and the influence of the agents that can pressure corporations to

54 *The OECD Principles of Corporate Governance.*

comply with good corporate governance practice is important as same as the regulations.

Based on the fairness, transparency, accountability and responsibilities, the OECD introduced principles of corporate governance. The OECD principles are intended to assist member and non-member governments in their efforts to evaluate and improve the legal, institutional and regulatory framework for corporate governance.⁵⁵ The OECD Principles provide also guidance and suggestions for stock exchanges, investors, corporations and other parties that have a role in the process of developing good corporate governance.

The OECD ad hoc task force of the Business Sector Advisory Group has identified five basic principles of corporate governance as follows:

- a) The corporate governance framework should protect shareholders' rights;
- b) The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights;
- c) The Corporate governance framework should recognize the rights of stakeholders as established by law and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises;
- d) The corporate governance frameworks should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company; and
- e) The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders.⁵⁶

In Indonesia, as part of the commitment made by the government to the IMF, the National Committee for Corporate Governance (NCCG) was established on 9 August 1999.⁵⁷ This committee has the following duties:⁵⁸

- a) to codify corporate governance principles;
- b) to develop an institutional framework to implement the code.

55 Ibid.

56 Ibid.

57 The Decree of the Coordinator Minister of the Economic, Finance and Industry No. Kep. -1-/M.EKUIIN/08/1999 dated 9 August 1999.

58 Ibid.

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Finally, in March 2000, NCCG has drafted the Indonesian Code of Corporate Governance. This code adopted the OECD Principles of Corporate Governance. The basic principles of corporate governance as set forth in this code are as follows:

Shareholder Protection

In Indonesia, protection to shareholders rights has been provided under the Indonesian Code.⁵⁹ Under this code the rights of the shareholders shall be protected, and accordingly, the shareholders shall be able to exercise their rights pursuant to appropriate procedures that have been adopted by the companies. This code suggests that it is necessary to apply regulations having the force of law for the procedures to protect the rights of shareholders.

According to the Indonesian Code, the rights of shareholders are basically:

- a) the right to attend and vote at any shareholders meeting on a one share/one vote basis;
- b) the right to obtain relevant corporate information, in a timely and regular manner, to enable a shareholder to make informed decisions concerning his shares in the company; and
- c) the right to receive part of the company's distributable profit in proportion to their respective shareholding in the company, through dividends or other distributions.

This basic right is similar to the basic right of shareholder as provided in the OECD Principles.

Indonesian Company Law and the capital market regulators have adopted the principle of corporate governance for protection of the rights of shareholders. The general rights of shareholders can be found in some articles of Indonesian Company Law, as follows:

- a) The rights to attend and vote in shareholders meeting have been provided in Indonesian Company Law that shareholders with a valid right to vote, either on their own or by written power of attorney, have the right to attend the general meeting of shareholders and each share shall have one right to vote, unless the articles of association determine otherwise.⁶⁰
- b) For the right to obtain corporate information in a timely and on regular manner, Indonesian Company Law provides a general provision that within five months after the close of the company accounting year, the directors shall compile an annual report for submission to the general shareholders

⁵⁹ The Indonesian Code of Good Corporate Governance.

⁶⁰ Articles 71 (1) and 72(1) of the Indonesian Company Law.

meeting.⁶¹ When the directors summon the shareholders for the general shareholders meeting, this annual report shall be ready to be accessed by the shareholders. As part of the disclosure requirement, listed companies shall also lodge a variety of periodical reports (annual, semi-annual and quarterly) to Bapepam and the stock exchanges.⁶² Material transactions and events relevant to the listed companies shall be reported to both the above institutions within two days after the date of the transaction.⁶³ Public and shareholders may have access to all reports and data submitted to Bapepam and the stock exchanges.

- c) For the right to a dividend, Indonesian Company Law specified this right that shareholders have. However, distribution of net profit as dividend or other distribution is subject to approval of the general shareholders meeting. In case the general shareholders meeting does not determine the use of profit, all of the net profit, after having deducted certain reserved funds, shall be distributed to the shareholders as dividends.⁶⁴

There are other rights of shareholders which have been accommodated in Indonesian Company Law such as pre-emptive rights,⁶⁵ the right of the shareholders to claim against the company,⁶⁶ and the right to request the company to purchase the shares of shareholders due to the company's action which caused detriment.⁶⁷ The pre-emptive right is also regulated in capital market regulation.⁶⁸

The right of shareholder to claim against the company is a derivative right. This right enables every shareholder to file a suit against the company with the court, when he suffers a loss because of the acts of the company that are deemed to be not equitable and are unreasonable and unfair as a result of a decision of the general shareholders meeting, the directors and the commissioners.⁶⁹

The right to request the company to purchase the shareholders' shares can be used when a shareholder does not agree with the action of the company that damages the shareholders or the company, such as an amendment to the articles of association (the company's constitution), the sale, guarantee, or exchange of

61 Article 57 (1) of the Indonesian Company Law.

62 In Indonesia, there are two stock exchanges: the Jakarta Stock Exchange (JSX) and the Surabaya Stock Exchange (SSX).

63 Bapepam Rule IX.K.1

64 Articles (61) and (62) of the Indonesian Company Law.

65 Article 51 of the Indonesian Company Law.

66 Article 54 of the Indonesian Company Law.

67 Article 55 of the Indonesian Company Law.

68 Bapepam Rule IX.D.1.

69 Article 54 of the Indonesian Company Law.

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substantially or all of the assets of the company, or merger, consolidation, or take over of the company.⁷⁰

The Equitable Treatment of Shareholders

Equitable treatment of shareholders in Indonesia has been accommodated under the principle of the shareholders' rights. This principle suggests that shareholders of the same kind of shares shall be treated equitably based on the principle that shareholders of the same kind of shares have the same equitable position in the company.⁷¹ For this purpose, the shareholders shall hold voting rights in accordance with the type and number of shares and each of shareholders shall be provided with full and accurate information about the company unless there is a justifiable reason not to do so.⁷² Under this principle, insider trading or self dealing with the intention of personal gain is prohibited for any shareholder and member of the boards.

Beside the rights of the shareholders, the Indonesian Code also provides a principle that deals with shareholders responsibilities.⁷³ According to this principle, the shareholders owning a controlling interest in a company shall be mindful of their responsibilities as shareholders when they exercise any influence over corporate management, whether by the exercise of their voting rights or otherwise.⁷⁴ This principle suggests that the minority shareholders have corresponding responsibilities to the effect that they do not misuse their rights under the regulations having the force of law.⁷⁵ This principle tries to avoid control of a company by minority shareholders.

Equitable treatment of the shareholders in the same class is provided in the Indonesian Company Law that the shares of the same class confer to their holders the same rights.⁷⁶ In addition, fraud, market manipulation and insider trading are also prohibited under the capital market law.⁷⁷

The Role of Stakeholders in Corporate Governance

The principle of corporate governance in Indonesia regarding the rights of stakeholders mentions that the rights of stakeholders under the prevailing regulations having the force of law and /or pursuant to any contracts entered into

70 Article 55 of the Indonesian Company Law.

71 The Indonesian Code of Corporate Governance.

72 Ibid.

73 Ibid.

74 Ibid.

75 Ibid.

76 Article 46 (2) of the Indonesian Company Law.

77 Chapter XI, articles 90-99 of the Capital Market Law No. 8 of 1996 contain provisions regarding fraud, market manipulation and insider trading.

by the company with customers, suppliers, creditors and surrounding community, shall be respected.⁷⁸ For this purpose, the principle suggests that the stakeholder shall be provided with an opportunity to monitor and offer inputs to the company's board of directors.⁷⁹

The role of stakeholders is not regulated under Indonesian Company Law or the capital market regulations. However the role of stakeholders can be found in other laws or contracts which regulate the relationship between the company and the stakeholders. For instance, the role of creditors can be determined in the loan agreement. In Indonesia, a contract between two parties shall be deemed as a law for such parties.⁸⁰ The role of employee in the company is regulated under the labor law and the employment agreement between the employee and the company.

Disclosures and Transparency

As in the OECD Principles, the Indonesian Code contains a principle that the company shall disclose material information through its annual reports and financial statements to shareholders and the relevant government authorities in accordance with the prevailing regulations, in a timely, accurate, understandable and objective manner.⁸¹ This principle stresses also the importance of materiality in the disclosure of information and other sensitive issues in the information and also information regarding implementation of the principles of good corporate governance.⁸²

The Indonesian capital market regulations have a legal framework for the implementation of disclosure and transparency. Listed companies are required to comply with disclosure requirements as set forth in the Company Law and the Capital Market Law. Basically, the disclosure requirements can be divided into two steps: (i) primary market disclosure, when a company issues securities either debt or equity for the first time, and (ii) continuous disclosure.⁸³

In primary market disclosure, a company which will publicly offer securities in an initial public offering of shares, rights issues, private placements, issues of debt securities, issues of warrants and other form of securities shall lodge with Bapepam a registration statement. This statement shall include prospectus,

78 The Indonesian Code of Corporate Governance.

79 Ibid.

80 Article 1338 of the Indonesian Civil Code.

81 The Indonesian Code of Corporate Governance.

82 Ibid.

83 This disclosure regime is very common in other countries, such as in Malaysia, the disclosure obligations are contained in the Companies Act 1965 and the Securities Commission Act 1993. See Rabrindra S. Nathan, Chiew Sow Lin and Sooo Wai Fong, *Country Paper For Malaysia*, a paper presented in 2nd Asian Roundtable On Corporate Governance, 31 May to 2 June 2000, Hong Kong.

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financial statement, due diligence report from professionals such as public accountant and legal counsel and a valuation report on the assets of the company.⁸⁴

Bapepam imposes continuous disclosure for public companies so that on a routine basis, periodical reports must be lodged to Bapepam and the stock exchanges. A listed company is obliged to submit a periodical report to Bapepam and announce such report to public.⁸⁵ Periodical reports which shall be lodged to Bapepam and the stock exchange are (i) a periodical financial report, yearly and semi annually,⁸⁶ and (ii) a progress report for the use of proceed of public offering;⁸⁷

The Responsibilities of the Board

Adoption of the OECD Principles in Indonesia follows the two-tier system in the boards of the companies. According to the Indonesian Code, the board of commissioners shall be responsible and shall have the authority to supervise the actions of the directors and shall give advice to the directors when required.⁸⁸

A new development in corporate issues in Indonesia is the establishment of some committees to support the implementation of the task of the board of commissioners. The Indonesian Code suggest that the following committee shall be established in the company:⁸⁹

- Nomination Committee: to prepare the selection criteria and nomination procedures for the executives who are not members of the board of directors and for other executive positions in the company, and to formulate a system of assessments and provide recommendations in respect of the number of members of the board of commissioners and the board of directors in the company.
- Remuneration Committee: to prepare a remuneration system and provide recommendations in respect of (i) the assessment of such a system, (ii) the granting of options, such as a stock option, (iii) pension rights, and (iv) redundancy and other compensation scheme.
- Insurance Committee: to conduct periodical assessment and provide recommendations in respect of the type and coverage of the insurance of the company.

84 Article 73 of Capital Market Law.

85 Article 86 of Capital Market Law.

86 Chief of Bapepam Decree No. Kep-80/PM/1996 dated 17 January 1996.

87 Chief of Bapepam Decree No. Kep-15/PM/1997 dated 30 April 1997.

88 The Indonesian Code of Corporate Governance.

89 Ibid. The formal prevailing laws and regulation in Indonesia do not provide any provisions regarding the establishment of these committees.

- Audit Committee: to promote an adequate structure of internal control, improving the quality of financial disclosure and reporting, reviewing the scope, accuracy and cost effectiveness of the external audit and the independency and objective of the external auditors' and preparing a letter describing the duties and responsibilities of the audit committees during the year under review.

There is no formal regulation which deals with the establishment of these committees. However, the Jakarta Stock Exchange requests the listed company to appoint independent commissioners and to set up an audit committee. Basically, there is no penalty for breach of this policy.

Regarding the responsibilities of board, Indonesian Company Law has provided a corporate governance framework to ensure the strategic guidance of the company, the effective monitoring of management by the board and the board's accountability to the company and the shareholders. For instance, the responsibility of the board of directors and the board of commissioners in taking care of the company is very broad. Under the Company Law, each director and commissioner is fully and personally liable for any mistake or negligence found in the discharge of his responsibilities.⁹⁰ In bankruptcy cases, the directors shall be jointly and severally liable for losses as result of the board's fault or negligence, and the burden of proof to dismiss allegation lies on the directors.⁹¹ A derivative action can also be initiated by a shareholder controlling not less that 10 percent of the issued shares against the directors and commissioners for the loss suffered by the company.⁹²

Corporate Secretary

Public companies in Indonesia are required to have a corporate secretary. The capital market regulations require public listed companies to appoint a person as corporate secretary. This person will act as a liason officer and can be assigned to administer and maintain corporate documents.⁹³ In practice, the function of corporate secretary can be carried out by a Director.

The Indonesian Code mentions that the accountability of the corporate secretary is to the board of directors. The corporate secretary has a role to ensure that the company will always comply with the regulation in Indonesia, including regulations in respect of disclosure requirements. Another duty of the corporate secretary is to provide periodically report to the board of directors and the board of commissioners any information relevant to their duties in the company.⁹⁴

90 Article 85 and article 98 of the Indonesian Company Law.

91 Article 90(2) and article 90(3) of the Indonesian Company Law.

92 Article 85(3) and article 98(2) of the Indonesian Company Law.

93 The Indonesian Code of Corporate Governance.

94 Ibid.

Confidentiality

Under the Indonesian Code, the board of commissioner and the board of directors are under an obligation of confidentiality to the company,⁹⁵ but the term of confidentiality is not clear in this code, i.e. whether it covers all-important information and data or only specific information which has been established as a confidential information to the company. This principle has not been replicated in any formal regulation in Indonesia.

Business Ethics and Corruption

To deal with corruption and business ethics, the Indonesian Code has tried to adopt a principle in this area. Although it would be difficult to implement, the existence of this principle at least can be used as a warning for the bad practice of corruption and violence of the business ethics. The Indonesian Code provides that members and the board of commissioners, the board of directors and all employees shall never make or offer, directly or indirectly, anything of value to a customer or government official to influence or reward an action, in accordance with the prevailing regulations having the force of law.⁹⁶ In addition to that, a business courtesy, such as a gift, contribution or entertainment, should never be offered under circumstances that might create the appearance of an impropriety.⁹⁷ This principle basically is consistent with the effort of the government to reduce corruption in Indonesia. To deal with corruption, anti corruption laws and clean government laws have been applied in Indonesia.⁹⁸

Donations

As the political environment in Indonesia becomes more democratic, political parties often, informally, ask the owners of the companies to provide funding for their political activities. This practice may endanger the position of the company, other shareholders and stakeholders as well. To avoid the effect of this practice, the Indonesian Code applies a principle that it is inappropriate that any of the corporate funds or assets or profits be diverted to political donations, but donations to charities are acceptable within reason.⁹⁹ Donations which may trigger corruption has been referred to in the Corruption Law, but donations to a political party which may have same result with corruption, have not been regulated in Indonesia.

95 Ibid.

96 Ibid.

97 Ibid. The Law No. 28 of 1999 regarding Clean Government Practice, Free From Corruption, Collusion and Nepotism and Law No. 31 of 1999 regarding Anti Corruption have been implemented, but to reduce the level of corruption in Indonesia is not enough by only enacting a sophisticated rules or code in this area.

98 Ibid.

99 The Indonesian Code of Corporate Governance.

Compliance With Health, Safety and Environmental Protection Regulations Having the Force of Law

Another new principle that has been introduced is that the directors shall ensure the compliance of the companies with the applicable environmental and health regulations. The implementation of this principle is very difficult as it may affect the costs of production of the companies in Indonesia. Basically, this principle has been regulated clearly in the laws regarding environment and labor, but these regulations are not very effective to protect environment and workers.

Equal Employment Opportunity

Another new principle of corporate governance under the Indonesian Code is regarding the welfare and career path of the workers or employees in Indonesia. The Indonesian Code requires that the board of directors shall use merit, qualifications and other job-related criteria as the sole basis for all employment related decisions.

The Level of Compliance and Problem of Legal Transplant

Level of Compliance

The Level of compliance to the principles of corporate governance in listed company is very low. Listed companies tend to postpone implementation of good corporate governance until there is formal regulation, which obliges the companies to implement certain principles of corporate governance. From a pilot program for strengthening corporate governance conducted by the Asian Development Bank and the Jakarta Stock Exchange, among the listed companies in the Jakarta Stock Exchange, only 8 companies or 3.12 percent were found to have acceptable corporate governance standards.¹⁰⁰ Generally, implementation of corporate governance in listed companies achieves success in the following area:

Disclosure and transparency

As Bapepam and the Jakarta Stock Exchange are very strict in the implementation of regulations regarding disclosure and transparency, the level of compliances is very high. Failure to comply with this regulation will result in an administration penalty such as fine for Rp. 1 million a day or trigger de-listing.

100 The Jakarta Stock Exchange Press Release, 29 October 2001
<<http://www.jsx.co.id>>.

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Appointment of Corporate Secretary

All listed companies currently have appointed a corporate secretary. In many cases a member of the board of director carries out the function of corporate secretary. The existence of a corporate secretary in listed companies is quite effective, as it may encourage the listed companies in Indonesia to comply with the disclosure requirements.

Appointment of Independent Commissioner and Audit Committee

The level of compliance in this area is high. About 86 percent from 315 listed companies in the Jakarta Stock Exchange have appointed independent commissioners to comply with the principle of good corporate governance.¹⁰¹ In many cases, the independent commissioners have been appointed from various professionals such as politician, lawyer, accountant, former army general and even other professions. Some of these professions actually have no knowledge about the duties of the independent commissioner.

The level of compliance in the establishment of audit committee is quite high. From all listed companies in the Jakarta Stock Exchange, 193 companies or 61 percent have established audit committees.¹⁰²

In contrast, the level of compliance in the following corporate governance is still low.

Protection to the Right of Minority Shareholders

The level of compliance in the protection of minority shareholders is low. Expropriation of the rights of minority by the management or majority shareholders still exists in practice. Most of investigations of the violation of capital market regulations have connections with expropriation of minority shareholders' rights.¹⁰³

Protection to the Creditors Rights

As same with the minority shareholders, the level of expropriation of the rights of creditors is still high. In many cases, the unsecured creditors cannot execute their rights in the listed companies as the majority shareholders which control the management have transferred the main assets out of the companies. This condition can be seen in the bankruptcy of PT. Fiskar Agung. This company was a

101 *Bisnis Indonesia*, 19 February 2002.

102 *Ibid.*

103 Report on investigation of the breach of capital market regulation can be seen at Bapepam's website <<http://www.bapepam.go.id>>.

listed company with an outstanding debt approximately US\$ 24 million.¹⁰⁴ When this company was declared bankrupt in mid 1998, the management converted all assets into account receivables. As most of the accounts receivable are difficult to collect, there is no bankrupt estate which can be distributed to the creditors and the shareholders.

Two years after its introduction to the listed companies, the level of compliance of the Indonesian Code of Corporate Governance is still low. The response of the capital market society in Indonesia is quite positive, but implementation of this code as voluntary regulation will need a certain period of socialization. As happened in other adoptions of foreign codes or legal systems in Indonesia, implementation of new foreign code to the listed companies will face failure if there is no effort to adjustment on the existing legal culture in the Indonesian capital market.. Adoption of foreign bankruptcy principle, for instance, has failed in its implementation. Currently, there are only approximately 300 cases of bankruptcy in the Commercial Court.¹⁰⁵

Problem of Legal Transplants

According to Alan Watson, a successful legal transplant-like that of a human organ-will grow in its new body, and become part of that body just as the rule or institution would have continued to develop in its parent's system.¹⁰⁶ Adoption of a foreign legal system in Indonesia in many cases has received negative reactions from member of society. The failure in legal transplant can be seen from implementation of the new bankruptcy law in Indonesia.¹⁰⁷ This condition has happened also in the implementation of the principles of corporate governance. During the two years of its implementation, only 8 companies have implemented good corporate governance.¹⁰⁸

There is something missing when the government adopted a foreign code or legislation. The government concentrates only on the content of the code and ignores other variables that may affect implementation of new code in Indonesia. Lawrence Friedman argued that in many cases of legal transplant, people always forget about legal culture. According to Friedman, a legal system comprises of three sets of basic components: legal structure, substantive law and legal culture.¹⁰⁹

104 Hukumonline news <<http://hukumonline.com>>.

105 Information regarding bankruptcy cases in Indonesia can be access through <<http://pengadilanniaga.com>>.

106 Alan Watson, *Legal Transplants, An Approach to Comparative Law* (1973), 27.

107 The new Indonesian Bankruptcy Law is a combination of the old Dutch bankruptcy law and the United States bankruptcy law.

108 The Jakarta Stock Exchange news <<http://www.jsx.co.id>>.

109 Lawrence M. Friedman, 'Legal Culture and Social Development', (1969) 4 *Law & Society*

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Legal structure refers to the institutions and process within a legal system. According to Friedman, it is the body, the framework, and the long-lasting shape of the system.¹¹⁰ It contains the court system, the legislature, the banking system and the corporate system as well.¹¹¹ Substantive Law refers to the laws, both the substantive and procedural rules, and norms used by institutions which bind the structure together. Both legal structure and substantive law are real components of a legal system, but they are at best a blueprint or a design, not a working machine.¹¹² Friedman also argued that the structure and substance were static. They were like a still photograph of the legal system.¹¹³

For transplanting law, structure and substance alone is not enough. Legal culture is very important to be considered as it gives life to a legal system. Legal culture refers to the attitudes, values, and opinions held in society, with regard to law, the legal system, and its various parts.¹¹⁴ It is those parts of general culture, customs, opinions, ways of doing and thinking, that bend social forces toward or away from the law and in particular ways.¹¹⁵

During 30 years under Suharto's era, people in Indonesia have experienced how the legal system has been used to maintain the existence of political power of Suharto. People lose faith in the purpose of law. Corruption and cronyism in the courts have caused skepticism of the people in the importance of the legal system and law enforcement system. This circumstance has affected the success of adoption of new laws, especially the laws that have been adopted from foreign legal systems.

The failure in the implementation of the Indonesian Code of Good Corporate Governance in the listed companies has a connection with the general opinion of the people of the code or regulations in Indonesia. Over concentration to the structure and the substance of the code contributes also to such failure. Legal culture has never been considered by the government as a key success in the implementation of this code.

Foreign analysts have discussed issues of legal culture since 1972.¹¹⁶ Many scholars in Indonesia expressed the importance of legal culture in a legal

Rev. 29 and Lawrence M. Friedman, *Law and Society: an Introduction* 6-9, ch. 7 (1977).

110 Ibid.

111 Ibid.

112 Ibid.

113 Ibid.

114 Ibid.

115 Ibid.

116 Daniel S Lev, 'Judicial Institutions and Legal Culture in Indonesia', in Claire Hold (ed), *Culture and Politics in Indonesia* (1972), 246.

system,¹¹⁷ and yet, the government has always ignored the role of legal culture. The government has never used experts such as sociologists and anthropologists to become involved in the drafting of a new regulation or code such as the code of corporate governance. These experts can be involved to predict the reception of a new regulation in a certain society so that from the beginning other alternatives can be designed to implement this new code.

Patrimonialism in a patriarchal system is very common in Indonesia as well as overseas in other Asian countries. This sociological concept, actually, has influenced the way the corporations are managed. Cronyism basically has a root to this patriarchal system in that, in doing business, people deem that they will feel secure if they deal with the members of the families or there is a father figure who keep in check to all member of the families. In practice the government always ignores the existence of patrimonialism when the government applies a new regulation and experiences a failure in its implementation.

Conclusion

The implementation of the code of corporate governance in listed companies in Indonesia faces many problems which arise from concentration of ownership, pyramiding structures of group companies, cross shareholdings, lack of independent directors, corruption, and cronyism. These characteristics are found in most listed companies in Indonesia and often it has become something like a “culture” for the companies. Implementation of a new code which was adopted from foreign cultures will not achieve success for this code has been built up in a totally different culture.

The Indonesian Code of Corporate Governance is adopted from the OECD Principles of Corporate Governance. These principles were developed in the developed countries such as the United States, the United of Kingdom and other OECD countries. In these countries, there are no issues in the lack of law enforcement or weakness in regulations. In addition, people support the voluntary codes or informal codes such as the code of corporate governance. While in Indonesia, due to their experience during the last two-decades that the formal legal systems were not effective to maintain their rights, people give little appreciation to formal regulations. In the situation when formal regulations are not much appreciated, introduction of a voluntary regulatory code such as the code of corporate governance will be meaningless.

There is a tendency for people in Indonesia to prefer to avoid any norm or code if they can do this safely and bring benefit to themselves. This kind of attitude

117 Mochtar Kusumaatmadja, ‘Law and Development in the ASEAN Region: the Indonesian Experience’, 1 (1) *Asean Law Journal* 1, 6 (1982).

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becomes an obstacle to the implementation of good corporate governance. There should be a penalty for this kind of violation. For listed companies in Indonesia, Bapepam and the stock exchanges should be pro-active to play their role in supervising and monitoring the implementation of good corporate governance. For instance, ratings in the implementation of good corporate governance can be applied with certain standards to measure this implementation.

To deal with a problem of legal culture in the implementation of corporate governance, sociology approaches can be implemented. Basically, there are three communities which control listed companies in Indonesia: *the Chinese community*, *the Christian community* and *the Moslem community*. Implementation of good corporate governance may achieve its effectiveness if the code can be accepted voluntarily by those communities.

For the Chinese community, as most of them still adopt Confucian traditions, the way corporate governance can be implemented should follow this tradition. Confucianists reason that if each individual perfects his behavior, society as a whole would likewise be perfect.¹¹⁸ In Indonesia, this philosophy is reflected in the way the Chinese people treat the oldest. They respect the oldest people and in many cases, problems among the member are settled through involvement of the oldest person. Based on this tradition, corporate governance can be introduced as an alternative to achieve perfect behavior of the individual. In this case this applies to the owners of the listed companies. It can start with the oldest in the Chinese community being persuaded to implement corporate governance in their companies. Generally, the others will follow the oldest to implement good corporate governance.

The Christian community, like the Chinese, although they are in a minority, is very dominant in terms of control of listed companies in Indonesia. The financial crisis has brought the Christian entrepreneurs to apply Christian values in their business activities. In practice, the Christian entrepreneurs have their senior leaders in the Christian community to give advice about doing business. In this case, this leader can be a priest, pastor or other persons who have better knowledge about the Christian values. Implementation of good corporate governance can be done with the assistance of these Christians leaders. For instance, in a Sunday service, a priest or pastor may introduce a basic principles of corporate governance to the Christian community.

For the Moslem community, basically they are open to any new development as long as it brings benefit to the members. In listed companies, often a company is operated in accordance with “*Syariah Islam*”. For instance, to fight corruption, Muslim people in Indonesia apply a “jihad program”.¹¹⁹ Implementation of

118 Lucian W. Pye, *China, An Introduction*, fourth ed., (1991), 37.

119 In this case, jihad means a high commitment of the members of Moslem community to protect the Moslem values.

corporate governance in Indonesia should consider the role of “*Syariah Islam*” for business.

Finally, the problem of legal transplant of corporate governance in Indonesia is that the policy makers always ignore the importance of legal culture. Foreign codes of corporate governance work well in western countries because the principles of corporate governance are alive in their legal culture. These principles become part of the legal culture. Adoption of the principles of corporate governance in Indonesia should take into account the existence of domestic legal culture otherwise it will fail in its implementation.

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