CHAPTER I

INTRODUCTION

1.1 Background

What differentiates a developing and developed country is the financial system, wherein the system is more developed in the latter.[1] A financial system is a broad concept which points to the interaction of supply and demand for capital and other finance-related services.[2] A narrow concept of the financial system points to the financial sector. This part of the economy offers and provides financial services, for example the central bank, non-bank financial institution and more, to other sectors of the economy.[3] This particular industry may be organized using markets. The financial market boosts economic development by enhancing physical capital accumulation as it extends a borrower's financial capacity, improves trade efficiency and provides investors with the necessary funds to execute projects.

Types of financial market includes, capital market, money market, foreign exchange market, commodity market, derivatives market (consisting of exchange-traded and over-the-counter derivatives) and insurance market. The capital market refers to a place where stocks and bonds with long-term maturities are sold and purchased for the purpose of investment or trading.[4] It is further divided into 2 (two)

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[1] John Gurley and E. Shaw, "*Financial Aspects of Economic Development*", The American Economic Review, Volume 45, Number 4, 1995.
[2] Reinhard H. Schmidt and Marcel Tyrell, "*What Constitutes a Financial System in General and the German Financial System in Particular*", Johann Wolfgang Goethe-Universität Working Paper Series: Finance and Accounting, No. 111, 2003.
[3] *Ibid.*
[4] Henry Campbell Black, *Black's Law Dictionary,* 9th edition, (St. Paul Minn: West Publishing CO, 2009), p. 1056.

markets, namely stock and bond market. A well-developed stock market increases saving and the efficiency of capital allocation to productive investments which will increase the economic growth rate of a country. By expanding the available financial instruments that savers may utilize to diversify their investment, the stock market aids in mobilizing domestic savings.[5]

Share ownership in a well-developed stock market is able to provide investors with liquid means to share risks when investing in ventures. The stock market helps investors cope with liquidity risk by encouraging other investors who do not encounter liquidity shocks to sell their shares. This ensures that resources needed to satisfy short-term funding needs is not unnecessarily withdrawn from enterprises. The stock market is a big player in the distribution of resources in the private sector – presenting a major impact to the economy. When the government liberalize the financial system, it is important to grow the capital market to ensure that the allocation of capital is conducted efficiently. If it is not well-developed, it will slow down trade and decrease the trust of foreign investors, which will have a negative effect on the economic growth of the country.

The stock market is beneficial to a country as it is a platform for liquid trading and price determination for a wide range of financial instruments that enables investors to distribute risks and match the maturity preferences of capital raisers (usually long-term) and investors (usually short-term). This encourages investment while simultaneously reducing capital costs, thus leading to a long-term economic

[5] Guglielmo Maria Caporale, Peter G. A Howells, and Alaa M. Soliman, "*Stock Market Development and Economic Growth: The Causal Linkage*", Journal of Economic Development, Volume 29, Number 1, 2004.

growth. It is important for market participants to uphold good market practices in order to have a well-developed stock market.

The capital market in Indonesia was founded long before Indonesia's independence. It was, however, closed and re-opened multiple times due to Indonesia's constantly changing political climate. During the Dutch colonial period, the first stock exchange in Indonesia was set up in 1912 in Batavia. Trade was centred on shares of Dutch companies, government bonds (provincial and municipal) and stock certificates of American companies issued by the administration office in the Netherlands. The exchange was created mainly for the benefit of the Dutch East Indies. The Batavia Stock Exchange, along with other exchanges in Semarang and Surabaya, was closed during World War I and was reopened in 1925.

In the early 1939, the Surabaya and Semarang Stock Exchange were closed due to political reasons, namely World War II, and the Jakarta Stock Exchange was subsequently closed in 1942 for the same reason. In 1956, the stock exchange was re-activated by the Minister of Justice through the Capital Market Emergency Regulations 1952, trading only Indonesian Government Bonds. The stock exchange quickly became sluggish and inactive due to the nationalist programs imposed by the Indonesian government on Dutch businesses.[6]

The exchange was re-activated by President Soeharto on 10 August 1977 and was supervised by the Capital Market Supervisory Agency (hereinafter *Badan Pengawas Pasar Modal*/ 'BAPEPAM'). This occasion was marked by PT Semen

[6] Jonker Sihombing, *Pengantar Hukum Pasar Modal*, (Jakarta: Ref Graphika, 2016), p. 18-21.

Cibinong going public and became the first issuer listed in the Jakarta Stock Exchange. However, activity was rather dull as there were only 24 (twenty-four) listed companies. Compared to the capital market, people favoured investing in banks. The introduction of the 1987 December Policy Package provided the means for companies to go public and foreign investment in Indonesia. The deregulation packages in the banking and capital market sector attracted foreign investors which caused improvements on trading activities in the Jakarta Stock Exchange.

On 2 June 1988, the Indonesian Parallel Bourse, consisting of brokers and dealers, started operating. It was managed by the Securities and Money Trading Organization. Jakarta Stock Exchange was privatized on 13 July 1992 and the functions of BAPEPAM shifted to be the Capital Market Supervisory Agency (*Badan Pengawas Pasar Modal dan Lembaga Keuangan*/ 'BAPEPAM-LK'). As capital market popularity increases, parties involved in its transactions require regulations to ensure that transactions conducted are proper, fair and does not create chaos nor disadvantage parties involved. Law No. 8 of 1995 concerning Capital Market (hereinafter 'Capital Market Law'), issued on 10 November 1995, became the basis for the current market activities.

The Capital Market Law grants BAPEPAM-LK, as the supervisory body, authority to conduct investigations and examinations on crimes occurring in the capital market sector. In addition to that, Self-Regulation Organizations ('SRO') within the sector is authorized to implement regulations within the industry which eases law enforcement, thereby ensuring legal certainty.[7] The current Capital Market Law is supplemented with Government Regulation No. 45 of 1995 concerning the Implementation of Activities in the Capital Market Sector (hereinafter 'GR No. 45/1995'), Government Regulation No. 46 of 1995 concerning Investigation Procedures in the Capital Market Sector and Government Regulation No. 12 of 2004 concerning Implementation of Activities in the Capital Market Sector, along with several ministerial decrees.[8]

In the early 1990s, the government reformed the stock market as a response to their own need to revamp state-owned companies and the Indonesian capital market began growing. BAPEPAM-LK was established to ensure the fair operation of securities markets in Indonesia. When the Asian Financial Crisis occurred in 1997 to 1999, the capital market and banking sector crashed. To recapitalize the banking industry, the government issued bonds to the bank. The government bond market was developed in the early 2000s which eventually grew to be one of the capital market's largest segments.[9]

Since the introduction of Law No. 21 of 2011 concerning the Financial Service Authority (hereinafter *Otoritas Jasa Keuangan/* 'OJK' Law), the function of BAPEPAM-LK as a supervisory body shifted to OJK. OJK is tasked with the regulatory and supervisory duties over the financial service activities conducted by sectors such as banking, capital market and non-bank financial institutions. It was

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[7] Nasrudin and Surya, *Aspek Hukum Pasar Modal Indonesia,* 5th edition, (Jakarta: Kencana, 2008), pp. 73-74.
[8] Nasrudin and Surya, *op. cit.*, p. 73
[9] Kahlil Rowter, "Indonesian Capital Market Developments and Challenges", <http://www.nomurafoundation.or.jp/en/wordpress/wp-content/uploads/2016/10/NJACM1-1AU16-05_Indonesia.pdf>, accessed on 19 February 2020.

intended to facilitate and coordinate a regulatory and supervisory structure which would be incorporated into the operations of the financial services sector. OJK's objective includes structured, equitable, open and accountable implementation; achieving sustainable and stable growth in the financial system; and protecting the interests of investors and the society.[10]

The stock market is not only an option for the stock resources and public investment of a business, it also promotes the infrastructure necessary for sales and purchase and other related activities. Capital market is very important for Indonesia's economy due to its 2 (two) functions, namely, (1) as an alternative for a company's capital resources and (2) public investment. The capital resources obtained through the public offering may be beneficial for the development and expansion of a company to name a few. Moreover, by means of the stock market, the public may invest their money in accordance with their desired return and the risk characteristics of each instrument.

There are actions which may cause unfair business practices in the capital market, including market manipulation, fraud, insider trading and more. Market manipulation refers to the deliberate conduct intended to mislead investors by manipulating the security market or artificially influencing it. Manipulation may include a variety of methods designed to affect the supply of a stock or the demand for it. They may include, but are not be limited to, the publication of false or misleading company information; unfairly restricting the number of shares

[10] Jonker Sihombing, *Otoritas Jasa Keuangan, Konsep, Regulasi, dan Implementasi,* (Jakarta: Ref Publisher, 2012), p. 49-50.

available to the public; or rigging quotations, rates or trades to create a false or deceptive image of security demand.[11]

In the 17th century Amsterdam Stock Exchange, manipulators often spread out false news in local cafes, prompting other investors to sell or buy based on the inaccurate information circulated around the neighbourhood.[12] While stock market manipulation has been around for a very long time, it is no doubt that the current technological development and the introduction of internet transactions have a larger impact to a larger audience. This type of manipulation is causing problems to even developed stock markets. Manipulators tend to be potentially knowledgeable individuals, including corporate insiders, brokers, underwriters, major shareholders and market makers.[13] Presently, the market infrastructure, disclosure, regulations and enforcement of the Indonesian Stock Exchange (hereinafter 'IDX') are definitely lower than developed markets in countries such as Australia, Singapore and more.[14] This is a challenge as market manipulation is perceived to be a big impediment to the growth of the stock market.

Prices should reflect the stock's true value by the accounting information along with all the disclosed information regarding the particular listed company, without any judgment on behalf of the investors. When market manipulation occurs, there are bound to be consequences which incurs loss not only to the market

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[11] Securities and Exchange Commission, "Manipulation", <https://www.sec.gov/fast-answers/answerstmanipulhtm.html>, accessed on 21 March 2020.
[12] Mamduh Hanafi, "*Unusual Market Activity Announcements: A Study of Price Manipulations on the Indonesian Stock Exchange*", Gadjah Mada International Journal of Business, Volume 12, Number 2, 2010.
[13] Rajesh K. Aggarwal and Guojun Wu, "*Stock Market Manipulation – Theory and Evidence*", AFA 2004 San Diego Meetings, March 2003.
[14] Mamduh Hanafi, *op. cit.*

but also to the investors. These consequences include a loss of public trust in the honesty and correctness of the capital market, equal pricing of capital assets, a decrease in stock liquidity, investment deductions and an unoptimized distribution of resources and lastly, the decrease in economic development.[15] Market manipulation research will be able to provide insights to the characteristics of manipulated stocks as well as the techniques used to manipulate such stocks, which will be beneficial in helping regulators design a better and more effective market surveillance.[16]

Presently, *transaksi semu* (hereinafter 'illegal transaction'), a form of market manipulation, commonly occur in Indonesia.[17] Illegal transactions or more often called 'frying' of shares,[18] is actually not a new story in the world of the Indonesian capital market. In principle, it is a transaction on the exchange that simply does not really occur. This is because the sales and purchase are conducted by the same party. The purpose of this seemingly illicit deal is to gain money from investors stuck in it. Illegal transactions or 'frying' shares are very damaging to the market, because trading takes place unfairly.

Shares traded in this practice is now more commonly known as *saham gorengan* (or literally translated as fried stock). This term does not have a strict definition. It may refer to a company stock whose increase is out of the ordinary

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[15] Bahram Moazeni and Faride Asadollahi, "*Manipulation of Stock Prices and its Consequences*", European Online Journal of Natural and Social Science, Volume 2, Number 3, 2013.
[16] Guolin Jiang, Paul G. Mahoney, and Jianping Mei, "*Market Manipulation: A Comprehensive Study of Stock Pools*", Journal of Financial Economics, Volume 78, Number 1, 2015.
[17] Abdul Muslim, "Melindungi Investor", <https://investor.id/archive/melindungi-investor>, accessed on 15 March 2020.
[18] *Ibid.*

because its movements are being engineered by market participants with specific interest.[19] It also refers to stocks with volatile price movements and wide price range. The prices of this type of shares can go up and down with high presentation and price movements are controlled by bookies.[20] Usually, share price falls on the 'tier three' category, namely shares with market capitalization below Rp. 500 (five hundred) billion.

There may be parties looking to make profit through open trading tricks while still following applicable IDX rules. This practice is called 'trading strategy' and cannot be considered as a violation. Fried stock may lead to 2 (two) possibilities, merely trading strategies/tricks or a scheme designed for a certain dirty purpose which may rob investor funds. It becomes bad when there is a collusion between the stock market, the issuer and the investor funds manager because this is where investor funds can be drained and shifted to certain parties neatly but slyly. This term, however, is never specifically mentioned nor defined in the laws.[21]

The issue of illegal transaction of fried stock became a major headline due to the recent case of PT Jiwasraya. The Republic of Indonesia Supreme Audit Agency (hereinafter *Badan Pemeriksa Keuangan*/ 'BPK') and the Attorney General's Office investigated Jiwasraya's insurance policy default and found that it was due to the purchase low-quality, high-risk shares and mutual fund instruments with

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[19] Irvin Avriano Arief, "Apa Itu Saham Gorengan? Ini Definisi, Ciri-ciri, dan Tipsnya", <https://www.cnbcindonesia.com/investment/20200102162008-21-127172/apa-itu-saham-gorengan-ini-definisi-ciri-ciri-dan-tipsnya>, accessed on 30 January 2020.
[20] Hari Prabowo, "Apa yang salah dengan Saham Gorengan?", <https://investor.id/investory/apa-yang-salah-dengan-saham-gorengan >, accessed on 2 February 2020.
[21] Hamdi Hassyarbaini, "Gorengan atau Goreng Saham?", <https://investor.id/investory/gorengan-atau-goreng-saham>, accessed on 30 January 2020.

parties allegedly conducting price manipulations, resulting in negative spreads and liquidity pressure on the company. [22] As of June 30, 2018, Jiwasraya is known to have 28 (twenty-eight) mutual fund products with 20 (twenty) of them having a share above 90 (ninety) per cent. Most of these mutual funds are low quality and illiquid funds.

Jiwasraya often placed funds in fried stocks which includes PT Sugih Energy Tbk, PT Trikomsel Oke Tbk and PT Eureka Prima Jakarta Tbk. Placement of shares is not supported by a review of adequate placement proposals.[23] After investigating files from 2008 to 2018, BPK predicts the potential state loss of Rp. 16.8 (sixteen point eight) trillion due to the company's activities – Rp. 4.65 (four point sixty-five) trillion from stock investment and Rp. 12.16 (twelve point sixteen) trillion from mutual fund investment.[24]

In comparison, the United States of America (hereinafter 'U.S.'), with 2019 gross domestic product of $21.4 (twenty-one point four) trillion, is considered to be the world's biggest economy comprising 15 (fifteen) per cent of the global economic output.[25] During the Revolutionary War between 1775 and 1783, the new U.S. government issued bonds with the promise of future repayment to fund war effort. On paper, purchasers were issued promissory notes. Upon the conclusion of

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[22] Fika Nurul Ulya, "BPK Sebut Jiwasraya Investasi di Saham Gorengan ini, Apa Saja?", <https://money.kompas.com/read/2020/01/08/181838426/bpk-sebut-jiwasraya-investasi-di-saham-gorengan-ini-apa-saja?page=all>, accessed on 2 February 2020.

[23] *Ibid.*

[24] Syahrizal Sidik, "Skandal Jiwasraya: Negara Rugi Rp. 16.8 T, Aset Sitaan Rp. 18.4 T", <https://www.cnbcindonesia.com/market/20200921145035-17-188250/skandal-jiwasraya-negara-rugi-rp168-t-aset-sitaan-rp184-t>, accessed on 21 September 2020.

[25] Elvis Picardo, "Why Wall Street is a Key Player in the World's Economy", <https://www.investopedia.com/articles/investing/100814/wall-streets-enduring-impact-economy.asp>, accessed on 15 February 2020.

the war, bond holders began trading for immediate compensation. This behavior made people aware that these bonds and commodities needed a place to exchange.[26]

Wall Street, as the trading center for the world's largest financial markets, has a significant effect not just on the U.S. but also on the global economy. The Wall Street-based New York Stock Exchange is a worldwide leader in terms of its listed company's average daily share trading volume and overall market capitalization. In addition to that, the Nasdaq Stock Exchange, which is the second-largest exchange worldwide, is also located on Wall Street.

Despite having a developed stock market, market manipulations still occur in the U.S. market. In the U.S., Wash Trading is a form of market manipulation that is most similar to the practice of fried stock trading. Wash trading refers to the simultaneous or near-simultaneous selling and re-purchase of the same security for the purpose of generating activity and increasing price.[27]

It is a form of market manipulation where the parties involved conduct sham orders in order to create artificial movements in the volume and price in the market for their benefits.[28] Wash trading inflates the price of the financial instrument that is traded, for example securities, as parties constantly conduct 'trades' to increase the price of the instrument. This is a bad practice as it causes unwitting and innocent parties to buy those financial instruments at artificially inflated prices.[29]

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[26] Britt Barclay, "History of the Stock Market in America", <https://pocketsense.com/history-stock-market-america-6716985.html>, accessed on 21 September 2020.
[27] Labaton Sucharow, "Market Manipulation: Common Securities Violations", <https://www.secwhistlebloweradvocate.com/securities-laws/common-securities-violations/market-manipulation/>, accessed on 21 March 2020.
[28] John Teall, *Financial Trading and Investing*, 1st edition, (Academic Press), 2012.
[29] Charles R. P. Pouncy, "*The Scienter Requirement and Wash Trading in Commodity Futures: The Knowledge Lost in Knowing"*, Cardozo Law Review, Volume 16, Number 5, 1995.

Despite being used to increase the price of instruments in the market, wash trading can also be considered as a scheme to drive market prices downwards. Parties involved in the manipulation, either in the scenario of the price increase or decrease, is not exposed to real financial risks as they continuously gain from the deceitful methods conducted to create an illusion of trade in the market which impacts the prices and volume of instruments traded.[30] Wash trading schemes also generate rebates and kickbacks from providers such as exchanges and brokers in addition to being initiated to manipulate rates. Due to these reasons, the U.S. congress and courts consider wash trading schemes to be an unconstitutional challenge to the proper and fair functions of the financial markets.

The Great Depression in 1929 was arguably the worst financial crisis for the U.S. wherein its stock markets lost over 85 (eighty-five) per cent of their value. [31] The stock market crash resulted in nearly 5,000 (five thousand) banks being closed, leading inevitably to bankruptcies, rising unemployment, pay cuts and even homelessness.[32] On June 6, 1934, the Securities Exchange Act of 1934 (hereinafter 'SEA 1934') was signed by President Franklin D. Roosevelt to regulate the secondary trading of securities including stocks, bonds and debentures.

Section 4 of the SEA 1934 became the basis for the establishment of the Securities and Exchange Commission (hereinafter 'SEC') to supervise the capital market. It is hoped that by creating this agency, the government would be able to

[30] Jerry W. Markham, *Law Enforcement and the History of Financial Market Manipulation*, 1st Edition, (New York: Routledge), 2014.
[31] Britt Barclay, *op. cit.*
[32] History.com, "SEC: Securities and Exchange Commission", <https://www.history.com/topics/us-government/securities-and-exchange-commission>, accessed on 22 September 2020.

restore investor trust in the capital market by providing more accurate information and clear rules and guidelines for fair and honest dealing with the public and investors.

SEC aims to provide investors with greater security, maintain fair, orderly and efficient market and promote the market formation. This is for the sake of fulfilling the common interest of all Americans – a growing economy. A growing economy is important to the country as it will produce more jobs which will reduce unemployment rate, improve the standard of living and protect the value of savings. To fulfil this hope, all actions taken by the SEC must be geared towards the promotion of capital formation that is essential in sustaining economic growth.[33]

The notion of illegal transaction is not a recent discovery and has been discussed before. This is evident with other research conducted on the said topic, namely *Legal Protection of Investors Against Illegal Transactions in Indonesia's Secondary Market* [34] and *Financial Services Authority Oversight of Brokers Conducting Illegal Transactions in the Indonesian Capital Market*[35] among others. However, this thesis will focus on comparing the regulations applicable for illegal transaction in Indonesia and the U.S., the difference in supervision and the subsequent sanctions for violators.

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[33] Securities and Exchange Commission, "What We do", <https://www.sec.gov/Article/whatwedo.html>, accessed on 20 February 2020.
[34] Rio Cahya Nandika, "Perlindungan Hukum Investor Terhadap Praktik Transaksi Semu di Pasar Sekunder Indonesia". *Thesis,* Surakarta: Universitas Sebelas Maret Faculty of Law, 2018.
[35] Jessica Rahayu Sitorus, "Pengawasan Otoritas Jasa Keuangan Terhadap Pialang yang Melakukan Transaksi Semu di Pasar Modal Indonesia". *Thesis,* Medan: Universitas Sumatera Utara Faculty of Law, 2017.

1.2 Formulation of Issues

To further understand illegal transactions, analysis on the current regulations in Indonesia and the U.S. governing such transactions will be conducted. The formulation of issues are as follows:

1. How is illegal transaction regulated in Indonesia and the U.S.?
2. How are sanctions on illegal transactions regulated in Indonesia and the U.S.?

1.3 Research Purpose

This comparative study will help in determining how the law in Indonesia should be implemented to ensure that there is fair and honest business practice in the Indonesian stock market to help increase the rate of economic growth. The purpose of the research is as follows:

1.3.1 Identify and analyze regulations governing illegal transactions in Indonesia and the U.S.; and

1.3.2 Identify and analyze the sanctions implemented by both countries regarding such practices.

1.4 Research Benefit

The benefits of this research shall consist of (1) theoretical and (2) practical benefit.

1.4.1 Theoretical Benefit

The research aims at enriching legal studies on Capital Market Law to contribute to a further understanding of how the practice of illegal transaction should be regulated with the aim of decreasing such practices and improving the economy. It is hoped that the research may be used as material knowledge and as a comparison and source of reference for the same field of study.

1.4.2 Practical Benefit

The research is hoped to be able to contribute to enriching the library references for academics and to apply the methods or knowledge acquired during class and lectures to analyze the existing issues within the Indonesian legal system and recommend the solutions to such issues.

1.5 Framework of Writing

Framework of writing aims to facilitate the understanding and study of research. In this research, the framework of writing consists of 5 (five) chapters, each of which will be explained in the outline below:

CHAPTER I: INTRODUCTION

This chapter contains materials refining the research proposal including the background of the issue, formulation of issues, research purpose, research benefit and framework of writing. It introduces the importance of capital market for the country's economy as well as the negative impacts brought by market manipulation practices, such as illegal transaction. It provides an example of illegal transaction that occurs in

Indonesia in the form of fried stock along with a similar practice that occurs in the U.S., namely wash trading.

CHAPTER II: LITERATURE REVIEW

This chapter outlines the theories that underlie the detailed discussion to be used as basis for analyzing the data obtained. This chapter is divided into theoretical and conceptual review. It looks into the history of both the Capital Market Law and SEA 1934 as well as the understanding of illegal transaction and wash trading in each respective country. The conceptual review will focus on expanding the understanding of both the capital market and market manipulation.

CHAPTER III: RESEARCH METHODOLOGY

This chapter will elaborate the research methodology of the Author. It will contain the different types of research methods, types of research, procedures for obtaining the research materials and legal materials, along with the most ideal research technique that will be utilised in this thesis.

CHAPTER IV: ANALYSIS AND DISCUSSION

This chapter contains the data analysis to assess the regulations regarding illegal transactions in relation to fried stock. Based on the data obtained in Chapter II, the Author will analyze and compare data regarding the different regulation between Indonesia and the U.S. It will focus on the comparison between Indonesia and the U.S. regarding the regulations and the implementation of the regulations.

CHAPTER V: CONCLUSION AND RECOMMENDATION

This chapter contains the conclusions of a series of thesis discussions based on the analysis that has been done as well as suggestions to be submitted to the object of research or for further research.