Draft Rule on Material Transactions and Changes in Core Business: Way out for USD Bond Issuers?

On 24 February 2011, BAPEPAM-LK published an amended version ("Draft Rule") of BAPEPAM-LK Rule No. IX.E.2 on Material Transactions and Changes in Core Business ("Rule IX.E.2"). BAPEPAM-LK is now accepting submissions on this Draft Rule from capital market practitioners until 2 March 2011. There is as yet no information available as to when the amendments are expected to be adopted and put into effect. One of the key reasons for the framing of the Draft Rule appears to be the provisions of Rule IX.E.2 that restrict the issuance of debt securities by an Indonesian issuer or public company ("issuer") in offshore markets, usually in reliance on foreign securities regulations ("securities regulations").

Under Rule IX.E.2, the definition of material transaction includes lending and borrowing transactions with a value of 20% or more of the issuer's equity. Exemptions to Rule IX.E.2 only apply to the issuance of debt securities through a domestic public offering. Therefore, any offshore issuance of debt securities, whether through a public offering or private placement, is subject to Rule IX.E.2. In such case, if the value of the securities is more than 50% of the issuer's equity, it must obtain the approval of its General Meeting of Shareholders ("GMS") and consequently must announce the details of the transaction, such as price amount and a summary of the appraisal report, 30 days before the GMS. This requirement may give rise to a conflict with the securities regulations in the place where the debt securities are to be listed or marketed, such as the U.S. Securities Act.

In the case of an offering conducted in reliance on securities regulations such as the U.S. Regulation S/Rule 144A, the issuer is normally prohibited from delivering any press release or any other disclosure during the period commencing with the start of the offering process up until the pricing is fully completed (blackout period). In addition, pre-announcing the details of the issuance, e.g., price range, at a very early stage of the offering may adversely affect its success.

We will now discuss a number of material points of the Draft Rule and analyze the relevant legal issues:

A. <u>Issuance of Material Offshore Debt Securities: A Possibility</u>

Under Rule IX.E.2, any material transaction with a value exceeding 50% of the issuer's equity must first be approved by the GMS. This includes the issuance of debt securities in offshore markets, whether through public offering or private placement. The issuer is also required to announce information on the proposed material transaction in the newspapers well before the GMS. In addition to violating the blackout restriction under the securities regulations, such an announcement prior to the GMS may be considered premature since at that time the pricing and amount of the debt securities have yet to be determined. Consequently the appraiser cannot prepare its report for inclusion in the announcement.

Under the Draft Rule, BAPEPAM-LK has made the following exemptions to the information that must be disclosed:

a. the particulars of the subscribers or purchasers of the debt securities;
b. the total proceeds from the issuance of the debt securities;
c. interest rate or yield; and
d. summary of the appraiser's report.

Therefore, the announcement of the GMS only needs to provide the following information:

a. an elaboration of the material transaction in the form of the issuance of debt securities;
b. explanations, considerations and the rationale behind the proposed issuance of debt securities and its effect on the issuer's financials, which must be presented in a proforma financial statement reviewed by an independent accountant.

These new exemptions may resolve some of the problems that currently arise under Rule IX.E.2 as sensitive information such as pricing, amount and the appraisal report will no longer need to be disclosed. However, the pre-announcement requirement, regardless of its significance, still poses potential problems as counsel in the relevant jurisdiction may consider such announcement as tantamount to market conditioning. Now that significant information has been exempted, perhaps it may be apropos to question the precise significance of the pre-announcement and GMS approval requirements.

The existing Rule IX.E.2 does not require GMS approval for a loan transaction, regardless of its value. Most offshore public offerings impose stringent disclosure requirements at a level generally more rigorous than in the case of loan transactions. Therefore, the issuance of offshore debt securities should at least enjoy the same complete exemption from being classified as a material transaction as a loan transaction under Rule IX.E.2.

B. New Definitions, Different Reach

If adopted, the new Draft Rule will replace the term "subsidiary" in Rule IX.E.2 with the term "controlled company," which is defined as a company that is either directly or indirectly controlled by the issuers. "Control" means the ability to determine, either directly or indirectly, the management and/or policy of the issuer. This change broadens the application of this rule from a subsidiary that is 99% owned by the issuer to other direct or indirect subsidiaries insofar as the issuer controls them.

In addition, the Draft Rule defines "core business" as an activity stipulated in the issuer's articles of association and actually engaged in directly by the issuer. The addition of "directly" into the definition may adversely impact on an issuer as at present it may not engage in the businesses mentioned in its articles of association directly, but instead through a direct or indirect subsidiary(ies).

C. Additional Exemptions

The Draft Rule also excludes four additional types of transaction from the definition of material transaction:

1. obtaining a loan directly from a local or offshore bank, venture capital or other financing institution;
2. pledging of collateral or extending a guarantee to a financial institution in respect of a loan obtained directly by the company or through any controlled company in which it holds at least 99% of the shares;
3. a material transaction by a bank in the form of a loan facility from the Indonesian central bank, or any other Government institution, with a value of more than 100% of the bank's own paid-up capital, or in any other circumstances that may result in the restructuring of such bank by the relevant Government authority;
4. a material transaction by a company, other than a banking institution, that possesses negative net operational capital and net equity.

D. Additional Acquisition Procedure

Under the Draft Rule, an issuer conducting an acquisition with a value exceeding 50% of the issuer's equity must first secure GMS approval in accordance with BAPEPAM-LK Rule IX.J.1. This means that the transaction must be approved by at least ¾ of the total number of shareholders attending or represented at the GMS and approved by more than ¾ of the total votes cast at the GMS.

In the event that a material transaction that has been announced, or been approved by the GMS, is cancelled, or any changes occur to the information provided in respect thereof, the issuer must immediately disclose such information under BAPEPAM Rule No. X.K.1.

E. Conclusion

The issuance of this Draft Rule is an interesting development as it reveals that BAPEPAM-LK is prepared to go some way to accommodate foreign securities regulations in order to facilitate Indonesian issuers wishing to conduct offshore debt securities offerings or private placements. Unfortunately, the effort remains half-hearted as the Draft Rule maintains the pre-announcement requirement, which, while being of little significance, has the potential to hamper such transactions. Hopefully BAPEPAM-LK, in the light of analyses such as the above, will reconsider the proposed changes and opt for a market-friendly approach instead.

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