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Possible Effects of the New Regulatory Framework on Franchising

Editorial Team

Overview

Franchising is a business model that has enjoyed immense success in Indonesia. This is because it not only paves the road for franchisors that wish to penetrate the Indonesian market, but it also provides an alternative investment method, to novice Indonesian entrepreneurs who lack in managerial, marketing, and business start-up knowledge in the form of a conservative business model.

One of the advantages of franchising is that there is a greater certainty of success. This means that franchising is an appealing investment opportunity for entrepreneurs in Indonesia.

The Indonesian Government hopes that franchising will stimulate the economy. This is because as franchising expands, the demand for labor and supplies will also rise. However, in order for the franchise industry to benefit society at large, it must engage with them. That is, franchises need to procure products and services from local businesses.

Previous regulations on franchise did not require franchise businesses to source locally. This changed in 2012, when The Ministry of Trade ("MoT") issued [Regulation No. 53/M-DAG/PER/8/2012](#) on Organizing Franchise Businesses ("2012 Regulation"), which revoked previous MoT [Regulation No. 31/M-DAG/PER/8/2008](#) ("2008 Regulation").

With the 2012 Regulation, the Government aims to encourage growth of small and medium-sized enterprises ("SME") by forcing franchises to procure from them. However, while this requirement is likely to increase participation of local small and medium sized enterprises in the process, some franchises might see this as a logistical and procurement challenge.

Indonesian Version

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Purpose

This edition of Indonesian Law Digest ("ILD") will focus on the provisions of the 2012 Regulation. To this end, it will discuss the following issues:

1. Current Regulatory Framework
2. Changes Under The 2012 Regulation in Brief
3. Focus: Establishing and Operating a Franchise Business in Indonesia
4. Focus: Obligation to Engage Domestic Businesses as Suppliers and Contractors
5. Focus: Obligation to Prioritize Local SMEs as Franchisees
6. Focus: Limiting Franchise Operation to Its Principal Business
7. Focus: Ongoing Development in the Regulatory Framework

Current Regulatory Framework

Applicable Laws and Regulations that specifically govern franchising are:

- [Law No. 9 of 1995](#) on "Small Enterprises" (Art. 27 (d)) ("Law 9/1995");
- [Government Regulation No. 42 of 2007](#) on "Organizing Franchise Businesses" (PP 42/2007);
- [Minister of Trade Regulation No. 53/M-DAG/PER/8/2012](#) on "Organizing Franchise Businesses" ("2012 Regulation");
- [Director General of Domestic Trade \("DGD"\) Decree No. 138/PDN/KEP/10/2008](#) on "Technical Guide on Organizing Franchising" ("DGD Decree 138/2008").

Note: DGD issued Decree 138/2008 based on the revoked 2008 Regulation. This ILD will refer to it for illustration only. However, a new DGD Decree/Regulation that will implement the 2012 Regulation is expected and readers should consult the DGD for updates.

In addition to the above laws and regulations, a franchise must also comply with the [intellectual property rights \("IPR"\) legislation](#), as it is required to register its intellectual property rights (see Art. 2 (f) 2012 regulation *juncto* Art. 3 (f) PP 42/2007). The IPR laws that relate to franchise businesses are:

- Trademark: [Law No. 15/2001](#) on Trademark
- Patent: [Law No. 14/2001](#) on Patent

- Copyright: [Law No. 19/2002](#) on Copyright
- Industrial Design: [Law No. 31/2000](#) on Industrial Design

Changes Under the 2012 Regulation in Brief

The 2012 Regulation governs areas that were left unregulated under the 2008 Regulation. In addition, it changed some of the existing rules. This section lists significant changes in the 2012 Regulation.

Obligation to Use and Sell Domestic Products and Services

80% of products and services that a franchise uses for production, or sells to consumers, must be domestically sourced. The Minister of Trade may make an exception to this obligation based on his/her discretion (Art. 19)

Franchisor's Obligation to Engage Local Small and Medium Sized Enterprises (SME)

A franchisor must prioritize contracting with local SME(s) as its franchisees or suppliers if they are able to meet the franchisor's terms and conditions (Art. 20).

Limiting Scope of Operation to Principal Business

Franchisors and franchisees may not deviate from their principal business for which they are licensed. They may sell products that support the principal business, but only under certain circumstances and not more than 10% of the types of goods sold (Art. 21).

Unilateral Termination of Agreement By Franchisor

A franchisor that unilaterally terminates the agreement must settle the dispute with the franchisee before it can appoint another franchisee. Previously, if a franchisor opted to not settle the dispute, it only had to wait six months after the termination (see Art. 8, 2012 Regulation and compare with Art. 6, 2008 Regulation).

Change of Authorities that Process Franchising Permits (STPW)

Both the franchisor and the franchisee must own a franchise permit, known as "Surat Tanda Pendaftaran Waralaba" ("STPW"). Under the 2012 Regulation, the agencies that administer the process are different from the 2008 Regulation. See next section for details.

Obligation to Display Ministry of Trade "Certified Franchise" Logo

A franchise that obtained an STPW must display the "Certified Franchise" Logo, which distinguishes certified franchises that may legitimately trade from those that are yet to obtain a permit and may not operate (Art. 18). Minister of Trade will issue a regulation to specify the logo's details and display.

Focus: Establishing a Franchise Business in Indonesia

In order for a franchise business to operate, it must meet criteria listed in Article 2(1) of the 2012 Regulation and obtain an STPW. All franchisors and franchisees must also make an annual operation report to the Director General of Domestic Trade.

Article 2(1) Criteria

For a business to be named a franchise, it must meet the criteria set out in Article 2(1) of the 2012 Regulation.

These criteria should be read in conjunction with DGDT Decree 138/2008, which provides technical guidance. It should be noted that although DGDT Decree 138/2008 will soon be replaced, Article 2(1) of the 2012 Regulation is similar to the same provision in the 2008 Regulation, and thus, it is unlikely that technical guidance would also change significantly. The criteria are:

- a. *Unique Operation/Characteristics* - this refers to the business' advantage or distinction that is not easily copied by other comparable businesses. This includes management system, products, sales and services, or distribution method;
- b. *Proven as Profitable* - the franchisor must show profit for a period of approximately five years. This can be demonstrated by sustainability and growth;
- c. *Having Standardized Services and/or Products in Writing* - the franchise must have a standard operational procedure that all franchisees can emulate and apply;
- d. *(Having a business practice that is) Easily Transferable and Applicable* - the business operation must be feasible enough so that inexperienced franchisees can operate it with relative ease;
- e. *Continued Support* (from the franchisor to the franchisee) - this includes operational guidance, training, and advertising;
- f. *Registered Intellectual Property Right* - This can be a registered or a pending IPR certification.

Application for STPW

In order to receive permission to operate, every franchisor and franchisee must obtain an STPW (Arts. 9(1) and 10(1)). The application procedure is governed under Articles 9-17 of the 2012 Regulation. Once issued, an STPW is valid for 5 years. STPW can be renewed after expiry for another 5 years. There is no limitation on how many times franchise permits can be renewed.

All franchisors must apply with the Trade Services Office, which is a part of the Directorate General of Trading Business Development ("DGTBD"). This involves submitting a prospectus for registration, along with the form in Appendix III A-1 and documents listed in Appendix IV (Art. 9(2) *juncto* Art. 11).

A prospectus that was registered by a foreign franchisor must be legalized by a notary and certified by Indonesia's trade attaché or an Indonesian embassy official in the country of origin (Art. 13).

A franchisee contracting with a foreign franchisor must apply with the Trade Service Office. It must submit the agreement for registration and enclose the form attached in Appendix III B-1, as well as documents listed in Appendix IV (Art. 10(2) *juncto* Art. 11).

A franchisee contracting with a domestic franchisor, foreign sub-franchisor, or a domestic sub-franchisor must apply with the Jakarta trade authority, a regency/municipal trade authority, or the local Indonesia One-Stop Service office. It must submit the agreement for registration and enclose the form attached in Annex III B-2 and documents listed in Appendix IV (Art. 10(3) *juncto* Art. 11).

All applications submitted for an STPW must enclose all documents found in Annex IV. All franchisors and franchisees must also sign the applications and present original documents for verification (Art. 11 and 12).

Timeframe for STPW Application Process

An STPW is issued within two (2) days if all of the documents are complete and are in order. Incomplete and incorrect applications will be sent back within two days. If this occurs, the applicant may reapply (Art. 14).

Issuance of STPW

Authorities that receive applicants' STPW applications also issue STPWs. These authorities are:

- Trade Services Office for applications from all franchisors (under Art. 9(2)) and franchisees who contract with foreign franchisors (under Art. 10(2)) (see Art. 23 and Art. 25);
- DKI Jakarta trade authority, or the INSW in Jakarta, for applications made in Jakarta by all other franchisees (Art. 23 and Art. 25(2));
- Regency/municipal trade authority, or local INSW, for applications made in other regencies or cities for all other franchisees (Art. 23 and Art. 25(2)).

An issuing authority may request clarification or further information from the applicant. In this case, the authority will invite the applicant to make a presentation before an evaluation team. The team will make a recommendation to either accept or reject the application based on the presentation (Art. 15).

Sanction

There is an administrative sanction for non-compliance with Articles 9 and 10 (e.g. operating without an STPW). It includes a warning letter - which may lead to a business operation suspension and eventually a business permit revocation - and also a fine up to IDR 100 million (Art. 32).

Annual Operation Report

Pursuant to Article 30, franchisors and franchisees must each submit annual operation reports to the authority that issues the STPW. The report must use the form found in Appendix VI. The report must include such specifications as: royalties paid/received; percentage of domestic and imported raw materials used in production; and quantity and types of own and other merchants' merchandise the franchisor/franchisee sells.

Focus: Obligation to Engage Domestic Businesses as Suppliers and Contractors

Domestic Sourcing Rule

Article 19(1) of the 2012 Regulation requires that at least 80% of raw materials and capital goods used in production and sale of merchandise are domestic.

The implication of the domestic sourcing rule to franchise operation remains unclear because it leaves the following two issues unresolved.

First, it does not regulate whether 80% is calculated based on quantity of products used/sold, or the accumulative monetary value required in the entire production.

Second, it does not specify whether every operating expense counts towards the 80% threshold, particularly labor and utilities. Calculating these two expenses is likely to increase the percentage of domestically sourced services, seeing that the PLN monopolizes electricity service and majority of a franchise's workforce would be Indonesian.

As such, it is possible that the Government and franchises may interpret the components of the 80% threshold differently.

Analysis on the Likely Impact of the "Domestic Sourcing Rule"

The extent to which the "Domestic Sourcing Rule" will affect a franchise depends on how rigid its product standardization practice is. The less flexible it is towards switching raw materials, the more this rule will affect a franchise.

A restaurant franchise that built its brand and reputation on the quality of its ingredients would find it harder to adapt. McDonald's, for example, normally uses Russet Burbank potatoes for its french fries. Thus, McDonald's sources Russet Burbank potatoes from producers that follow the same growing standards and can provide the quantity of potatoes required by the restaurant.

As of 2009, no farm in Indonesia produced Russet Burbank potatoes and McDonald's Indonesia imported them all. In a situation where McDonald's would be required by law to switch to domestically grown potatoes, it would have to find a replacement producer of its raw materials.

The same case also applies to Sizzler-American Grill, a US-based restaurant chain, which sells imported steak in their menu from the United States, Australia, and Japan. It is noteworthy that Sizzler's business is founded on selling premium imported steak-meat, as it is perceived that it cuts like butter, contrary to Indonesian steak-meat.

On the other hand, a minimarket franchise with a business that depends on location would adapt better. It can tailor the variety and quantity of its products to suit local preferences.

Focus: Obligation to Prioritize Local SMEs as Franchisees

Article 20 of the 2012 Regulation requires that franchisors prioritize local SME(s) to become franchisees or suppliers if they are able to meet the franchisor's terms and conditions.

One point to consider is that the 2012 Regulation does not stipulate what terms may or may not be included in the agreement. Franchisors are thus free to set their own terms, such as a high capital requirement and a minimum experience. As a result, Local SMEs with little capital or experience might not be able to meet these terms. Although Article 20 aims to prioritize SMEs involvement in the franchising business, it is too lenient to have a significant force on franchisors to change their practices.

Focus: Limiting Franchise Operation to Its Principal Business License

Article 21(1) of the 2012 Regulation limits a franchise operation to the business for which it is licensed, which suggests that its operation may not deviate from the license.

An example of a franchise operation that deviates from its business license is 7-Eleven, which obtained a restaurant business permit. Recent media coverage reveals that 7-Eleven operation deviates from its permit to retail, instead of restaurant.

As franchises must state their main products in the annual report to the DGD, in accordance with the Annex 6 form, the 2012 Regulation allows a franchise to sell supporting products outside the main products. The threshold under Article 21(3) is set at 10% of total goods sold by the franchise for the sale of supporting products.

7-Eleven is an ideal example to explain Article 21(3). Pursuant to their restaurant - business license, 7-Eleven may only sell food and beverages as their main products. However, primary products sold are supporting products, such as cigarettes, lighters, chips, batteries, medicine, toiletries, stationery, underwear, mosquito repellent, magazines, etc.

Thus, it can be seen that supporting products amount to more than 10 % of the types of products that they are permitted to sell.

Focus: Developments in the Regulatory Framework

Regulation on the Limit of Outlets One Person May Own

Current public discourse reveals that Ministry of Trade is currently considering limiting the number of franchise outlets an individual may own. Currently, there are talks with interested parties to limit individual ownership to 100 - 150 franchise outlets per owner.

The rationale behind this policy is to level the playing field so that small enterprises can compete with larger enterprises. The talks have not yet reached a consensus on the number.

At this point, it is unclear whether this limitation will apply only to individuals, entities, or both.

Further Regulation on "One License One Business Type" for Franchises

Prompted by the example of 7-Eleven, Ministry of Trade is in the process of drafting a new regulation that would force a franchise to stick to its business permit. If this Regulation were issued, it would complement Article 21(3) of the 2012 Regulation on the 10% limitation of supporting products sales.

Lastly, one of the debated issues is whether a new Regulation should allow a business to operate across a number of sectors simultaneously, as with the example of 7-Eleven. 🇮🇩