

Integrating Islamic Law into Indonesia's Capital Market Framework

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ABSTRACT

This study examines the integration of Islamic law into Indonesia's national legal framework, focusing on the Islamic capital market. As normative legal research, the study employs a statutory approach by analyzing existing regulations, legal principles, and authoritative sources related to both national and Islamic law. The purpose is to understand how Islamic law principles are incorporated into the regulatory framework of Indonesia's capital market and to assess the challenges and effectiveness of such integration. The research highlights the role of legal pluralism in shaping a cohesive and functional system that accommodates both Sharia law and secular laws within the national context. The findings suggest that while there have been significant efforts to harmonize Islamic law with national law, certain legal ambiguities and operational challenges persist. This calls for continuous reform to ensure that the Islamic capital market adheres to both national standards and Sharia principles effectively.

Keywords: Legal Framework, Islamic Capital Market, Regulation

Introduction

The Islamic financial services industry, consisting of Islamic banking, takaful (Islamic insurance), and the Sharia Capital Market has evolved into a growing segment within the global financial market and has garnered significant interest as a viable and efficient alternative financial model. The increasing awareness and

demand for investments in accordance with Sharia principles on a global scale have acted as a catalyst in shaping the Islamic financial services industry into a developing sector. This also reflects the rising wealth and capacity of both Muslim and non-Muslim investors to seek and invest in new investment products that meet their needs. Islamic financial products also represent a class of investment products that may appeal to those seeking socially or ethically responsible investments, as these products must comply with strict Sharia rules of a religious nature.¹

In line with Todaro & Smith's statement that capital accumulation is a primary driver of economic growth, the Indonesian government is actively developing the investment sector, particularly through the development of the capital market. The capital market plays a crucial role in stimulating savings by offering a variety of financial instruments that meet the public's liquidity needs. Additionally, it serves as a platform for companies to obtain funding at favorable costs. Beyond its conventional function, the Islamic Capital Market is an integral part of the Islamic financial system, along with Islamic banking and Islamic insurance. The Islamic Capital Market (ICM) facilitates investments in accordance with Islamic principles, ensuring that financial instruments comply with Shariah guidelines by avoiding elements of interest (*riba*), speculation (*maisir*), uncertainty (*gharar*), and involvement in prohibited activities such as gambling, arms trading, or environmentally harmful practices. By upholding ethical standards, the ICM expands access to Shariah-compliant investment opportunities to a wide range of societal segments, addressing needs that may not be adequately met by the conventional financial system.²

The capital market is a segment of the financial sector where medium- and long-term securities are issued to raise funds for financing productive activities. The Sharia Capital Market is a subsector of the capital market that promotes Sharia-compliant securities/instruments as an alternative to conventional ones, offering investment opportunities for many investors. The ICM forms an integral part of the Islamic economic system, complementing the role of investment in the Islamic banking

¹ OICU-IOSCO, "Islamic Capital Market Fact Finding Report, Report of The Islamic Capital Market Task Force of The International Organization of Securities Commissions", July 2004, <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD170.pdf>

² Fasya Kamilia Muftia dkk, "The Role of Islamic Capital Market To Indonesia's Economic Growth in 2011-2021", "Ekspansi : Jurnal Ekonomi, Keuangan, Perbankan, dan Akuntansi, Vol.15 (1), 2023, Politeknik Negeri Bandung", <https://jurnal.polban.ac.id/ojs-3.1.2/akuntansi/article/view/4684>

sector. Since Islam emphasizes equity-based and asset-backed transactions, the ICM plays a significant role in meeting the needs of investors seeking to diversify their investments.³

As Chapra suggests, the Islamic Capital Market (ICM) is part of the Islamic economic system, which differs from other economic frameworks due to its deep connection with Sharia, which serves as its worldview and guiding principles. Unlike secular economic systems, Islamic economics does not solely prioritize material gains. Instead, its objectives are strongly rooted in the enhancement of human welfare and the development of a virtuous life. This system emphasizes values such as brotherhood, socio-economic justice, and the balanced fulfillment of both material and spiritual needs for all individuals.⁴

The welfare of the state and its people has always been a primary concern throughout history. The state plays a key role in creating welfare for its citizens, which is the essence of its sovereignty. The concept of the Welfare State holds a great responsibility in ensuring the well-being of its people in various aspects of life. However, the challenge lies in how the state can play its role appropriately so that the economy runs smoothly and the welfare of the people is guaranteed. "The institution of Islamic economic law serves as an essential foundation in the development of the Islamic economic structure." The availability of a legal framework reflects that legal regulations play an important role in formulating normative laws, such as Islamic law, to become an integral part of national law. In this context, the positivization of law refers to the formalization process of normative laws, such as Islamic law, to become an integrated part of the national legal system. Therefore, Islamic law that has undergone the process of positivization becomes a legitimate part of national law, with all official regulations governing Islamic economic practices in Indonesia having to pass through a positivization process recognized by the state. Thus, when an economic law has been formalized by the state, its legal force originates from state legitimacy, which universally applies to all Indonesian people and can be effectively

³ Securities and Exchange Commission Nigeria, Understanding Islamic Capital Market, 2019, <https://sec.gov.ng/understanding-islamic-capital-market/>

⁴ Kurniawan Desiarto, "Urgensi Pembentukan Undang-Undang Tentang Pasar Modal Syariah". *Al-Qanun: Jurnal Pemikiran Dan Pembaharuan Hukum Islam*, 2021, 24 (2):308-39. <https://doi.org/10.15642/alqanun.2021.24.2.308-339>.

enforced in economic activities. According to Lawrence M. Friedman, the law has a significant impact on society because it is created with specific purposes. This concept is evident in the context of the development of Islamic economic law in Indonesia. Various studies on the relationship between law and Islamic economics emphasize that the progress of Islamic economics cannot be realized without a strong legal foundation. Therefore, the legal system and the economic system deeply influence and interact with each other.⁵

In 2021, the Financial Services Authority (OJK) conducted a National Sharia Capital Market Survey online with the assistance of an independent party. Through this survey, OJK aimed to assess the real extent of public understanding of the Sharia capital market. The results showed that the literacy rate of the Indonesian public regarding the Sharia capital market stood at 15%, while the inclusion rate was at 4%. Based on this data, it is clear that there is still significant potential for improving both the literacy and inclusion of the public in the Sharia capital market. According to the Refinitiv Sukuk Perceptions and Forecast Study 2021, global sukuk issuance reached US\$147 billion in the first nine months of 2021, continuing the momentum of strong growth seen in 2020. Sukuk issued by Malaysia, Indonesia, and several Gulf Cooperation Council (GCC) countries throughout 2021 were part of efforts to finance economic recovery following the Covid-19 pandemic, as well as to support ongoing infrastructure financing and economic development. In 2020, the primary sukuk market overcame the economic challenges posed by Covid-19, setting a new record for annual sukuk issuance at US\$174 billion. This strong issuance momentum was driven by leading countries whose governments sought to fund economic recovery and address widening fiscal deficits during the pandemic. The top five countries issuing sukuk—Malaysia, Saudi Arabia, Indonesia, Turkey, and Kuwait—together accounted for 90% of total issuance in the third quarter of 2021. Sovereign sukuk issuances made up 58% of the total. Sukuk issuance reached US\$147 billion by Q3 2021, with sovereign issuances from key markets, including Malaysia, Indonesia,

⁵ Mul Irawan, "Politik Hukum Ekonomi Syariah Dalam Perkembangan Lembaga Keuangan Syariah di Indonesia, *Jurnal Media Hukum*", Vol. 25 No.1 Juni 2018, DOI: <https://doi.org/10.18196/jmh.2018.0097.10-21>

and the Gulf States, rising to help finance Covid-19 recovery plans, infrastructure projects, and ongoing economic development efforts.

Method

Normative or doctrinal legal research is the method used in this paper. Doctrinal legal research plays an active role in finding accurate answers by examining the desired legal truth or written provisions in regulations, teachings, or applicable legal doctrines.⁶ The approach applied is divided into two: the “statute approach” and the “conceptual approach.”⁷ The statute approach is used to analyze regulations involved in the formulation of Sharia Capital Market laws, ensuring alignment with Sharia principles. Meanwhile, the conceptual approach is utilized to understand Sharia concepts relevant to transactions in the Sharia capital market, with the hope that “normative regulations in legal rules will leave no room for misinterpretation in the process of formulating Sharia Capital Market laws.”

To achieve the research objectives, it is essential to carefully and comprehensively search for and collect data. Delays or incomplete data can impact the depth of analysis in the study. Therefore, the success of the findings largely depends on the completeness and accuracy of the collected data. Sugiyono emphasizes that data collection techniques are a crucial stage in the research process, aiming to gather materials that are relevant and aligned with the legal framework being used.⁸ In this study, the author employs a descriptive analysis technique to outline the structure of decisions related to the legal context, focusing on primary legal norms such as statutory regulations.⁹

Result And Discussion

Bagehot and Schumpeter argue that financial activities and services significantly impact economic growth. They analyze how financial development positively affects the real economy, marking the origins of the financial-growth relationship argument. This leads to four important hypotheses: the supply-leading

⁶ Ika Atikah, “Metode Penelitian Hukum”, Sukabumi, CV. Haura Utama, 2022

⁷ I Made Pasek Diantha, “Metodologi Penelitian Hukum Normatif Dalam Justifikasi Teori Hukum”, Jakarta, Kencana, 2016

⁸ Muhaimin, “Metode Penelitian Hukum”, Mataram, Mataram University Press, 2020

⁹ Ika Atikah, “Metode Penelitian Hukum”, Sukabumi, CV. Haura Utama, 2022

hypothesis, which originates from Schumpeter's ideas and is further developed in the financial repression theory by McKinnon and Shaw. This theory suggests that financial development influences economic growth. The demand-following hypothesis, which comes from Robinson, states that financial development lags behind economic growth, meaning that real economic growth precedes financial development. Patrick introduced the interdependence hypothesis, which asserts a reciprocal, two-way relationship between financial development and economic growth. He argues that in underdeveloped countries, finance drives growth, whereas in developed countries, growth influences finance. Finally, Lucas proposed the neutrality hypothesis, arguing that the financial-growth relationship is overstated, implying that finance is not a significant factor in the growth process. To provide new evidence for this argument, this study follows endogenous growth theory. According to endogenous growth theory, the accumulation of growth depends on how variations in output or income are linked to the accumulation of physical and human capital and how much they contribute to the efficient utilization of capital. Growth accumulation starts with specifying an aggregate production function. In this study, the aggregate production function proposed by Mankiw, Romer, and Weil, and de Gregorio is applied as an endogenous growth model.¹⁰

Finance contributes to economic growth through various channels. According to Waheed and Younus, the financial system promotes economic growth primarily through two main channels: increasing savings and investment (known as capital accumulation or quantity effect), and enhancing productivity (quality effect). Capital accumulation refers to the process of increasing the quantity of investment, thereby expanding the stock of capital used in the production process. This accumulation serves as an important indicator or foundation for growth, particularly for companies and organizations.¹¹ On the other hand, capital productivity, which represents capital efficiency, reflects a situation where an organization operates efficiently and

¹⁰Gani Ibrahim Musa et al, The Impact of Islamic Capital Market on Malaysian Real Economy, *Jurnal Ekonomi Malaysia* 54 (2), 2020, 91-103

¹¹ I.M. Gani, "Islamic Banking Sector Development and Economic Growth: Empirical evidence from Malaysia and a Lesson for Nigeria, Islamic banking and finance". "The nexus with the real economy, Proceedings book of 2nd IIIBF Bayero University Kano", Kano: Benchmark publishers limited, 2015, 352-368

successfully implements its ideas. It plays a crucial role in explaining the material standard of living and is fundamental in determining the rate of return.¹²

In general, the Capital Market functions as a platform where entities in need of capital (issuers) and those who have capital (investors) conduct transactions to utilize funds. The Islamic Capital Market (ICM) is a segment of the capital market whose entire mechanisms, particularly regarding issuers, types of securities that can be traded, and the trading process, adhere to Sharia principles. The capital market includes activities related to public offerings and securities trading, the issuance of securities by public companies, and professional institutions associated with securities. Securities consist of various forms of tradable instruments, including debt instruments, securities, stocks, bonds, debt instruments, participation units in collective investment schemes, futures contracts on securities, and all their derivatives.¹³

The Islamic Capital Market (ICM) does not stand alone as a separate entity but is an integral part of the overall capital market. The instruments traded in the Islamic capital market include stocks, bonds, and mutual funds, but with the main difference in their operational mechanisms, which are based on Sharia principles. In addition, the ICM is supervised by a Sharia supervisory board that ensures the implementation of these principles. Instruments traded, such as Sharia-compliant stocks, bonds, and mutual funds, must adhere to these principles. The ICM can be defined as a capital market that applies Sharia principles in its transactional activities and is free from prohibitions such as usury (riba), gambling, and speculation. Therefore, only instruments that comply with Sharia principles can be traded in the Islamic capital market. The Islamic capital market is based on several key principles, namely:¹⁴

1. **Principle of Prohibition on Transactions Involving Haram Items:** As in general buying and selling transactions, in the buying and selling of stocks, there is a condition that the company whose shares are being purchased must not be

¹² Shreya Sinha, Mapping India's capitalism: Old and new regions, *Journal of Agrarian Change* 16(3), 2015, 507-511, <https://onlinelibrary.wiley.com/doi/abs/10.1111/joac.12157>

¹³ Andi Soemitra, "Hukum Ekonomi Syariah dan Fiqih Muamalah di Lembaga Keuangan dan Bisnis Kontemporer", Jakarta, Kencana, 2018

¹⁴ Ahmad Rifai, Sharia Principles in Sharia Capital Market, *Budapest International Research and Critics Institute-Journal (BIRCI-Journal) Humanities and Social Science*. Volume 5, No 4, November 2022, Page: 28913-28922 e-ISSN: 2615-3076 (Online), p-ISSN: 2615-1715 (Print) www.bircu-journal.com/index.php/birci

involved in haram (forbidden) business activities. For example, it is not allowed to buy shares in a company that produces alcoholic beverages. Even though the transaction itself is permissible, the goods being traded are haram, making the shares of companies engaged in haram businesses forbidden.

2. **Principle of Prohibition of Activities Involving Riba (Usury):** When buying stocks, a partnership (syirkah) contract occurs. The main principle in a partnership contract is the possibility of both profit and loss. Therefore, companies that promise fixed profits contradict this principle because they are considered a form of riba. Thus, the buying and selling of conventional bonds is not in line with Sharia principles as they are essentially interest-bearing loans. However, Islamic bonds (sukuk) have a substantially different structure from conventional bonds, making them compliant with Sharia principles.
3. **Prohibition on Activities Containing Gharar (Uncertainty) and Maisir (Gambling):** This principle applies to all forms of muamalah (transactions) but is of higher importance in the context of the capital market. Many participants in the capital market act as speculators rather than true investors. They often bet on high-risk assets with uncertainty, resembling gambling practices, which goes against Sharia principles.
4. **Principle of Prohibition of Bai' al-Ma'dum (Sale of Non-Existent Items):** Bai' al-ma'dum refers to the sale of goods that do not exist or are not owned at the time of the transaction. This is a major concern in stock trading, as it often involves the buying and selling of shares that the seller does not actually own. If this practice becomes widespread and fails at a certain point, it could lead to market instability. This is because there is a large circulation of money that is not backed by actual assets.
5. **Principle of Prohibition of Fraudulent Activities and Market Manipulation:** A dangerous activity in the capital market, especially for beginners, is market manipulation or false offerings. This tactic is used to inflate the price of certain stocks by creating the illusion of high demand. When the stock price rises due to the apparent high demand, many investors are attracted to buy. However, once the price reaches its peak, it can plummet drastically, causing significant losses for many investors who are trapped in this scheme.

In all of these transactions, there is interaction with an organization or company engaged in prohibited (haram) activities. The transaction itself may not violate the law, but it involves providing goods or services at a certain price to individuals or institutions involved in haram activities. The most conservative Islamic scholars do not allow investment in the equity of companies engaged in haram business activities. Some allow investment in companies that derive a small portion of their income from haram activities, as long as these activities are not their main focus. Some scholars approve of this exception only if it serves the public interest (maslahah). Another perspective allows exceptions if haram activities are widespread in society and difficult to avoid. For example, serving alcoholic drinks on national airline flights may fall under the first category, while earning interest through treasury management may be considered an example of the second category.¹⁵

Sharia investors adhere to the principles and regulations of trade and investment outlined in Islamic teachings. In Islam, activities are categorized as Halal (permissible) or Haram (forbidden). Sharia law prohibits Muslims from engaging in certain activities, such as consuming alcohol or pork, which leads compliant companies to refrain from participating in businesses that generate income from such activities. In evaluating the compliance of investment proposals with Sharia requirements, Khatkhatay and Nisar (2007) emphasize two main aspects: a) the presence of *riba* (interest) or similar elements in the transaction structure, and b) the nature of the counterparty (business). For example, this includes working at conventional banks or casinos, renting property to conventional banks, casinos, or insurance companies, printing promotional materials for evangelical organizations, or providing transportation services, or printing cartons/labels for alcoholic beverages.

The collaboration between the government and the Indonesian Ulema Council (MUI) in drafting ICM regulations has a significant impact on upholding compliance with Islamic principles in financial transactions. Based on the fatwa issued by MUI, the government can establish a regulatory framework aligned with Islamic values,

¹⁵ Syed Faiq Najeeb, "Islamic Capital Markets : An Exploratory Study on Investor Rationality", 2011, SSRN: <https://ssrn.com/abstract=1910660> or <http://dx.doi.org/10.2139/ssrn.1910660>

governing permissible investments, halal trading methods, and guidelines for Islamic financial institutions. Reliance on MUI's fatwa provides authority and credibility to the ICM, rooted in the scholarly interpretation of Islamic law by religious scholars. However, it is important to note that Sharia capital market regulations must also consider market dynamics, economic effectiveness, and investor protection. Therefore, in formulating these regulations, the government must strike a balance between adhering to Sharia principles and addressing practical challenges in a sustainable economic landscape.

The development of the Islamic Capital Market (ICM) in Indonesia has its roots in the launch of the Sharia Mutual Fund by PT. Danareksa Investment Management on July 3, 1997. The next step involved a collaboration between the Indonesia Stock Exchange (IDX, previously BEJ) and PT. Danareksa Investment Management, leading to the launch of the Jakarta Islamic Index on July 3, 2000. This index was designed to guide investors who wanted to invest in accordance with Sharia principles, providing them with a selection of compliant stocks. On April 18, 2001, the National Sharia Board of the Indonesian Ulema Council (DSN MUI) issued Fatwa No. 20/DSN-MUI/IV/2001, the first fatwa directly related to the capital market. This fatwa provided investment guidelines for Sharia mutual funds. The growth of Sharia investment instruments in the capital market continued with the issuance of PT. Indosat Tbk's Sharia bonds in early September 2002, which were the first Sharia bonds with a mudharabah contract. Additionally, the development of ICM was also reflected in the institutions involved in its regulation, starting with the signing of a Memorandum of Understanding (MoU) between the Capital Market Supervisory Agency and the MUI Sharia Financial Institutions on March 14, 2003. The MoU reflected an agreement between both parties to advance the ICM in Indonesia.

Islamic finance is an investment approach based on Sharia principles (Islamic law), which emphasizes fairness and prohibits any forms of unethical, speculative transactions, and those involving interest (*riba*). These principles are implemented through a two-tier Sharia screening methodology to assess the compliance of equities with Sharia norms and principles. Qualitative screening ensures that companies are not involved in prohibited activities, such as producing and selling pork, alcohol,

tobacco, gambling, spreading immorality, and conventional interest-based financial services and derivatives. Quantitative screening, on the other hand, involves financial ratios that set limits on leverage, liquidity, and unlawful income. These principles apply equity selection to a unique and conservative asset class. Financial assets (equities) that meet these criteria are expected to reduce risks and enhance financial stability. Socially responsible investments and Islamic finance principles have a positive impact on society and the environment, and both have the potential to meet market demand for ethical investments.¹⁶

Islamic finance has experienced significant growth over the past few decades, necessitating the development of a strong regulatory framework to ensure stability and adherence to Sharia principles. Regulatory bodies play a crucial role in overseeing activities in the Sharia capital market, which include the issuance of Sharia-compliant securities (sukuk), Sharia investment funds, and Islamic banking products. These bodies typically consist of central banks, securities commissions, and Sharia supervisory boards, each contributing to the formulation and enforcement of regulations governing Islamic finance. The sukuk market has seen rapid growth in recent years. The decline in oil prices has been a major driver for the issuance of sukuk by countries in the Gulf region, as they face increasing budget deficits. Although Islamic banking (IB) plays a similar role as conventional banking (CB) as a financial intermediary, it differs in many ways. Islamic banks are supervised by Sharia boards that ensure all products offered comply with Sharia principles. Therefore, Islamic banks are prohibited from financing or investing in activities that are not Sharia-compliant and cannot charge or accept interest (riba).¹⁷

Sukuk involves an asset structure arranged according to Sharia principles, where investors collectively own the asset or its income and are entitled to a share of the profits generated. The main difference between sukuk and conventional bonds is that sukuk is asset-backed, while conventional bonds are usually not asset-backed and

¹⁶ Edib Smolo et al, Performances of leading Islamic finance markets prior to and during the COVID-19 pandemic, *Heliyon*, Volume 9 Issue 1, January 2023, <https://doi.org/10.1016/j.heliyon.2023.e12870>

¹⁷ Houcem Smaoui & Hatem Ghouma, Sukuk market development and Islamic banks' capital ratios, *Research in International Business and Finance*, Volume 51, January 2022, 101064, <https://doi.org/10.1016/j.ribaf.2019.101064>

focus more on return on investment rather than the actual cash flow generated by the financed project. The fluctuating value of the underlying asset affects the level of risk for sukuk investors. Unlike conventional debt securities, sukuk must comply with Sharia rules, requiring structuring and securitization in accordance with Islamic principles. In general, "loans" can be made and profits earned through three Islamic financial structures: lease-based contracts, sale-based contracts, and equity-based contracts. The main difference between these structures is the tangible nature of the underlying assets. In Arabic nomenclature, there is a distinction between tangible assets ('ayn) and intangible assets (dayn), which helps assess whether Islamic legal values can reduce the risks of sukuk securitization investment. It is estimated that lease-based sukuk have the lowest investment risk because lease-based assets are generally tangible, offering better protection against market uncertainty. On the other hand, equity-based sukuk have the lowest level of tangible asset support in securitization and, thus expected to have the highest investment risk. Sale-based sukuk falls in between lease-based sukuk and equity-based sukuk in terms of investment risk spectrum. Therefore, it is assumed that lease-based sukuk requires the least number of steps and the lowest level of subordination, while equity-based sukuk requires the highest.¹⁸

ICM (Islamic Capital Market) is an integral part of the Islamic economic system that aims to enhance the efficiency of resource and capital management while supporting investment activities. Products and activities in the Islamic capital market must reflect Islamic principles, which emphasize trust, justice, and the presence of tangible assets or activities as the basis for transactions. Additionally, transactions in the capital market must be managed fairly and transparently. The performance of the Islamic stock market in Indonesia is measured using the Jakarta Islamic Index (JII), which was established on July 2, 2000. JII consists of 30 stocks selected based on specific criteria set by the Capital Market and Financial Institutions Supervisory Agency (Baepam & LK). These criteria are regulated under the Chairman's Decree of Baepam & LK No. KEP-181/BL/2009 on the Issuance of Islamic Securities,

¹⁸ Zairihan Abdul Halim et al, Asymmetric information and securitization design in Islamic capital markets, Pacific-Basin Finance Journal, Volume 62, September 2020, 101189 <https://doi.org/10.1016/j.pacfin.2019.101189>

which was later updated with the Head of Bapepam & LK Decree No. KEP-208/BL/2012 on the Criteria and Issuance of Sharia Securities Lists. Since 2003, the National Sharia Council (DSN) of the Indonesian Ulema Council (MUI) has issued Fatwa No. 40/DSN-MUI/X/2003 on the Capital Market and General Guidelines for Implementing Sharia Principles in the Capital Market. Issuers or public companies must meet both qualitative and quantitative requirements to have their shares included in the JII group. Prohibitions on *riba*, *gharar*, *maysir*, *tadlis*, and *ikrahah* in all *muamalah* activities are basic principles that must be adhered to. Additional important principles include the principle of risk-sharing, the prohibition of speculative behaviour, the protection of property rights, transparency, and fairness in contract agreements. These principles ensure that all activities in the Islamic capital market are conducted with Islamic values, aiming to create a fair, transparent, and sustainable financial system. The issuer or public company is not involved in activities related to gambling or games classified as gambling. It does not offer financial services based on *riba*. It is not involved in transactions with risks containing elements of *gharar* (uncertainty) and *maysir* (speculation). It does not produce, distribute, trade, or provide goods or services that are forbidden (*haram*). The total interest-based debt should not exceed 45% of total assets. The total income from interest and other *haram* sources should not exceed 10% of total income and other earnings. These criteria ensure that issuers or public companies listed in the Jakarta Islamic Index (JII) comply with Sharia principles in their operations.¹⁹

In many jurisdictions, existing financial regulations have been modified or expanded to accommodate Islamic finance principles. This integration includes ensuring compliance with Sharia law, which prohibits activities such as *riba* (interest), *gharar* (uncertainty), and *maysir* (gambling). Regulatory bodies collaborate with Sharia scholars to develop guidelines and criteria for Islamic financial products and transactions. For example, in Malaysia, the Securities Commission works with the Sharia Advisory Council to ensure that Islamic capital market activities adhere to

¹⁹ Imam Wahyudi & Gandhi Anwar Sani, Interdependence between Islamic capital market and money market: Evidence from Indonesia, *Borsa Istanbul Review*, Volume 14, Issue 1, March 2014, Pages 32-47 <https://doi.org/10.1016/j.bir.2013.11.001>

Sharia principles.²⁰ In addition, several countries have implemented specific regulations designed for Islamic finance. These regulations govern the unique characteristics of Islamic financial instruments and transactions, providing legal certainty and enhancing investor confidence. For example, the Dubai Financial Services Authority (DFSA) in the United Arab Emirates has established a comprehensive regulatory framework for Islamic finance, which includes licensing requirements, business conduct rules, and Sharia governance standards.

Regulatory bodies actively collaborate with international standard-setting organizations to align standards and practices across jurisdictions. The Islamic Financial Services Board (IFSB) and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) are two prominent bodies that develop global standards for Islamic finance. Regulatory bodies participate in the formulation of these standards and integrate them into their regulatory frameworks to enhance consistency and interoperability. For example, the Central Bank of Bahrain, as a founding member of AAOIFI, adopts accounting and auditing standards for Islamic financial institutions.²¹ Similarly, the regulatory authorities in the member countries of the Organization of Islamic Cooperation (OIC) adhere to the IFSB's prudential standards and supervision to ensure the health and stability of the Islamic financial system.²²

Lawrence M. Friedman's legal system theory offers valuable insights into the regulatory framework governing the "Islamic Capital Market" in Indonesia. According to Friedman, legal systems develop through a combination of external forces and internal dynamics, shaping the legal landscape of a society. In the context of the regulation of the "Sharia Capital Market" in Indonesia, Friedman's theory suggests that the interaction between Sharia principles, global financial standards, and domestic legal traditions influences the development of regulatory norms. Sharia-compliant financial practices, rooted in Islamic law (Sharia), provide the fundamental principles guiding the regulation of the Sharia capital market in Indonesia. However,

²⁰ Securities Commission Malaysia, "Shariah Advisory Council," Accessed May 03, 2024. (<https://www.sc.com.my/about-us/organisation-structure/shariah-advisory-council>)

²¹ Accounting and Auditing Organization for Islamic Financial Institutions, "About AAOIFI," Accessed May 05, 2024. (<https://aaoifi.com/about/>)

²² Islamic Financial Services Board, "About IFSB," Accessed May 05, 2024. (<https://www.ifsb.org/about.php>)

integrating these principles into the modern regulatory framework requires reconciling them with global financial standards and adapting them to Indonesia's legal traditions. This dynamic process reflects Friedman's idea of legal pluralism, where diverse sources of law coexist and interact within a legal system. Therefore, Indonesia's regulatory approach to ICM embodies the complex interaction between Sharia principles, international standards, and domestic legal traditions, illustrating the application of Friedman's legal system theory in understanding the regulatory dynamics.²³

The regulatory framework governing ICM, particularly Sukuk, in Indonesia is closely linked to Sharia principles, reflecting the country's commitment to align Islamic finance with its legal system. Sukuk, as an Islamic financial instrument, adheres to Islamic principles such as the prohibition of interest (*riba*) and speculation (*gharar*), and promotes profit-sharing arrangements and asset guarantees. In Indonesia, the integration of Sharia principles into the rule of law is primarily achieved through a dual legal system, where Sharia law operates alongside conventional legal structures. The Financial Services Authority (OJK) supervises the regulation and oversight of ICM, ensuring compliance with Sharia principles while maintaining alignment with Indonesian laws and regulations. This regulatory approach aims to facilitate the growth of Islamic finance while upholding legal certainty and investor protection. Specifically, the issuance and trading of Sukuk are subject to strict Sharia supervision by the Sharia supervisory board to ensure compliance with Islamic principles. The collaborative efforts between regulatory authorities, Sharia experts, and market participants play a crucial role in driving the development of ICM in Indonesia within a strong legal framework.²⁴

In addition, the ICM is also governed by Islamic legal foundations through the Fatwa issued by the "National Sharia Board of the Indonesian Ulema Council" (DSN MUI). This Fatwa serves as a basis that provides guidelines for ensuring the compliance of financial products and transactions with Sharia principles. It outlines the parameters within which Sukuk can operate, ensuring that Sukuk adhere to

²³ Lawrence M. Friedman, "Law in Changing Societies: The Legal Systems of the World", New York: Simon & Schuster, 1975

²⁴ Otoritas Jasa Keuangan (OJK), "Peraturan Ketua OJK Nomor 31/POJK.04/2015 tentang Penerapan Prinsip Syariah Bagi Perusahaan Efek, Efek Syariah, dan Kegiatan Pasar Modal Syariah"

Islamic jurisprudence. The issuance of Sukuk must comply with the guidelines set forth in the Fatwa, covering various aspects such as underlying assets, profit distribution mechanisms, and risk-sharing structures. By integrating Sharia principles into the legal framework, Indonesia fosters an environment conducive to Islamic finance, promoting ethical and fair financial practices. This not only ensures compliance with regulations but also enhances investor confidence in Sukuk as a Sharia-compliant investment instrument, thus driving the growth of the Sharia capital market in Indonesia.

The DSN-MUI fatwas play a significant role in the development of the Sharia capital market in Indonesia, even though they are non-binding. To date, 17 DSN-MUI fatwas related to the Sharia capital market have been issued. Among them, five have become important foundations in the development of the Sharia capital market. DSN-MUI Fatwa Number 40/DSN-MUI/X/2003 discusses general guidelines for the application of Sharia principles in the capital market. DSN-MUI Fatwa Number 80/DSN-MUI/III/2011 regulates the implementation of Sharia principles in the trading mechanism of equity securities in the regular stock exchange market. DSN-MUI Fatwa Number 124/DSN-MUI/XI/2018 addresses the application of Sharia principles in securities depository and transaction settlement services, as well as the management of integrated investment infrastructure. DSN-MUI Fatwa Number 138/DSN-MUI/V/2020 discusses the application of Sharia principles in the clearing and guarantee mechanism for the settlement of equity securities transactions in the stock exchange. DSN-MUI Fatwa Number 135/DSN-MUI/V/2020 examines aspects related to shares within the context of Sharia principles. These fatwas provide important guidance for the development of the Sharia capital market, demonstrating a commitment to implementing Sharia principles in capital market activities in Indonesia.

Regulations related to the Sharia capital market in Indonesia are products of the Government and the Financial Services Authority (OJK), issued in the form of laws, regulations, and circular letters. Currently, OJK has issued 11 regulations related to the Sharia capital market. These regulations cover provisions governing various operational aspects, transactions, and the principles underlying activities in the capital market that adhere to Sharia principles. Therefore, these regulations serve as the

foundation for participants in the “Sharia capital market” to carry out their activities, providing clarity and ensuring the sustainability and fairness of Indonesia's Islamic Capital Market (ICM) ecosystem. These include: POJK No.15/POJK.04/2015 on the Implementation of Sharia Principles in the Capital Market, POJK No.17/POJK.04/2015 on the Issuance and Requirements for Sharia Securities in the Form of Shares by Sharia Issuers or Public Sharia Companies, POJK No.18/POJK.04/2015 on the Issuance and Requirements for Sukuk, POJK No.20/POJK.04/2015 on the Issuance of Sharia Asset-Backed Securities, POJK No.53/POJK.04/2015 on Contracts Used in the Issuance of Sharia Securities in the Capital Market, POJK No.30/POJK.04/2016 on Sharia Real Estate Investment Funds in the Form of Collective Investments, POJK No.35/POJK.04/2017 on the Criteria and Issuance of the Sharia Securities List, POJK No.3/POJK.04/2018 on Amendments to POJK No.18/POJK.04/2015 on the Issuance and Requirements for Sukuk, POJK No.33/POJK.04/2019 on the Issuance and Requirements for Sharia Mutual Funds, POJK No.5/POJK.04/2021 on Sharia Capital Market Experts, SEOJK No.3/POJK.04/2022 on the Mechanism and Procedures for Determining Equity Securities as Sharia Securities in Technology-Based Fundraising Services. The state’s intervention in formulating ICM regulations based on fiqh principles and its rules, as well as other sources of Islamic law, has made a significant contribution and gained legitimate recognition, as long as it adheres to Sharia principles.

Conclusion

This research highlights the importance of integrating Islamic law principles into the national legal framework, particularly in the capital markets sector. It emphasizes the need to meet the requirements of Muslim investors while expanding the investor base and strengthening overall confidence in the capital market. The study reflects a positive direction in the development of the Islamic Capital Market (ICM), noting the increasing number of Sharia-compliant financial products and growing interest from both Muslim and non-Muslim investors seeking to align their investments with Islamic values. However, amidst these advancements, the research rightly acknowledges the challenges that remain in legal integration. There is a need

for a strong and coherent legal framework that supports the growth of ICM without compromising efficiency and effectiveness. Such a framework requires careful legislative and regulatory efforts to ensure compliance with Sharia principles. Furthermore, the study underscores the importance of collaborative efforts involving government agencies, financial institutions, academics, and other stakeholders. This collective involvement is seen as essential in creating a conducive environment for the development of ICM. The research also emphasizes the dual nature of integrating Islamic law into national law—both as a moral obligation and a path toward economic prosperity. By facilitating access to Sharia-compliant financial products, this integration not only attracts domestic and international investors but also enhances the stability and inclusiveness of the financial market. Therefore, while recognizing the progress made so far, the study stresses the need for a steadfast commitment from all stakeholders and a robust regulatory framework to fully harness the potential of Islamic law integration in driving Indonesia towards inclusive and sustainable economic growth, as well as strengthening its position in the global market.

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