

THE PROMISES AND CHALLENGES OF CROWDFUNDING FOR FINANCING SMALL BUSINESSES AND START-UPS IN UZBEKISTAN

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Article Info	ABSTRACT
Article history: Received May 05, 2024 Revised May 10, 2024 Accepted May 25, 2024 Keywords: Equity crowdfunding, Reward-based crowdfunding, Debt- based crowdfunding, Small businesses, Start-ups, External financing	This article examines three types of crowdfunding and their beneficial aspects in financing small businesses and start-ups Uzbekistan. It delves into the practical applications and challenges of legal regulation from both legal and economic perspectives This is an open-access article under the CC-BY 4.0 license. 

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INTRODUCTION

Crowdfunding involves the collective effort of individuals to finance a project or business. Similar to traditional charity, each contributor makes a financial donation based on their capabilities. Today, crowdfunding is widely used as a modern financing mechanism in many countries to fund business projects, known as crowd investing.

The following types of crowdfunding are widely used to finance business projects:



Equity crowdfunding



Reward-based crowdfunding



Debt-based crowdfunding

Each type of crowdfunding shares similarities with traditional legal relationships, such as equity participation in commercial organizations, retail sales, and loan agreements. They offer several advantages in financing businesses, particularly for start-up projects and small businesses.

This article employs several methods to analyse crowdfunding for start-ups and small businesses in Uzbekistan. Existing legal literature is reviewed and laws, regulations, and international frameworks related to crowdfunding are examined. Particularly relevant Uzbek legislation is legally analysed and relevant case is provided to explore legal practical applications of crowdfunding in the local context. Data analytics techniques used are data collection, data presentation, conclusion drawing and deduction.

RESULT AND DISCUSSION

Equity crowdfunding campaigns involve the participation of investors in a project by investing capital, which leads to a proportional distribution of shares in the project's authorized capital and corresponding dividends. This type of crowdfunding focuses on enhancing investment efficiency, allowing investors to participate by purchasing shares in commercial organizations.

Traditionally, investors acquire shares issued by profit organizations (joint-stock companies) and registered by the state through stock exchanges or private transactions. Equity crowdfunding, however, operates through specialized online platforms, enabling investors to invest their desired amount without being limited to nominal share values. This approach allows for a broader range of investment opportunities and greater flexibility for investors.

Before directly analysing the advantages of equity crowdfunding in business financing in Uzbekistan, it is important to consider the current financing practices. In the national context, business financing has not yet become widespread, and the available sources of financing are not fully utilized. The most common source of business financing is bank loans. As of June 1, 2024, the total amount of bank loans provided by commercial banks to legal entities amounted to 331 trillion sums.

While bank loans offer enterprises the opportunity to attract large amounts of financial resources, they come with several disadvantages:

Firstly, interest rates on loans are very high. According to estimates from The Global Economy website for 2022, Uzbekistan ranked 5th out of 109 countries for high-interest loans. The Central Bank reported that the weighted average annual interest rate on loans granted to legal entities exceeded 22%. This high rate is attributed to several macro- and microeconomic factors, including high inflation, a significant gap between credit supply and demand, and the lack of alternative financing sources. These elevated interest rates

increase the costs for commercial organizations in the form of interest payments, subsequently reducing their profit margins.

Secondly, when issuing loans to commercial organizations, banks consider the borrower's available capital and property. Borrowers are often required to provide collateral through a pledge agreement or guarantee. While this requirement may not pose a problem for large business entities, it is a significant hurdle for small businesses with low cash flow and insufficient assets for collateral. Given that more than 80% of operating enterprises and organizations in Uzbekistan are small businesses, many of these entities lack access to loans, which are a primary source of financing. Consequently, a significant portion of business units are unable to secure the financial resources needed to implement their business plans. This has contributed to the fact that about half of the registered enterprises and organizations in Uzbekistan are currently inactive.

Another external source of financing is the stock market. On the stock exchange, financial resources can be raised through an initial public offering (IPO) or by issuing additional shares (SPO). According to legislation, only joint-stock companies (JSC) can issue shares. However, the costs associated with the state registration of shares, filing a prospectus, reports, and disclosure of information (compliance costs) pose economic difficulties for most small businesses.

Furthermore, the requirement of foreign investor's participation creates a joint-stock company adds another layer of complexity for newly established business entities to organize as joint-stock companies. As for another type of securities—corporate bonds—the legislation stipulates that the bonds issued must not exceed the amount of the issuer's authorized capital. Additionally, requirements regarding the profitability, solvency, financial stability, and liquidity of the issuer are also imposed. The capital of vast majority of businesses is small and not enough to meet these financial conditions, resulting in their inability to issue corporate bonds.

In addition, the stock market is inactive due to the average income of the population and low financial literacy. Therefore, the possibilities of attracting financial resources through a public offering of shares or issuing corporate bonds on the stock exchange are limited. Considering that other investment mechanisms, such as venture capital, investment, and mutual funds, are also underdeveloped, there is no effective external source of financing for start-ups and small businesses.

Equity crowdfunding can serve as an alternative external source of financing for start-ups and small businesses. Firstly, all types of business entities, regardless of their financial position and organizational form, can raise funds using crowdfunding opportunities. Additionally, in many jurisdictions, equity crowdfunding is not considered a security. Even in states where it is regulated, campaigns launched by start-ups and small businesses

are often exempt from state registration requirements, the provision of brochures, and regular reporting. This exemption frees from the compliance costs associated with these requirements.

Unlike venture capital funds, which mainly invest in large and successful enterprises, crowdfunding democratizes the process of starting a business and entering the market by financing new and small enterprises. In essence, it promotes diversity and encourages the entry of new commercial organizations into the market, thereby increasing market competition.

Reward-based crowdfunding involves individual investors investing in a business project in exchange for certain rewards. These rewards can range from a simple thank-you letter to the right to purchase one of the first products being developed, exclusive products, or other benefits associated with the project at discounted prices. This type of crowdfunding is similar to the pre-purchase of a product, akin to a retail purchase agreement.

Reward-based crowdfunding offers business entities, particularly those in the manufacturing sector, the opportunity to test market demand before launching production. Products initially appear as projects, and production begins only after sufficient funds have been raised. If fundraising is insufficient, it indicates a lack of market demand for the product. In such cases, the business can abandon the plan, and the collected money is returned to the investors. This mechanism helps reduce the number of bankruptcies or business closures due to low product demand.

Considering that approximately 37% of registered business entities in the production sector ceased their activities in Uzbekistan in 2024, reward-based crowdfunding could have a positive impact on the national business environment.

Debt-based crowdfunding, also known as peer-to-peer lending, involves individuals lending money to businesses or others through online crowdfunding platforms, with borrowers paying interest to investors.

All three types of crowdfunding—equity-based, reward-based, and debt-based—are facilitated through online platforms, allowing thousands of investors to participate by investing varying amounts based on their financial capacity.

In Uzbekistan, strict criteria for bank loans pose significant challenges for start-ups and small businesses lacking strong credit histories or sufficient collateral. Debt-based crowdfunding platforms address these challenges by directly connecting businesses with individual and institutional investors. This direct interaction streamlines the funding process, enabling entrepreneurs to secure necessary capital faster and more easily compared to traditional bank loans.

Moreover, unlike bank loans with rigid repayment schedules, debt-based crowdfunding offers businesses the flexibility to structure borrowing terms according to their business plans and cash flow projections. Borrowers can set interest rates and payment schedules that align with their financial strategies, fostering more favourable and adaptable financing arrangements.

In Uzbekistan, crowdfunding lacks an official legal framework, yet several successful crowdfunding campaigns have been conducted. One notable example is IMAN Halal Investments limited partnership, established in 2020, which utilized crowdfunding through the Iman Invest application to finance its activities. According to data from the State Committee of Statistics, the company's authorized capital exceeds 40 billion sums, with 94% of this capital owned by 4,642 individuals who invested via the Iman Invest platform. Although this form of financing is not formally recognized as crowdfunding, it exhibits all the characteristics of equity crowdfunding. Specifically, the company attracted a large number of investors from the general public, and these investors participate in profit distribution as limited partners in accordance with the legal framework.

Legally, equity crowdfunding in Uzbekistan adopts a structure resembling a limited partnership. Drawing from the German experience, initially crowdfunding in Germany began as a "silent partnership" and later evolved into profit-sharing loans based on participation in profits. The German "silent partnership" shares similarities with Uzbekistan's limited partnership model, where silent partners do not engage in management decisions like limited partners (investors) but participate solely in profit distribution proportional to their contribution. Unlike a limited liability partnership, a silent partnership is a contractual arrangement rather than a separate legal entity, resembling a conventional partnership under civil law in many aspects.

In our assessment, the current mechanisms in national legislation are inadequate for effectively organizing crowd investing campaigns. The existing organizational and legal forms of entities are not well-suited for crowdfunding, particularly equity crowdfunding, due to several reasons.

Firstly, limited liability companies (LLCs) face limitations such as the cap on the number of participants (not exceeding 50) and the requirement for state re-registration of changes in ownership. This leads to excessive costs and administrative complexities.

Secondly, the formation or reorganization of small businesses into joint-stock companies (JSCs) is burdensome due to the complexity of the process, costs associated with share registration, and compliance reporting requirements, which may deter potential investors.

Thirdly, under Article 962 of the Civil Code of Uzbekistan, only individual entrepreneurs and commercial organizations can enter into simple partnership agreements for

entrepreneurial activities. This restricts citizen investors from participating directly in commercial organizations through simple partnership agreements.

Additionally, private enterprises require sole proprietor participation, while family enterprises are limited to family members and their personal labour, making them unsuitable for crowdfunding purposes.

Furthermore, crowdfunding agreements differ significantly from traditional legal agreements. In reward-based crowdfunding, akin to retail purchase agreements, investors face risks such as receiving products that do not meet expectations. In European countries, investors are protected by the right to terminate contracts within 14 days of product delivery without providing reasons, ensuring consumer protection. In contrast, Uzbek legislation allows for warranty periods to be negotiated in contracts, with terms set by mutual agreement.

Regarding debt-based crowdfunding, while beneficial for borrowers, it presents high risks for investors due to potential non-repayment caused by low cash flow and inadequate assets. Despite these risks, financial markets acknowledge investment risks as inherent, mitigated by strategies like incremental interest rates based on credit ratings and caps on individual investor contributions per campaign.

CONCLUSION

In conclusion, enhancing legal protections for consumer investors in reward-based crowdfunding and addressing regulatory challenges for equity crowdfunding are essential to foster a conducive environment for alternative financing mechanisms in Uzbekistan.

Based on the analysis conducted, here are the final conclusions and recommendations for legislation regarding crowdfunding as a method of business financing in Uzbekistan:

1. **Introduction of Legal Framework:** It is imperative to establish a comprehensive legal framework specifically regulating crowdfunding. This framework should encompass all forms of crowdfunding, including equity-based, reward-based, and debt-based crowdfunding, to provide clarity and legal certainty for participants and investors.
2. **Equity crowdfunding:** Considering the limitations of existing legal entities under Uzbek law, such as LLCs and JSCs, a simple partnership agreement appears to be the most suitable legal form for equity crowdfunding. This approach allows citizen investors to participate effectively without the constraints of participant caps and frequent re-registration requirements, thus fostering broader participation and reducing administrative burdens.
3. **Consumer Protection in Reward-Based Crowdfunding:** Given the risks associated with reward-based crowdfunding, it is crucial to establish robust consumer protection measures. Specifically, implementing a strict warranty period for consumers, similar to

European standards, would safeguard investors against receiving products that do not meet expectations. This measure aims to enhance consumer confidence in crowdfunding platforms and mitigate potential losses.

4. Regulatory Oversight: Implementing regulatory oversight is essential to monitor and supervise crowdfunding activities, ensuring compliance with legal standards and protecting the interests of investors and participants. This oversight should include mechanisms for transparency, accountability, and dispute resolution to maintain the integrity and reliability of crowdfunding platforms.

In conclusion, regulating crowdfunding in Uzbekistan presents an opportunity to diversify and expand financing options for small businesses and start-ups. By establishing a clear legal framework, revisiting legal entity options for equity crowdfunding, enhancing consumer protections in reward-based crowdfunding, and implementing effective regulatory oversight, Uzbekistan can create a conducive environment for sustainable economic growth and entrepreneurial development through crowdfunding initiatives

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