

Traditional Financing Mechanisms Of Entrepreneurial Activities And Their Legal Regulation Mechanisms

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Abstract: Today, special attention is being paid to developing the field of entrepreneurship and supporting entrepreneurs in the process of starting their businesses. To prevent them from shutting down their activities in a short period and to avoid various bureaucratic hurdles, tax incentives are being applied, and the processes for obtaining licenses and permits are being simplified. Furthermore, the requirement to request several documents and pieces of information from various state bodies has been abolished, and procedures have been established for authorized bodies to directly obtain the necessary information through relevant information systems. The main resource every entrepreneur needs to start their business is capital. With this capital, an entrepreneur registers with the state and acquires a space to conduct business. They also purchase essential equipment and pay employee salaries. Therefore, today it is crucial to simplify the financing of business activities and expand the types of financing available. Today, every financing method has its own advantages and disadvantages. Although legislative acts have been adopted to regulate relations related to the financing of entrepreneurial activities, their diversity and the complexity of their use require the improvement of legislative acts in this area, as well as the introduction of additional financing methods into the legislation. In this article, a legal analysis of the importance of financing, its types, and its unique aspects is carried out. The legal regulation of relations related to financing activities is analyzed from a scientific-theoretical and scientific-practical perspective based on the research of various scholars and the national legislation of the Republic of Uzbekistan.

Keywords: Entrepreneurship, financing, credit, subsidy, factoring, venture capital, crowdfunding, personal funds, equity

Introduction: Entrepreneurial entities are a crucial component of any economy. They play a key role in creating new jobs, introducing innovations, strengthening the competitive environment, and ensuring economic growth.

For this reason, special attention has been paid to improving the legislative base to support entrepreneurial activities and create additional conveniences and benefits for them in our republic. Specifically, to date, a number of regulatory documents have been adopted regarding the state registration of entrepreneurial entities, providing them with tax incentives, allocating preferential bank loans and state support, and simplifying the procedure for obtaining licenses and permits.

As a result of the practical measures implemented, 160 types of licenses and permits have been abolished over

the last three years, and the practice of requesting 120 types of information and documents from citizens and entrepreneurs has been eliminated.

To establish a single system for issuing all licenses and permits to entrepreneurial entities, the "License" information system was created. Currently, it is possible to obtain more than 140 types of public services through this system.

When starting an entrepreneurial activity, providing it with funds, i.e., financing, is of great importance. Having access to financial resources allows entrepreneurs to plan their activities and ensure stable growth.

The legal regulation of entrepreneurial financing is crucial for the formation of an investment environment, the protection of investors' and creditors' rights, and the assurance of financial stability.

Analyzing the legal framework of financing, Alan Morris emphasizes that clear and understandable legislation ensures the fulfillment of credit agreements, reduces risks for investors, and thereby helps attract long-term investments. In his opinion, without this, there can be no trust between market participants [1].

Haver Smith, an expert in financial law, stated that a weak regulatory framework governing financing sources can pave the way for corruption and lead to instability in the financial market. He emphasized that legal norms make financing processes transparent and fair, thereby preventing economic crimes [2].

Although Peter Drucker was a management scholar, in his works on entrepreneurship and financing, he also touched upon the importance of the legal environment. In his opinion, one of the functions of an effective financing system is to ensure that capital is directed toward the most productive projects. This is only possible when strong legal protection mechanisms are in place [3].

When starting an entrepreneurial activity, having initial capital from the moment of registration up to the payment of employees' salaries helps in the effective establishment of the business in the future.

Although legislative acts regulating relations related to the financing of business entities have been adopted in our country, the diversity and complexity of financing methods, types, and procedures require improving the relevant legal documents, reviewing their legal regulation mechanisms, and introducing alternative financing methods into practice.

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The sources for financing entrepreneurial activities can be divided into two main groups: internal sources and external sources [4].

Internal financing sources are funds generated from the business's own internal reserves. Profits, depreciation deductions, and accounts receivable can be cited as examples of internal financing sources. Some enterprises may reinvest a part of the net profit generated from their activities, while others may use funds calculated for the depreciation of fixed assets (equipment, buildings, etc.) to acquire new assets or modernize existing ones. Additionally, funds that are owed to the enterprise by other entities can also help expand the company's operations.

External financing sources are funds raised from outside the company, often in the form of debt or equity. These include bank loans, leasing, microloans, venture funds, and capital received from various investors.

Furthermore, based on the period they were

introduced into the entrepreneurial sector and their scope of application, financing methods can be divided into traditional and non-traditional types.

If we consider widely used methods such as bank loans, leasing, factoring, and support from state funds as traditional financing types, then venture funds, crowdfunding, business angels, mezzanine financing, and convertible notes, which are new to our legislation, fall under the category of non-traditional methods.

The legal regulation mechanisms of each financing method differ from one another, and each has its own unique advantages and disadvantages.

A bank loan is a widely used traditional financing method, and its legal basis is defined by loan agreements and collateral legislation. Its essence is based on a debt relationship between a bank and an entrepreneur, where the bank provides funds for a specific period and with interest.

Our country has several legal acts aimed at the legal regulation of the lending sector. In particular, the Civil code, the Law "On banks and banking activities" and the Law "On non-bank credit organizations and microfinancing activities" reflect the general rules of lending.

According to legislation in our country, the institutions that provide entrepreneurial entities with credit can be divided into two types: banks and microfinance organizations.

According to Article 744 of the Civil code, under a loan agreement, one party – a bank or other credit organization (the creditor)—undertakes to provide funds (a loan) to the other party (the borrower) in the amount and on the terms stipulated in the agreement, while the borrower undertakes to repay the received amount and pay interest for it.

The most important legal document in the lending process is the loan agreement. This document must clearly specify all terms related to the loan amount, interest rate, repayment periods, penalties, and collateral. It serves as the primary tool for protecting the borrower's rights.

According to statistical data, the average interest rate on bank loans in the national currency was 23.1% in January-June 2025. In the first six months of the current year, a total of 373,678 loans worth 63,583 billion soums were issued. This, in turn, is an increase of 126,335 loans or 14,801 billion soums compared to the same period last year [5].

These figures show that despite the high interest rates and complex application procedures, the demand for bank loans remains high.

Before issuing a loan, banks thoroughly examine the

entrepreneur's credit history, financial condition, and collateral. Furthermore, most loans, especially large ones, require collateral. If a business does not have enough assets to offer as collateral, the chances of getting a loan are significantly reduced.

By taking out a loan, an entrepreneur assumes a strict repayment obligation. If the business does not generate the expected income, loan payments can lead to financial difficulties [6]. The terms of bank loans are usually rigid. When unexpected situations arise in the business, it is very difficult to change the loan terms or postpone payments. This poses a serious problem, especially in unstable market conditions [7].

According to Professor Joseph Stiglitz, one of the biggest problems in the regulation of bank loans is information asymmetry. This means that the bank may not have complete information about the borrower's true financial condition. For this reason, it is important to develop legal mechanisms, such as strengthening collateral rights and improving the credit information exchange system [8].

In foreign countries, bank loans are also strictly regulated by law, but with different approaches.

In the United States, there is no centralized legislation regulating bank loans; instead, a set of different federal and state laws are in effect. For example, the "Truth in Lending Act" (TILA) protects consumers' credit rights. It mandates that interest rates and other costs be clearly stated in credit agreements. In Germany, the "Bürgerliches Gesetzbuch" (BGB), or Civil Code, is the main legal basis for loan agreements. This code provides a comprehensive overview of all aspects of debt and credit relationships [9].

Leasing relations are primarily regulated by the Civil Code and the Law "On Leasing". According to Article 2 of the Law, leasing is a special type of financial lease where one party (the lessor), on the instructions of the other party (the lessee), acquires property (the object of the lease) from a third party (the seller) and transfers it to the lessee for possession and use for a period exceeding twelve months on the terms specified in the agreement, in return for payment.

This provision shows that the legal relations between the lessor and the lessee are regulated by the leasing agreement. In our national legislation, the scope of the leasing object and subjects, as well as the rights and obligations of the parties, are clearly defined. These norms are reflected in Articles 587-599 of the Civil code.

The main legal advantage of leasing is that the ownership of the leased object remains with the lessor. This makes the leasing agreement much more reliable

and less risky compared to a bank loan, as the lessor has the right to repossess the object if the debtor fails to fulfill their obligations [10].

One of the main ideas about leasing in foreign literature is that it emphasizes the use of an asset rather than its ownership [11].

It is also important to consider that the total payment amount of a leasing agreement is usually higher than the full purchase price of the asset. This is due to interest, commission, and the leasing company's profit. At the same time, leasing agreements may include numerous restrictions on the use of the property. For example, the lessor's consent may be required to lease the property to a third party or to make any modifications to it [12].

According to O.T. Hazratkulov, countries are divided into three main groups based on the level of legal protection for leasing relations:

Countries with special laws that harmonize leasing agreements (Uzbekistan, Kazakhstan, Russia, France, Belgium, Italy, and others);

Countries with special by-laws (England, Australia, New Zealand);

Countries without specific legislation (USA, Germany) [13].

A characteristic feature of the laws adopted in the first group of countries is that they regulate not only the relationship between the two main partners (the lessee and the lessor) but also the relationship between the leasing company and the supplier. In other words, they regulate the entire set of three-way property relations that arise in leasing. In accordance with these legal documents, a tripartite leasing agreement must specify that the equipment is being acquired for the purpose of future leasing and that it can only be used for the intended purposes. The agreement also specifies the terms regarding the right to purchase and the price at which the asset is to be bought at the end of the contract term.

In the second group of countries, leasing is regulated depending on the value of the property being provided for temporary use and the subjects of the leasing agreement.

Specifically, according to England's "Hire-Purchase and Sale of Goods Act", conditions are set where the lessee must be a legal entity and the value of the leased property should not exceed 2,000 British pounds. All other cases that do not meet these conditions are regulated by the norms of "common law".

In the third group of countries, namely the USA and Germany, until recently, leasing was primarily used with the goal of taking advantage of depreciation and

tax benefits. For this reason, leasing is regulated by legal documents that focus on taxation matters.

Another traditional financing method is factoring. According to Article 749 of the Civil code, under a financing agreement in exchange for the assignment of a monetary claim (factoring), one party (the financial agent) provides or undertakes to provide funds to the other party (the client) against the client's (the creditor's) monetary claim against a third party—a legal entity or an entrepreneurial entity (the debtor). The client, in turn, assigns or undertakes to assign this monetary claim to the financial agent. This agreement must be concluded in written form, describing the monetary claim. According to Article 750 of the Code, banks, factoring organizations, and other credit institutions may conclude financing agreements as a financial agent in exchange for the assignment of a monetary claim.

As a legal scholar, Professor James Fawcett interprets the legal basis of factoring relationships as a "transfer of rights for a fee" [14]. Factoring operations are usually much faster than bank loans. The process of submitting documents and receiving cash can be completed within a few days. However, if customers find out that their invoices have been sold to a factoring company, it may create a wrong impression that the company's financial condition is unstable. Furthermore, if the right to collect accounts receivable is transferred to the factoring company under a factoring agreement, the entrepreneur loses control over payment relations with customers [15].

The Decree of the President of the Republic of Uzbekistan No. PF-109 "On measures for the accelerated development of the factoring services market", dated August 12, 2024, was another significant step toward the legal regulation of the factoring services market. Specifically, the decree outlined tasks such as introducing the necessary documents for using factoring services, implementing the "Factoring services electronic platform", which allows for the rapid collection and real-time analysis of information about debtors, establishing the National factoring association to protect the rights and interests of factoring market participants.

One of the important documents created for the legal regulation of international factoring operations is the UNIDROIT International Factoring Convention (Ottawa, 1988). A number of countries, including France, Germany, Italy, China, Russia, the United Kingdom, Hungary, and the USA, have joined this convention, which was adopted in 1988.

Its main goal is to eliminate the differences in the factoring legislation of various countries and create a

unified and reliable legal framework for financing international trade.

Despite this, the number of countries that have joined the convention is relatively small. The main reason for this is that its provisions do not align with the national legal systems of some countries. As not all of the world's major trading partners have joined the convention, international factoring practices are often conducted on the basis of bilateral agreements and national legislation.

Results and discussions

Traditional financing methods like bank loans, leasing, and factoring continue to play an important role in business development. Their main advantages are stability, clear rules, and widespread use. However, in today's rapidly changing, digitized, and innovative era, their shortcomings in terms of flexibility and speed are becoming more apparent.

The processes of formalizing bank loans and signing leasing agreements are time-consuming, and the procedures for collateral and paperwork can create difficulties for entrepreneurs. Factoring is also limited to a certain scope and cannot meet all business needs.

Traditional financial institutions often shy away from high-risk projects. To strengthen the legal guarantees for entrepreneurs and investors in the global market, entrepreneurial financing requires fast and flexible methods.

It is precisely because of these shortcomings that non-traditional financing mechanisms are becoming increasingly important today. In particular, methods such as venture funds, angel investors, and crowdfunding have already begun to enter our legislation.

Venture capital refers to private investment funds that invest primarily in high-growth, often technological, startups. They provide funds in exchange for shares or an equity stake in the early stages of a project and aim to make a significant profit after a certain period (usually within 5-10 years) by selling their shares or their stake when the company goes for an IPO [16].

Unlike banks, venture investors evaluate a project based on its intellectual property, idea, and the potential of its team, rather than its material assets [17].

In most developed countries with a developed venture financing system, there is no single, special law that fully regulates the sector. In these countries, venture investment activities are regulated based on the legislative framework related to investment or innovation activities. Special legal acts on this subject have been adopted only in India and Hungary so far

[18]. While documents such as the “Securities Act of 1933” and the “Investment Company Act of 1940” have had a great impact on the development of the venture capital market in the USA, in Germany, venture funds are regulated by the Law “On Investment Funds”. In the Russian Federation, innovation activity is defined by intellectual property legislation, while venture investment activities are regulated by general legal acts [19].

In venture financing, an investment agreement is concluded between the fund and the startup. This document clearly specifies the investment amount, the equity stake in the company, the stages of fund transfer (tranches), and the investor's rights.

The first and most crucial stage of the investment process begins with drafting a document known as a term sheet. This document defines the investment amount, the company's pre-money valuation, the type of shares (e.g., preferred stock), the investor's seat on the board of directors, and key rights (e.g., rights in a company sale).

Following this, the fund's lawyers, financiers, and other specialists begin a thorough review of the startup's operations, a process known as Due Diligence. At this stage, the startup's financial reports, legal documents (e.g., registration papers, contracts), intellectual property rights (patents, trademarks), and information about the founders are meticulously verified. If the review reveals significant issues, the investor may withdraw from the deal or renegotiate the terms. After a successful Due Diligence, documents such as the Share Purchase Agreement and the Shareholders' Agreement are signed by the lawyers [20].

The venture fund ecosystem in our republic is also just beginning to form. Our national legislation has not yet adopted a separate law to regulate this sector. While national venture funds like UzVC and AloqaVentures were established based on government decisions adopted in 2020, the Resolution of the President of the Republic of Uzbekistan No. PQ-357 “On measures for the further development of the startup projects and venture financing ecosystem”, dated October 14, 2024, was one of the key steps toward creating conditions for attracting venture investments.

Crowdfunding is the process of raising small amounts of money for a project from a large number of people (the public) through internet platforms. Its main types include donation-based crowdfunding, reward-based crowdfunding, and investment-based crowdfunding [21].

Crowdfunding democratizes financing, opening up investment opportunities for ordinary people. It lacks the rigid collateral requirements and bureaucratic

procedures found in traditional financing. The key is the uniqueness of the idea and the ability to rally a community around it.

Crowdfunding relations are typically carried out among three main subjects: the project owner (entrepreneur), the investor (or donor), and the crowdfunding platform.

Different countries have varying approaches to the legal regulation of crowdfunding. In the United States, the “Jumpstart Our Business Startups (JOBS) Act” was adopted in 2012 to regulate crowdfunding. This document provided special benefits for crowdfunding, allowing small companies and startups to sell their shares to a wide range of investors, including ordinary citizens.

According to the law, companies must apply to the US Securities and Exchange Commission (SEC) and meet certain requirements. Specifically, they are required to disclose detailed information about their operations, financial condition, and investment goals [22].

On a European Union scale, the “European crowdfunding service providers regulation (ECSPR)” was adopted in 2020. This regulation establishes a unified set of rules for crowdfunding platforms operating in the EU member states. According to this regulation, crowdfunding platforms must obtain a license from the European securities and markets authority (ESMA) or a national competent authority and be entered into the relevant registry to begin their operations [23]. Professor Whitney Morris notes that the type of investor is crucial in the legal regulation of crowdfunding. For example, fewer restrictions can be placed on accredited (i.e., wealthy and experienced) investors, while stricter protection mechanisms (e.g., limits on investment amounts) should be introduced for ordinary citizens [24].

The legal framework for the crowdfunding system has not yet been established in our country. Although these concepts have been used in some Presidential and Government resolutions, the specific financing mechanisms, particularly the creation and registration of platforms, the rights and obligations of investors, and legal mechanisms to ensure the transparency of the investment process have not been regulated by a single, specific document.

In practice, several platforms have been created for raising funds for social projects, particularly for helping people with disabilities, developing youth sports, and improving the material and technical base of schools. Additionally, some financial technology (fintech) platforms that carry out financial operations are also offering the opportunity to collect funds for people in need. However, since the procedures for conducting

these activities and the rights and obligations of the parties are not defined within the framework of legal documents, this could lead to various fraudulent activities and the misuse of funds in the future.

Angel investors are wealthy individuals who invest their personal funds as capital in early-stage startups with high growth potential. They are usually successful entrepreneurs who provide not only money but also their experience to help others.

Angel investors provide seed funding for startups. At this stage, neither venture funds nor banks may be interested in the project because the risk is very high [25].

Unlike venture funds and banks, angel investors' decision-making process is fast and flexible. They can reach quick agreements, bypassing bureaucratic procedures that can last for months. However, it's also important to note that the capital invested by angel investors is smaller compared to venture funds. If a business requires rapid expansion, the funds from one or two angel investors may not be sufficient.

The activities of angel investors are not regulated by specific laws in the same way as venture capital funds. In the USA, the primary legal regulation is carried out through the concept of the "accredited investor". Their status is regulated by the "Securities Act of 1933". According to this act, if a company sells its shares only to accredited investors, it is exempt from the obligation to submit a full report to the Securities and Exchange Commission. This, in turn, accelerates and simplifies the process of attracting capital for startups [26].

In the United Kingdom, special tax incentives such as the "Seed Enterprise Investment Scheme" (SEIS) and the "Enterprise Investment Scheme" (EIS) have been introduced to support angel investors. According to these schemes, investors are exempt from up to 30% of income tax on EIS investments and up to 50% on SEIS investments. This significantly reduces the risk for investors and protects early-stage investments [27].

Professor Michael Classens emphasizes that the legal status of angel investors is often different from that of formal venture funds. In his opinion, agreements with angel investors are often less legally complex because a separate agreement is reached with each of them [28].

The stages of formalizing a deal with an angel investor are similar to those for reaching an agreement with a venture fund. The entrepreneur first presents their business plan. If the investor is interested, the parties sign a term sheet outlining the main conditions. The investor then conducts a Due Diligence process, verifying the entrepreneur's financial and legal status.

However, this process can be simpler than with venture funds. After the checks are successfully completed, documents such as the investment agreement, share purchase agreement, and shareholders' agreement are signed.

The concept of angel investors has not yet been introduced into our national legislation. Although there are individuals among our entrepreneurs who have the financial capacity to invest as angel investors, the lack of a defined legal status, investment procedures, and conditions for them is hindering the development of this sector.

In some developed countries, there is also a type of entrepreneurial financing called mezzanine financing. The concept of mezzanine financing is one of the most advanced and flexible approaches, widely used by companies in developed financial markets around the world.

Mezzanine financing is a type of financing that has characteristics of both debt and direct investment. According to this, the investor does not typically enter the company's capital. Instead, they provide funds through debt obligations for its development, while also having the right to purchase the borrower's shares at a predetermined price in the future [29].

While mezzanine financing emerged in the United States in the 1980s, the first mezzanine financing fund in Russia, called Volga River Credit Opportunity, was established in 2009 [30].

AQShda mezanin bozori ancha rivojlangan va standartlashtirilgan bo'lib, unda ko'proq xususiy kapital firmalari faoliyat yuritadi. Yevropa bozorida esa mezanin moliyalashtirish ko'proq tijorat banklari tomonidan amalga oshiriladi.

The positive aspects of this financing method are that mezzanine lenders require less collateral than banks, as they intend to cover the risk from the company's future revenues. Additionally, it allows for raising a large amount of capital without selling a significant portion of the company's shares [31].

Another specific feature of mezzanine financing is that in the event of a company's bankruptcy, mezzanine debt repayment is considered a middle-tier priority. This means that obligations are settled first for bank loans, then for mezzanine debts, and only then for the shareholders' claims [32]. According to Professor James Fawcett, the main legal issue in these transactions is the "hierarchy of creditors". A mezzanine lender typically has a lower level of protection compared to senior creditors (e.g., banks). Therefore, all payment procedures and rights in the event of potential bankruptcy must be clearly specified in legal

documents [33].

Mezzanine financing first appeared in market practice and was later reflected in the legislation of most developed countries (USA, UK, Germany). In the USA, mezzanine transactions are regulated by the "Uniform Commercial Code" and the "Securities Act of 1933".

In European Union countries, there are no specific laws regarding mezzanine financing. Its legal aspects are regulated mainly within the framework of civil codes, commercial legislation, and rules governing the activities of investment funds.

According to the Civil code of the Russian Federation, in mezzanine financing, a debt agreement is first signed, followed by an option agreement. The option agreement specifies the procedure for the investor to acquire shares or stakes belonging to the entity [32].

The processes for formalizing financing are similar to those for other types of investment. Specifically, an enterprise in need of funds first applies to a mezzanine fund. The fund conducts a thorough analysis of the company's financial condition, business model, and growth prospects. The fund and the company agree on the financing terms, including the interest rate, repayment period, and conditions for entering the capital. After an agreement is reached, the fund transfers the funds to the company. The company makes interest payments over the agreed period and repays the principal debt on the specified date. If the company is sold or goes for an IPO, the fund profits by selling its stake [34].

From the above, it is clear that the mezzanine financing mechanisms used in developed countries are similar to other types of financing procedures found in our national legislation. When there is a diversity of financing sources in the legal and financial fields, it becomes easier for an entrepreneur to make the right decision based on their available opportunities, and it also helps foster a competitive environment among investors.

Conclusion

During the research process, we studied the specific aspects and legal regulation mechanisms of traditional and non-traditional financing by comparing them with each other. Traditional methods such as bank loans, leasing, and factoring, which were reviewed in the article, remain the main pillars of the economy. However, with the rapid development of modern law and economics and the increase in innovative startups, the limitations of traditional financing are becoming obvious. Shortcomings such as collateral requirements, lengthy bureaucratic procedures, and a lack of adaptability to high-risk projects are creating a

foundation for the emergence and development of non-traditional financing.

Non-traditional methods like venture capital, angel investors, crowdfunding, and mezzanine financing can fill the "gap" that the traditional system cannot.

However, this requires the development of new legal norms and rules.

In particular, it is urgent to create the scientific and theoretical aspects of non-traditional financing methods. The essence of these types of financing and the procedure for formalizing the rights and obligations between the parties should be reflected in civil legislation.

It is also expedient to adopt a law "On the financing of entrepreneurial activity" that reflects the rights and obligations of the investor and the entrepreneur, methods of securing obligations, the legal status of investors, and the requirements placed on them, taking into account the specifics of each financing method.

Improving the legislation in this area and clearly defining the legal regulation mechanisms for each financing method will not only expand the opportunities for new entrepreneurs but also serve to increase the flow of foreign investments into the republic.

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