LEGAL MODELS FOR THE REGULATION OF HYBRID FINANCING IN VARIOUS JURISDICTIONS

Rakhmatov Azizbek Iskandar ugli
Head of Department, Ministry of Justice of the Republic of Uzbekistan, Ph.D. candidate of the Tashkent State Law University
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ABSTRACT

The development of entrepreneurial activity is primarily determined by the availability of adequate financing sources. Financing is the process of attracting monetary funds necessary for entities to start, expand, and modernize their operations. Conventional financing methods, particularly bank loans and equity issuance (capital financing), have long served as the main pillars of economic development. However, each method has inherent limitations: bank loans are restricted by high interest rates and stringent collateral requirements, while equity financing (such as an Initial Public Offering—IPO) demands complex legal procedures and high costs.

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Globally, the importance of hybrid financing is growing annually. In the United States, startups actively attract venture capital through convertible loans, while in developed markets like the European Union and Japan, large corporations are expanding their capital base using convertible bonds. Practice in these financial markets indicates that hybrid instruments not only create convenience for companies but also offer investors the potential for high returns alongside lower downside risks.

These global trends necessitate the study and introduction of hybrid financing mechanisms into national legislation, alongside taking necessary measures to protect the rights of both parties during the legal regulation process. The legal framework governing these mechanisms is crucial for shaping the investment environment and ensuring financial stability.

The core function of hybrid financing, as highlighted in academic literature, is to bridge the gap left by traditional financing and to ensure the financial stability of the initiative. Consequently, hybrid instruments serve to combine not only financial efficiency but also strategic and social efficiency. If an enterprise is solely focused on maximizing profit, it would opt for conventional debt or equity. However, entities with a hybrid mission (i.e., those with both social and commercial objectives), such as social enterprises, inherently require a hybrid financing structure (for instance, a combination of grants and investment capital).

Dr. Robert X. Thomas highlights that the main problem in the legal regulation of hybrid financing is that these instruments often fall into the gaps between debt and equity legislation, which complicates the determination of investors' legal protection.

In analyzing the regulatory challenges of hybrid instruments, the classic liberal perspective of jurist Richard A. Epstein is crucial. Epstein emphasizes the need to be cautious about excessive state regulation of financial markets, arguing that private interests are often more effective than government control in assessing various risks.

In his view, government oversight requires costly standard measures (e.g., registration), and the value of regulation tends to decrease over time, a phenomenon known as "Regulatory Depreciation". Epstein's criticism is that excessive regulation increases the concept of "Sovereign Risk", leading to capital flight from the domestic public securities market. Consequently, companies are forced to place hybrid instruments through less-regulated private offerings rather than public offerings. The main conclusion derived from this is that the legal protection of complex instruments like hybrids becomes largely dependent on private contractual agreements rather than the direct control of the state regulator.

The legal classification of a hybrid instrument becomes critical, especially during a company's distressed periods. For example, when a company's financial condition deteriorates, its solvency may hinge on how the security is classified under the law. If a hybrid instrument is characterized as debt, it increases the company's liabilities, which could potentially trigger insolvency. Conversely, classifying it as equity allows the company to avoid such a consequence. Thus, the legal nature of the security is an exceedingly important factor influencing the company's financial health and its ability to avoid bankruptcy. This implies that the selection and structuring of a hybrid instrument is not merely a financial decision, but primarily a legal one.

Various instruments are cited by different scholars and sources as examples of hybrid mechanisms. Specifically, J. Tirole refers to subordinated debt, preferred shares, and convertible debt as such examples, while Lorenzo Sasso focuses primarily on preferred shares and convertible bonds.

By distinguishing the debt (e.g., credit, loans, etc.) and equity (right to acquire shares) components of hybrid financing instruments, T.G. Bondarenko and O.A. Zhdanova note that hybrid instruments include an investor's option or an issuer's option.

Despite the absence of a clear and unified list of such instruments, hybrid financing encompasses a variety of instruments that tend to lean more towards either equity financing (e.g., preferred shares) or debt financing (e.g., convertible bonds).

One of the hybrid instruments widely used in contemporary global practice is the convertible bond. Such bonds, in addition to accruing interest, grant the investor the right to convert them into company shares upon the fulfillment of specific conditions. Unlike conventional loans, these bonds have a pre-agreed maturity date, by which time they must be either repaid or converted.

The Simple agreement for future equity (SAFE), developed in the US, differs significantly from convertible bonds. By its legal nature, SAFE is not considered debt. It has no maturity date and accrues no interest, which reduces the financial burden on startups. SAFE converts into an equity share only upon the occurrence of a specific event, such as a new round of financing. This makes it a more flexible instrument for startups but offers investors less protection due to the absence of a repayment obligation.

According to Professor Andrew Guzman, the legal challenge of issuing CoCo bonds is that bondholders may lose their claims during a crisis, leading to serious legal uncertainties regarding investor protection [10]. From a legal standpoint, the most complex process in CoCo issuance involves determining the conversion price and ensuring the precision of the trigger mechanism [11]. An inaccurately defined trigger could lead to market panic or unjust losses.

The comparative analysis demonstrates that Civil Law countries, such as Germany, South Korea, Turkey, and Belarus, traditionally rely on a deductive approach. In this approach, the legal norm originates from a comprehensive code. This is clearly manifested in South Korea's FSCMA (Financial Investment Services and Capital Markets Act), and in Germany's GmbHG (Limited Liability Companies Act) and AktG (Stock Corporation Act).

Canada (excluding Quebec), as well as the financial free zones of the UAE and Qatar, utilize an inductive approach. Here, legal norms are founded on judicial precedents and often supplement general legislation. While Turkey, a Civil Law country, has created a "de facto" practice-based system by employing the broad principle of contractual freedom, Belarus has established a unique legal hybrid by "de jure" incorporating certain institutions of English Law into its national legislation.

Comparative analysis of legal mechanisms for hybrid financing

Country	Primary Legal Basis	Common Instruments	Classification (Initial)	Regulatory Authority
Germany	Commercial Code, GmbHG, AktG	Wandeldarlehen (Convertible Loan)	Debt	No unified regulator
Canada	Provincial Securities Acts, NI 45-106 (Prospectus Exemptions)	Convertible Notes, SAFE	Debt (Notes), Equity (SAFE)	Provincial Securities Commissions
South Korea	FSCMA (Financial Services and Capital Markets Act), Commercial Code	Convertible Bonds	Debt	Financial Services Commission (FSC)

Turkey	Law of Obligations	Convertible Notes	Debt	No unified regulator
UAE (DIFC/ADGM)	Common Law (in Free Zones)	Convertible Debt, SAFE	Debt or Equity	Dubai Financial Services Authority (DFSA), Financial Services Regulatory Authority (FSRA)
Qatar (QFC)	Common Law	Convertible Debt, SAFE	Debt or Equity	Qatar Financial Centre Regulatory Authority (QFCRA)
Azerbaijan	Law on the Protection of Foreign Investments	Informal Instruments	Varies	Central Bank, IDDA
Belarus	Presidential Decree No. 8	Convertible Loan	Debt or Equity	High-Tech Park (HTP)

Legal systems for investor protection also vary across different countries. In many cases, hybrid instruments like the Wandeldarlehen (Convertible Loan) in Germany are unsecured. This consequently increases the risk for the investor. Conversely, convertible bonds typically grant the investor the right to demand repayment of the principal and interest if the conversion event does not occur, which provides a certain degree of protection.

In South Korea, the regulator actively intervenes to prevent fraud related to convertible bonds. In the Republic of Belarus, investors are formally protected from nationalization and have the right to transfer profits; however, these guarantees become conditional due to geopolitical risks and sanctions. In Turkey, the resolution of disputes can be complicated by the lack of specific regulation.

Hybrid financial instruments are an integral part of the modern financial and legal system, yet their legal status and regulatory environment vary significantly across jurisdictions. The central dilemma faced by all countries is finding a balance between legal certainty (essential for investor protection) and commercial flexibility (necessary for companies).

While Civil Law countries typically rely on codified laws, Common Law countries and their analogues in free zones employ more flexible, practice-based approaches. As venture capital and Fintech markets evolve, a global trend towards greater legal formalization of hybrid instruments is observable, exemplified by legislative activities in South Korea and Azerbaijan.

Given that Uzbekistan's legislation is codified and based on explicit norms, it is pertinent to develop the scientific and theoretical aspects of hybrid financing methods. Therefore, drawing upon the experience of countries like Germany, Turkey, and Azerbaijan, the substance of these financing types and the procedure for formalizing rights and obligations between parties should be reflected in civil legislation.

The improvement of legislation in this area and the clear definition of legal regulatory mechanisms for each financing method will not only expand the opportunities for nascent entrepreneurs but will also serve to increase the flow of foreign investment into the Republic by reducing legal risks and ensuring legal certainty.

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