Professor Mayank Patel

Crowdfunding by Start-ups and Small Businesses

-What We Know and What We Don't Know

In the months following 2008 financial crisis, startups, small businesses and social ventures found it very difficult to raise capital for their operations and growth. To beat the tough times, few dynamic entrepreneurs introduced a method called 'crowdfunding' to solicit funds from investors, and offer better return on investment in times of quantitative easing.

Crowdfunding is raising capital (in small amount) from a large number of investors (either individuals or organizations) through a web-based platform or social networking site for a specific project, business enterprise or a social cause. Many online platforms have also been built to facilitate crowdfunding. The underlying elements defining this financial market innovation are large number of investors, small size of investment and use of internet. Large number of investors contribute very small amount because they are generally not in a financial condition to take risk on large amount, and funds are mobilized using web-based platforms or social networking sites in order to keep the cost of raising funds very low, and to reach out to a large number of potential investors in a short time. It is a means of raising money for creative projects like music, film, book; benevolent or public-interest causes like renovating a garden, building a school or religious place, cleaning a river or lake; or a business venture. The investors offer fund because of their passion or commitment to creative project, public-interest cause or they are simply looking for return on investment.

Types of Crowdfunding

Based on the objective of the contribution or investment, four broad types of crowdfunding have emerged: social lending or donation crowdfunding, reward crowdfunding, peer-to-peer lending, and equity crowdfunding. Donation crowdfunding denotes solicitation of funds for social, artistic, philanthropic or religious purpose without expecting any tangible returns. When a large number of persons contribute funds to construct a hospital, the hospital is said to be crowdfunded. Reward crowdfunding is raising funds wherein the investors

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expect to receive some existing or future tangible rewards like some consumer product or a membership to rewards scheme for the money contributed. In peer-to-peer lending, an online platform matches lenders with borrowers in order to provide unsecured loans and the interest rate is set by the platform. Some of these platforms arrange loans between individuals, while others pool funds which are then lent to small and medium-sized businesses. In equity based crowdfunding, the company soliciting funds, issue equity shares to the investors. Some early-stage startups have raised capital using this mode. Peer-to-peer lending and equity based crowdfunding are collectively referred as financial return crowd-funding also.

Risk and Reward of Crowdfunding

For businesses raising capital through crowdfunding, there is very little risk. However, for investors, this market is *caveat emptor*. For investors participating in social lending or donation, the rewards are intangible – the joy or satisfaction of contributing to the cause they believe in or relate to. For investors participating in financial return based crowdfunding, the benefits are diversification of investment portfolio, exposure to alternative assets such as unlisted, non-publicly traded startups' equity and debt, and possible higher returns from investment.

There are a number of risks associated with crowdfunding. Some are investor specific and some are systematic, i.e. they may impact the entire economy. Peer-to-peer lending generally are unsecured loans. The possibility of losing entire investment principle is high and it is believed that investors understand this risk. This is an investor specific risk, but peer-to-peer lending is doubling every year in some countries like China. If large number of borrowing businesses defaults, the resulting large scale investment losses may reduce economic growth and force government intervention. In equity crowdfunding, the risk of investment failure is estimated to be around 50% (estimate by International Organization of Securities Commissions). It means that half of the money invested, would probably not return. Another risk is that of fraud. This is compounded in both peer-to-peer lending and equity crowdfunding by the anonymity created due to online aspect of these industries. There has been a case of few peer-to-peer lending platforms closing overnight, leaving no data on contracts behind and resulting in 100% investment loss. This is a text book

example of institutional risk of investment. Crowdfunding is still a nascent phenomenon, and almost no data is available on actual returns and risks.

Crowd funding Regulations

Regulation of crowdfunding is related to the type of crowdfunding. Peer-to-peer lending platforms are either unregulated, or has intermediary regulation, or has same regulation as banks or are completely prohibited. The US has two tier system, where these platforms need to be registered with Securities and Exchange Commission, and obtain license to conduct business on a state by state basis. In India, regulation of peer-to-peer lending platforms is being evaluated by the RBI. The US Congress was the first legislative organization to regulate and thus legalize equity based crowdfunding through Jump Start Our Startups (JOBS) Act in 2012. Similar laws have been enacted in New Zealand, Canada, and the UK also. These laws generally stipulate maximum amount of funding allowed to be raised, maximum number of investors in each funding, maximum amount of money an investor can invest, and qualifying income and networth criteria for investors. In India, Securities and Exchange Board of India (SEBI) had put a consultative paper for regulating crowdfunding on its website and requested stakeholders' comments. After some consultation, SEBI found that this financial market innovation – equity based crowdfunding- has the potential of being abused by unscrupulous players, and therefore, it is prohibited in India.

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