Research Paper Management

A Study on Crowd Funding and its Implications in India

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ABSTRACT

Crowd funding is essentially the opposite of the mainstream approach to business finance. Traditionally, if you want to raise capital to start a business or launch a new product, you would need to pack up your business plan, market research, and prototypes, and then shop your idea around to a limited pool or wealthy individuals or institutions. These funding sources included banks, angel investors, and venture capital firms, really limiting your options to a few key players. You can think of this fundraising approach as a funnel, with you and your pitch at the wide end and your audience of investors at the closed end. Fail to point that funnel at the right investor or firm at the right time, and that's your time and money lost .Crowd funding platforms, on the other hand, turns that funnel on-end. By giving you, the entrepreneur, a single platform to build, showcase, and share your pitch resources, this approach dramatically streamlines the traditional model.

KEYWORDS crowd funding, entrepreneurial finance, donations, pre-selling, FR crowd funding

Introduction

Crowd funding is the process of raising money to fund what is typically a project or business venture through many donors using an online platform, such as Kickstarter , Indiegogo and Crowd funder. The fundraising window is usually finite -- 90 days, for instance -- and the fees and rules vary across platforms. Crowd funding is typically done through an online platform that allows the fundraiser to set up a public campaign for accepting donations. The campaign will advertise details such as the nature of the project or venture, the amount of money the company is hoping to raise and the campaign's fundraising deadline. People can donate a specified amount through the fundraising campaign's website and often receive some sort of acknowledgement or reward in return for their donation.

History

The first instance of crowd funding was in 1997, when fans underwrote an entire U.S. tour for the British rock group Marillion, raising US$60,000 in donations by means of a fan-based Internet campaign. The idea was conceived and managed by fans without any involvement from the band, although Marillion themselves used this method successfully to fund the recording and marketing of their 2001 album *Anoraknophobia*, the first crowd funded recording. They continued to do so with subsequent albums *Marbles*(2004), *Happiness is the Road* (2008), and *Sounds That Can't Be Made* (2012).

In the film industry, independent writer/director Mark Tapio Kines designed a website in 1997 for his then-unfinished first feature film *Foreign Correspondents*. By early 1999, he had raised more than US$125,000 on the Internet from at least 25 fans, providing him with the funds to complete his film.

In 2002 the *"Free Blender"* campaign was an early software crowd funding precursor. The campaign aimed for open-sourcing the Blender raytracer software by collecting $100,000 from the community while offering additional benefits for donating members.

Crowd funding gained traction after the launch of ArtistShare, in 2003. Following ArtistShare, more crowd funding sites started to appear on the web such as IndieGoGo(2008), Kickstarter (2009) and Microventures (2010).

The phenomenon of crowd funding is older than the term "crowd funding." The earliest recorded use of the word was by Michael Sullivan in fundavlog in August 2006.

TYPES

Donation-Based Crowd funding

Broadly speaking, you can think of any crowd funding campaign in which there is no financial return to the investors or contributors as donation-based crowd funding. Common donation-based crowd funding initiatives include fundraising for disaster relief, charities, nonprofits, and medical bills.

Rewards-Based Crowd funding

Rewards-based crowd funding involves individuals contributing to your business in exchange for a "reward," typically a form of the product or service your company offers. Even though this method offers backers a reward, it's still generally considered a subset of donation-based crowd funding since there is no financial or equity return. This approach is a popular option here on Fundable, as well other popular crowd funding platforms like Kick-starter and Indiegogo, because it lets business-owners incentivize their contributor without incurring much extra expense or selling ownership stake.

Equity-Based Crowd funding

Unlike the donation-based and rewards-based methods, equity-based crowd funding allows contributors to become part-owners of your company by trading capital for equity shares. As equity owners, your contributors receive a financial return on their investment and ultimately receive a share of the profits in the form of a dividend or distribution.

Debt-based(peer to peer)

Debt-based crowd funding (also known as "peer to peer", "P2P", "marketplace lending", or "crowd lending") arose with the founding of Zopa in the UK in 2005 and in the US in 2006, with the launches of Lending Club and Prosper.com .Borrowers apply online, generally for free, and their application is reviewed and verified by an automated system, which also determines the borrower's credit risk and interest rate. Investors buy securities in a fund which makes the loans to individual borrowers or bundles of borrowers. Investors make money from interest on the unsecured loans; the system operators make money by taking a percentage of the loan and a loan servicing fee.

The Benefits of Crowd funding

From tapping into a wider investor pool to enjoying more flexible fundraising options, there are a number of benefits to crowd funding over traditional methods. Here are just a few of the many possible advantages, which we'll cover in greater detail later in this guide:

Reach – By using a crowd funding like Fundable, you have access to thousands of accredited investors who can see, interact with, and share your fundraising campaign.

Presentation – By creating a crowd funding campaign, you go through the invaluable process of looking at your business from the top level its history, traction, offerings, addressable market, value proposition, and more and boiling it down into a polished, easily digestible package.

PR & Marketing – From launch to close, you can share and promote your campaign through social media, email newsletters, and other online marketing tactics. As you and other media outlets cover the progress of your fundraise, you can double down by steering traffic to your website and other company resources.

Validation of Concept – Presenting your concept or business to the masses affords an excellent opportunity to validate and refine your offering. As potential investors begin to express interest and ask questions, you'll quickly see if there's something missing that would make them more likely to buy in.

Efficiency – One of the best things about online crowd funding is its ability to centralize and streamline your fundraising efforts. By building a single, comprehensive profile to which you can funnel all your prospects and potential investors, you eliminate the need to pursue each of them individually. So instead of duplicating efforts by printing documents, compiling binders, and manually updating each one when there's an update, you can present everything online in a much more accessible format, leaving you with more time to run your business instead of fundraising.

Key risks

- Risk of default: In equity crowd-funding the risk of default/investment failure is estimated to be around 50%. In peer-to-peer lending there has been a concerted effort by the industry to reduce default rates, which reached a high of 30% in 2009. While there has been some success in reducing the default rate, the actual rate of default in many cases is unknown as many of the platforms have only opened in the last three years and the loans originated by them have only recently started to mature.
- Risk of platform closure/failure: Despite the short life of crowd-funding, there has already been a case of a peer-to-peer lending platform closing leaving no data on contracts behind and resulting in 100% investment loss. Investors bear a higher risk than in many other types of investments.
- Risk of fraud: This is compounded in both peer-to-peer lending and equity crowd funding by the anonymity created by the online aspect of these industries. This is the case for both the lender/investor and borrower/issuer parties, whereby the opportunity to defraud is an ever present reality.
- Risk of illiquidity: Investors cannot sell their participations as there doesn´t exist a secondary market. This lack of liquidity in FR crowd-funding could be a risk for investors if they are not aware of this.
- Risk of cyber-attack: The online nature of FR crowd-funding makes FR-crowd funding vulnerable to the risk of cyber-attacks.
- Lack of transparency and disclosure of risks: Risks tend not to be disclosed until a lender/investor becomes a member of the platform

- **Systemic Risk:**

a) Due to the "individual" nature of crowd funding, there is a possibility that investors may not practice good diversification principles.
b) There may be no secondary market in which investors can sell their investments and exit and hence, there is a risk of illiquidity.
c) There is also possibility of Money laundering.
d) These platforms could expose other financial sectors to the risk of default, as occurred during the subprime mortgage crisis. If the rapid growth rate in peer to-peer lending continues, these risks could become systemic.
e) There are Cross-border implications, if the funds are solicited through internet, as there are disparities in Contract Act or securities law application in different jurisdictions.

SEBI's role in crowd funding,

To promote the startup ecosystem in India, the Securities and Exchange Board of India ("**SEBI**") has rolled out a 'Consultation Paper on Crowd funding in India' ("**Consultation Paper**") proposing a framework in the form of Crowd funding to allow startups and SMEs to raise early stage capital in relatively small sums from a broad investor base. Crowd funding, if introduced and regulated, will allow startups in raising capital in addition to the recently introduced Institutional Trading Platform ("**ITP**"). which is proposed to provide a cost effective and efficient method of fund raising, will mainly be limited to:

- recognition of the Crowd funding Portals
- oversight and regulation of the Crowd funding market in India
- playing no role in vetting of the Private Placement Offer letter of the issuing companies
- issuance of guidelines/circular regarding information required to be disclosed in Private Placement Offer Letter or on an ongoing basis or requirements of due diligence and screening or any other matter
- conduct of periodic inspections or audits of Crowd funding Platforms and enforcement of Crowd funding Regulations

SEBI's Proposal

- SEBI has proposed to allow only Accredited Investors to participate in crowdfunding. These include Qualified Institutional Buyers (QIBs); companies incorporated under the Companies Act of India, with a minimum net worth of Rs. 20 crore; High Net Worth Individuals (HNIs) with a minimum net worth of Rs. 2 crore; and Eligible Retail Investors.
- Most of this limited class of investors expect an outcome out of their investment. This is a setback to creative works and social causes which do not give return on investments. The technical startups will benefit the most from this new class of analyze-before-investing. Earlier, most crowdfunding was through small donations from individuals who invested because a friend had recommended or they felt for the project. The emotional vibes in investment will take a backseat as the accredited investors will evaluate the project and its potential before investing.
- A QIB will prefer to stay away from investing in a project where the risk element involved is higher and therefore, there are chances of investment not being returned. However, SEBI has proposed that a minimum of 5 per cent of the total number of shares of the company shall be held by QIBs.
- The number of investors has also been limited to 200 except QIBs (on which there is no limit). SEBI gives a startup the freedom to have as many QIBs retains the traditional crowdfunding model, but does not address the disinterest of most QIBs in investing in creative or social cause startups as the chances of a return are lesser. A startup must be less than 4 years old and cannot raise more than Rs. 10 crore in a year. The investment may not satisfy the capital requirements of a few technical startups.
- For receiving crowding, a company must not be a subsidiary or related to any other company which has a turnover in excess of Rs. 25 crore. It must not be listed on any Exchange. Companies engaged in real estate and activities not permitted under industrial policy of the Government of India shall not be allowed to raise money through crowdfunding. Further, the issuer shall not raise capital from multiple platforms, and shall not loan out the funds. An issuer shall have to disclose certain details of the company, its functioning and the venture it seeks to start. Most of the details required are basic and can be provided by an issuer. This is to ensure that an investor can make an informed choice.
- SEBI proposes to limit the entities which can establish por-

tals to stock exchanges, depositories, technology business incubators (TBIs) and angel investors. Internet companies which have so far effectively handled the crowdfunding business in India should not have been left out SEBI. Since the crowdsourcing is mostly done online, letting the existing internet companies to carry out their process should have eased SEBI's work. They also require a platform to own the domain name, then why not let the internet companies themselves run the crowdfunding business? SEBI should itself be the gatekeeper and verify the various the authenticity of various issuers and their rather than leaving the job on the portals.

INDIAN EXPERIENCE OF CROWDFUNDING

Crowd funding is relatively a new concept in India and the usage of Internet for raising funds is even less. According to a World Bank report (2012), India has only 10 CFPs as against 344 in the US and 87 in the UK. Few well known CFPs in India –

- Catapooolt - http://www.crowdfundinsider.com
- Ignite Intent – http://www.igniteintent.com
- Ketto - http://ketto.org
- Pick A Venture - http://signup.pikaventure.com
- Start 51 - http://www.start51.com
- Wishberry - https://www.wishberry.in/¬

Conclusion

There is no doubt that crowd funding is rapidly being looked upon as a serious way of raising funds for start ups and new businesses. There are serious concerns, which make it mandatory to bring this method under the laws of the land. India may soon bring in the requisite laws to support this in a big way, as efficient crowd funding system can really play the role of catalyst in bringing the start up ideas into reality.

Crowd funding comes with many advantages compared to existing avenues available to start ups and SMEs. Capital raise under the Crowd Funding Platform not being a public offer and thus not triggering public offer related pre-conditions, and the related costs and compliances therein, is a good starting point for this platform available for such new generation companies. This will also enable the Eligible Entities to reach out to a wider section of investors and investor groups for raising capital.

As there is an absence of track record requirement for the Eligible Entitles and such Eligible Entities can raise funds even before their venture actually becomes commercially viable, such capital investment through Crowd funding will be in the form of a risk capital. Thus, there is a greater need to have this space appropriately regulated rather than being over regulated (which may have overkill on the budding entrepreneurs and promoters and their creative and innovative business ideas).

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