



## HOW A TYPICAL CROWDFUNDING ROUND WORKS

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<b>Article history:</b>	<b>Abstract:</b>
<b>Received:</b> November 24 <sup>th</sup> 2022 <b>Accepted:</b> December 26 <sup>th</sup> 2022 <b>Published:</b> January 30 <sup>th</sup> 2023	The article describes the typical process of a crowdfunding round and its relevant characteristics. Crowdfunding typically involves an exchange of services between the donor and the person seeking funds only if the target amount is reached within a specified timeframe. Backers in crowdfunding typically have no say in the implementation of the project and have to rely on their trust in the initiator. Crowdfunding also often involves offering unconventional services to sponsors that can have a more complex meaning than purely economic. The idea of swarm intelligence is also discussed, where a large number of donors participating in a financing project can indicate its success and create a momentum for others to participate. The article also touches on the role of donors as multipliers and the importance of ongoing media processing and transparency in financing through crowdfunding.
<b>Keywords:</b> Crowdfunding, Round, Legal Examination, Performance-related, Exchange of Services, Donors, Unsecured Advance Payments, Lenders	

A typical crowdfunding round operates as follows, serving as the foundation for the legal examination. This process is based on various theories and highlights important characteristics.

### **A) PROCEDURE-RELEVANT CHARACTERISTICS**

#### **I. Only performance-related conditional exchange of services**

In crowdfunding, it's common for there to be an exchange of services between the donor and the person seeking funds only if the target amount is reached within the specified timeframe. Thus, the outcome of the crowdfunding round is uncertain for both parties at the beginning. This setup is meant to safeguard the donors as they are only obligated to make the final payment if the financing project proves to be feasible based on the funds raised. However, the person seeking funds only bears the risk of realization if they have a sufficient budget and won't have to fill any funding gaps with their own or external resources.

#### **II. Unsecured advance payments by lenders**

Once the financing phase is over, the backers typically have no say in what happens after they have made their monetary contribution. They are not involved in the implementation of the project and typically have no rights in this regard. Unlike traditional financiers, who try to mitigate their risks through investments (equity financiers) or collateral (debt financiers), crowdfunding backers have to rely on their trust in the initiator for the successful outcome. Thus, the trust the backers have in the person seeking funds plays a crucial role, as they provide their support at an earlier stage than the object of financing is executed.

For crowdfunding in company financing, depending on the type of contract, backers may receive (indirect) participation which can come with individual rights regarding information, participation, and termination. However, even in these cases, there is limited possibility for operational influence on the implementation process.

#### **III. Prospect of unconventional services (performance levels)**

It is typical for fundraising through crowdfunding that the sponsors are offered the prospect of some kind of, often unconventional, return service by the initiator for their participation in the crowdfunding round, the form of which depends on the amount of the cash payment.

It is characteristic of raising funds through crowdfunding that services can be promised that have a more complex than purely economic meaning for the donor, for example because they are particularly useful or have an ideal connotation.

Usually there is a gradation according to which a certain amount of money has to be paid depending on the service promised. This connection between the promised benefit in each case depending on the level of financial participation is referred to below as the benefit level.

Here is one example of rising funds by crowdfunding:

EUR 20,000 is needed to produce an illustrated book about US classic cars. This financing project will be published via an internet platform and various benefits will be promised for participation in this financing project. These differ according to the amount



of money to be granted. For example, a personal thank you card is offered for a share of EUR 10 in the financing project, for EUR 50 the illustrated book to be produced, for EUR 75 a signed version of the illustrated book to be produced and a name given to the Acknowledgments in the book. In a previously defined period, an amount of EUR 21,710 was raised with 202 people taking part.

According to the case given above, a personal thank you card was promised for a service level of EUR 10, for a service level of EUR 50 the sending of a copy of the illustrated book to be realized and, for example, for a service level of EUR 75 the sending of a signed one copy together with a mention of the name in the acknowledgments in the book. In addition, numerous other service levels were offered, which, depending on the amount, were supplemented by additional services, in particular typical fan articles such as lighters or T-shirts related to the project (e.g. the illustrated book and a T-shirt for EUR 80.00).

#### **IV. The idea of swarm intelligence**

It is also characteristic of fundraising through crowdfunding that a large number of donors typically participate in a specific financing project. Based on a correspondingly high number of donors, a certain indicative effect for the success of a financing project should be able to be derived. In this context, the idea of swarm intelligence is named as an overriding characteristic, according to which a sufficiently large number of decision-makers should automatically make the best possible decision even without special specialist knowledge. Gassman et al., for example, show a connection between swarm intelligence and the field of crowdsourcing and define it as "a strategy of outsourcing knowledge generation and problem solving to external actors through a public call to a large group" [1].

The effects of swarm intelligence in connection with crowdsourcing can also be applied to crowdfunding. This means that with a sufficiently large number of sponsors, an indication of the success of a financing project can be achieved. The advantage of raising funds through crowdfunding is that funding projects that are supposedly worthy of funding can be identified earlier and more accurately than would be the case with institutional financiers [2].

A certain momentum can also develop from this, as a result of which other donors "jump on the bandwagon" if only a significantly large number of donors have already contributed to the financing project.

#### **V. Donors as multipliers**

If the donors can be persuaded to participate in a crowdfunding round, they often also act as multipliers for the project to be financed, for example by spreading

the word about participation in a crowdfunding round via social media. This phenomenon can be described as "social commerce", a "merging of e-commerce and social media elements". Such a communicative link with the acquisition of funds is seen as an important unique selling point of financing through crowdfunding [3].

#### **VI. Ongoing media processing and transparency**

It is also characteristic of financing through crowdfunding that the donors are constantly informed about the financing status and, linked to this, the degree of realization of the respective financing project.

This is reflected in ongoing media processing, as it is constantly made clear what the amounts to be raised are used for and then used. Both in the course of the crowdfunding round and afterwards, in the implementation stage.

As a rule, not only the project to be financed is presented, but also its initiator. The aim is to present the financing project, provide up-to-date information and thus ensure maximum attention and transparency.

Since the financiers usually do not have collateral for the financing project and the amount of funds raised primarily increases with the credibility of the financing project and the initiator, such transparency is of great importance for the successful course of the crowdfunding round.

After the successful outcome of the crowdfunding round, the ongoing media processing of the implementation of the financing project is often the only control option available to the sponsors vis-à-vis the initiators.

### **B) FLOW OF A TYPICAL CROWDFUNDING ROUND**

The outer course of a typical crowdfunding round can be divided into four phases.

#### **I. Preparatory structuring**

At the beginning of a crowdfunding round, before the actual raising of funds, the focus is on structuring it. In the area of platform-based crowdfunding, this is regularly accompanied by the registration of the initiator on a crowdfunding platform. In the area of platform-independent crowdfunding, on the other hand, the initiator operates its own crowdfunding site.

##### *1. Determination of a period for raising funds*

In the case of platform-independent crowdfunding, the initiator determines the period of time for raising funds himself. In the area of platform-based crowdfunding, the possible duration of the crowdfunding round can differ depending on the case group and provider. An upper time limit does not necessarily have to be specified here, but such a limit can be, for example, 45 days or 60 with the option to extend it to 120 days [4].



### *2. Determination of a target sum*

The initiator also determines the target sum himself. In the area of platform-based crowdfunding, this can differ depending on the case group and provider.

Also affecting the achievable amount is whether the predefined target amount has a rigid upper limit or whether funding should also be possible beyond this target amount. This would happen if the target amount was already reached before the end of the predefined period for raising funds, but the funding continues until the predefined period for raising funds ends. This also differs depending on the case group and provider.

### *3. Determination of service content and service levels*

When planning the crowdfunding round, it must also be determined whether, and if so, what kind of benefits the donors should receive for their participation in the crowdfunding round.

There are regular differences as to whether the lenders are promised benefits at all, whether project-related benefits are promised, whether a share in the profits of a (young) company or interest and repayment are promised. The type and scope of the promised benefits can differ depending on the benefit level, as a connection between the promised benefit in each case depending on the level of financial participation.

## **II. Feasibility Check and Application**

Depending on the case group and the respective platform, the actual raising of funds "is preceded by a 'starting phase' in which the project initiator presents the project on the financing platform and solicits 'fans'." This is with the aim that the crowdfunding round is only then activated if enough potential sponsors have been found or if the financing project is classified as promising after an examination by the crowdfunding platform.

Such a structuring can be advantageous for both the initiator and the sponsor, since the potential is tested before the exchange of services takes place. Corresponding commitments in connection with financing projects are not new and can also be found in financing via the capital market. In this way, the media processing can be compared in a weakened form with a "marketing and publicity campaign", such as those that prevail in the course of an IPO or the market launch of a product [5].

## **III. Fundraising**

The actual crowdfunding begins with the activation of the financing project and, depending on the structure, lasts until the end of the predefined period for raising funds or until the target amount has been reached.

The donor's participation in the crowdfunding round usually requires registration on the respective crowdfunding platform.

The progress of financing is usually graphically highlighted on the respective project page and displayed as a bar chart or percentage value. The number of previous sponsors and the remaining time to participate are also shown separately on the page.

The usual models provide, for example, that the lender is immediately obliged to pay, even before it is clear whether the desired target amount will be reached. There are also arrangements in which the donor is only obliged to pay when the target amount has been reached [6].

The acquisition of the funds, the payment transactions and the safekeeping of the funds until they are ready to be paid out are basically designed in such a way that the initiator only has access to the funds when they are ready to be paid out. The crowdfunding platforms involved typically come into contact neither with the resulting payment flows nor with the funds received. For this purpose, payment transactions are made via external payment service providers or credit institutions. Funds collected during the crowdfunding round are held in trust by external payment service providers or cooperating banks.

## **IV. Result Of The Crowdfunding Round**

The further process depends on whether the outcome of the crowdfunding round was successful, i.e. whether the desired target amount could be raised.

### *1. Successful outcome of the crowdfunding round*

If (at least) the target sum is successfully raised, this is usually paid out to the initiator in the area of platform-based crowdfunding minus a commission (usually 5 to 10 percent). However, not all platforms charge a commission.

If the target amount has been successfully raised, the funds raised will be used by the initiator to implement the financing project and the promised services will also be provided. The financiers typically have no influence on the realization of the financing project.

### *2. Failed outcome of the crowdfunding round*

If the target sum cannot be successfully raised within the previously defined period of time, there is no exchange of mutual services. For the donors, this means that the financial contributions do not have to be paid or that payments already made owe back to them.

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