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CROWDFUNDING MODELS AND INVESTOR RISKS ASSOCIATED WITH CROWDFUNDING

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Abstract:

Crowdfunding is a way to finance or capitalize a successful business by amassing a large number of little contributions using an online funding platform. It is a modern, cutting-edge adaptation of a long-standing practice. This article discusses the essence of crowdfunding, its pros and cons, the types of crowdfunding models. This article also looks into five different risks or issues associated with crowdfunding for investors.

Keywords: Crowdfunding models, campaign, risks, fraud, donation-based crowdfunding, reward-based crowdfunding, credit-based crowdfunding, equity-based crowdfunding

Like the beginning of e-commerce in the 1990s, the advent of online crowdfunding platforms during the past ten years has sparked a lot of excitement among business owners, Web developers, consumers, and investors (and their lawyers) eager to take advantage of new opportunities. A few current financial institutions and professions risk being disrupted by crowdfunding, just as e-commerce did to the retail industry 20 years ago [1].

Crowdfunding platforms offer smaller companies and individual entrepreneurs' valuable opportunities for accessing finance which may not be available to them through financial institutions or the capital markets. Initial public offerings (IPOs), for example, require companies to produce an investor prospectus and undergo extensive due diligence, both of which are expensive procedures and effectively exclude smaller players from entering the equities market. Crowdfunding, by contrast, allows businesses with fewer resources to draw on a multitude of investors by linking them together through the internet. This approach also enables entrepreneurs to benefit from the expert advice that many of these investors are likely to possess, which further increases the chances of a venture being successful.

In particular, four main types of **crowdfunding models** can be distinguished [2]:

Donation-based crowdfunding is a simple model and is usually used for social or charitable purposes. Investors are mostly motivated by altruism and donate money without expecting anything in return. Examples of donation-based crowdfunding platforms include GoFundMe (http://www.gofundme.com/), YouCaring (https://www.youcaring.com/), and Crowdrise (https://www.crowdrise.com/).

Reward-based crowdfunding is the most popular model. As the name suggests, investors are rewarded based on the amount of money they bring to the project. Rewards can range from something as simple as a thank you card to a product prototype. Cash prizes are never allowed. This model is mainly used for creative projects ranging from art, music, games to design and technology. In addition, the reward model is often used as a form of pre-sale before entering the market. Two of the earliest and largest reward-based crowdfunding platforms are Kickstarter (http://www.kickstarter.com) and Indiegogo (https://www.indiegogo.com/).

Credit-based crowdfunding (lending-based crowdfunding). Credit-based crowdfunding in the form of consumer (P2P peer-to-peer) and business lending (P2B peer-to-business) constitutes the largest segment of the alternative finance market in Europe [3]. In this type of crowdfunding, investors provide funds through small loans to consumers or businesses and receive interest in return. This is a way to get a loan at a lower price than the loans that banks can offer. Examples of this model include Prosper (https://www.prosper.com/), Twino (https://www.twino.eu/) and Bondora (https://www.bondora.com/).

Equity-based crowdfunding offers investors the opportunity to become shareholders of the company being financed by purchasing small shares. In return for their financial contribution, investors share in the potential profits of the business. One of the world's first capital-based crowdfunding platforms is the English Crowdcube (https://www.crowdcube.com/), launched in 2010.

The downside of crowdfunding is that it does not offer investors the same degree of protection that capital markets provide: entrepreneurs seeking

investment in this way do not need to disclose the detailed information that stock exchanges, for instance, require of them. It is conceivable, as things stand in some jurisdictions, that investors could be invited to finance a project without having received any guarantee that the venture actually exists.

RISKS ASSOCIATED WITH CROWDFUNDING FOR INVESTORS

Crowdfunding projects typically draw investors because they give them access to new items before they are widely commercialized, give them access to new investment options, let them feel like they are a part of a larger community, and let them network with other investors.

However, these investors do not participate without being at risk. This article looks into five different risks or issues related to crowdfunding, in the following order: the first is that projects could be shady schemes to fleece investors; the second is that projects could be run by inept businesspeople; the third is that crowd investors might not be able to sell the shares they bought; and the fourth is that unclear regulations and tax laws might apply to crowdfunding.

FRAUD

The largest risk to crowdfunding campaigns is fraud. With these campaigns, traditional reputational and legal defenses may not be effective. First, sellers traditionally want to protect their reputation and prestige because they frequently depend on repeat customers. Due to the anonymity of the internet and the fact that sellers rarely raise funds again, incentives to avoid receiving negative reviews or a bad reputation may not be effective in the context of crowdfunding.

Fund-seekers might not be a return customer, but platforms are. In order to succeed, these platforms have incentives to avoid a bad reputation as a marketplace, to deter fraudulent schemes, and to conduct due diligence on each project and throughout the campaign: platforms may collaborate with banks that have experience identifying fraudulent projects; platforms can stagger the release of funds to reduce the amount of money that is impacted; etc.

Due to the fact that crowdfunding relies on small investments from many investors rather than large investments from a small number of investors, each individual investor may not have enough motivation to investigate and report fraud due to the small amounts involved. As a result, legal enforcement may also fail. Consequently, fraudulent activities such as pyramid schemes and fraud might target investors via crowdfunding platforms.

Overall, fraud appears to still be a rare occurrence, and due to restricted exposure and risk diversification, investors may be willing to invest despite these fraud concerns. Investors can reduce their risk exposure by making modest investments in crowdfunding projects. Additionally, investors have the option to spread their risk among a number of enterprises. In addition to all-or-nothing model anti-fraud characteristics and the wisdom of crowds, the crowd also contributes to fraud protection. Because the general public can typically see who invests and whether those personally acquainted with the campaigner (such as friends and relatives) engage and donate to the project, individual investors also send signals about projects. Fraud is a real risk but platforms and the crowd have their place to play in preventing fraud [4].

INCOMPETENCE

Aside from fraud committed on purpose, businesses may unintentionally fail by miscalculating their projects or being unskilled. Because the crowd gravitates toward projects that convey the right signals and because a project must attract enough investors to become viable, the wisdom of the people and the all-or-nothing paradigm moderate issues of incompetence. The amount of investment from friends and family gives indications about the quality of the entrepreneur, just like with fraud.

LACK OF EFFICIENT SECONDARY MARKET FOR EQUITY-BASED CROWDFUNDING

If they are unable to employ market mechanisms, investors, like campaign creators before them, may find it difficult to value their investment when they quit [5]. The slow growth of a secondary market for equity-based crowdfunding likewise hinders the growth of the main market. While there are a variety of reasons why investors participate in a project, the majority do so with the hope of making a profit. They must sell their shares back to the business owner or to other investors in order to repay their capital.

If an entrepreneur offers to purchase the shares back, investors cannot know whether the offer is appropriate. The initial investors may find it difficult to establish the price if they sell the shares to later investors. People with experience evaluating businesses (such as venture capitalists and business angels) might not be interested in crowdfunding because they prefer to be actively involved in the process or are concerned about exit-related concerns.

TAXATION

There are many concerns with tax and donations that platforms and campaigners must deal with. First of all, tax credits are sometimes offered for contributions made to charitable organizations. Campaigners contend that contributors should be eligible for the same tax deductions for funds given

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through crowdfunding websites. However, given that crowdfunding platforms can often be for-profit businesses that charge fees, they might not be able to do so. The initiatives and innovations that receive funding are impacted by these tax deductions.

Second, tax relief now differs in many states depending on whether businesses finance their R&D with earnings, equity, or debt. The need for capital, the development of crowdfunding, and how investors and fund-seekers frame their campaigns may all be impacted by these disparate tax treatment policies.

REGULATIONS

On the one hand, regulators pay little attention to reward-based crowdfunding because it is a type of pre-sale and benefits from conventional consumer protection (e.g. breach of contract if a product is not delivered) [6]. Consumer advocacy groups, however, have voiced concerns about specific projects and product safety. These organizations contend that reward-based crowdfunding, which has a wider (Internet) reach, may expose a larger portion of the public to risk if it is not properly regulated.

On the other hand, regulators have paid increased attention to equity- and lending-based crowdfunding. Credit-based crowdfunding competes with banks, which are frequently subject to strict regulation. Share emission, a component of equity-based crowdfunding that frequently comes within the jurisdiction of local national financial authorities. Lending and equity-based crowdfunding laws can be complicated. As a result, some platforms are set up to avoid these rules, while others seek to dispute the ambiguous financial legislation that might be applicable to crowdfunding.

Many jurisdictions have restrictions (rules) on who can finance a new business and how much they can contribute. These rules should protect unsophisticated or wealthy investors from putting their savings at excessive risk. As many new businesses fail, their investors are at high risk of losing their investment. Crowdfunding has made it possible for entrepreneurs to raise hundreds of thousands or millions of dollars from anyone with money to invest [7].

In order to ensure the protection of the rights and interests of potential investors, there is a need to legally regulate crowdfunding.

Legal regulation of crowdfunding will legitimize the possibility for relevant companies or investors to offer and sell securities through crowdfunding and will strengthen the confidence of crowdfunding investors in the industry.

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