Crowdfunding - concept and legal implications

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Abstract

Crowdfunding is a new method of financing business ventures started by young entrepreneurs who do not have access to traditional methods of finance/funding. In crowdfunding an intermediary website acts as a facilitator between the entrepreneur and the investor. The four different models of crowdfunding are: the donation model, the reward model, the lending model and the equity model. Crowdfunding has its own advantages and disadvantages. Crowdfunding is becoming popular in India also. SEBI and RBI have laws in place for regulating equity and lending models respectively. The President of India has also promulgated an Ordinance seeking to ban all unregulated deposit schemes including crowdfunding, unless the scheme is already regulated by SEBI, RBI, etc.

Keywords: Crowdfunding, Models of Crowdfunding, Donation Model, Reward Model, Lending Model, Pre-Purchase Model, Peer to Peer Crowdfunding.

1.0 Introduction

A first generation entrepreneur would find it extremely difficult to obtain money from external sources, to finance to his new business venture/startup. External investors like banks and equity capital will be very reluctant to invest large amounts of money in such new ventures for a variety of reasons. One major reason for such reluctance is the absence of sufficient reliable information with the investors regarding the viability of the startup (Cosh, Cumming, & Hughes, 2009). Lack of sufficient security with the entrepreneur to borrow money from the financial investor is another reason for non-availability of funds for investments in emerging ventures (Belleflamme, Lambert, & Schwienbacher, 2014). Lack of operational history and proven track records are also reasons for the same (Stemler, 2013).

Consequently, first time entrepreneurs normally rely on internal sources of finance like personal savings, funds from friends, family etc. to finance their new ventures (Kraus, Ritcher, Brem, Feng cheng, & Ling Chang, 2016). However, such internal resources have obvious limitations and a new startup may not be able to survive long with only internal sources of funding.
The emergence of internet and the World Wide Web, in the last forty years, has opened up new opportunities for first generation entrepreneurs to easily raise finance from external sources. Instead of focusing on a few investors, the entrepreneur through the medium of online websites seeks small amounts of money as investment from large number of investors. Since each individual investor is required to invest only a small sum of money, the risk involved is very less. Hence, it becomes easier to convince an individual investor to invest money in even risky ventures. Since the number of investors involved is large, large amounts of money can be easily raised (Agrawal, Catalini, & Goldfarb, 2014). Since money for even a small startup is raised from a large number of persons, this method of fund raising for business activity is popularly known as crowdfunding.

Crowdfunding has fast emerged as an important alternate way for entrepreneurs to arrange finance for their business not just in the developed world, but also in the developing world. India is no exception. In 2015, Indian entrepreneurs have raised $ 27.8 million through crowdfunding, which is the highest among all third world countries (Crowd, 2016). This is expected to exponentially grow in the coming years. Consequently, in order to protect the interest of investors, there is a need to regulate crowdfunding through law.

This article primarily seeks to analyze the conceptual framework of crowdfunding and its legal control through legislations in India. The next part of this article seeks to define crowdfunding, whereas the third part will identify the different models of crowdfunding. The fourth part of this article analyses the merits and demerits of crowdfunding methods. The fifth part of the article will briefly look at the crowdfunding scenario in India. The sixth part of the article will analyze the legal status of crowdfunding schemes. The final part of the article will conclude the findings.

2.0 What is Crowdfunding?

Crowdfunding is a new technique of raising money, for running a new business venture, through an intermediary website or internet platform. The said intermediary acts as a link between an entrepreneur, who has a project idea but is unable to raise funds in the traditional manner, and investors, who are ordinary people willing to invest small amounts of money into projects (Jegeleviciute & Valanciene, 2015). There are two essential characteristic features of crowdfunding which make the crowdfunding technique of raising finance unique.

1) In crowdfunding the necessary money is raised by accepting relatively small contributions from a relatively large number of persons (Bradford, 2012). Since only small amounts are requested from investors, the risk taken by each investor is relatively small.

2) The use of internet platform/website as the intermediary. The entrepreneur publishes his proposed business plan in the crowdfunding website along with information regarding the proposed return that would be provided to the investor. An investor who visits the website can browse the details provided and if impressed by the same, he can invest any amount of money that he desires (subject to any minimum or maximum prescribed by the intermediary). Thus, the intermediary website plays the role of a facilitator (Bradford, 2012). It aggregates small amounts of money collected from large number of investors towards a single business venture (Lee, Yen, & Fu, 2016). The advantage of using the medium of internet for raising funds is the ability to communicate real-time and to have very little incremental cost (Cohn & Yadley, 2007). Internet
facilitates the digital transfer of small amounts of money without any significant transfer cost. This has greatly helped crowdfunding. Extremely small amounts of money can be transferred across the world with almost negligible transfer cost.

### 3.0 Crowdfunding Models:

Crowdfunding techniques can be classified into four types, based on the type of reward or return, the investor eventually gets from his investment (Tomczak & Brem, 2013). They are: 1) The Donation Model, 2) The Reward Model and The Pre-Purchase Model, 3) The Lending Model (Peer to Peer Lending Model) and 4) The Equity Model. Most of the intermediary websites offer more than one model (Bradford, 2012).

1) Donation Model:

In the donation model of crowdfunding when an investment is made, the investor gets nothing in return including his initial contribution. Here even though the investor does not expect financial reward, the entrepreneur who receives the donation, may have profit motives (Bradford, 2012). In case of such voluntary donations, even though the investor does not have any financial motivation, he may have been motivated by intangible factors like direct psychological rewards, reciprocity etc. (Boudreau, Jeppesen, Reichstein, & Rullani, 2015). The examples of such donation based crowdfunding websites are ‘DonorsChoose.org’, ‘GiveForward’, etc. (Lee, Yen, & Fu, 2016).

2) Reward Model and Pre-Purchase Model:

The reward model and pre-purchase model of crowdfunding are quite similar to each other and can be explained under one head even though strictly speaking there are some differences between the two models. In case of both models, the investor is offered something in return for his contribution. However, no share in the profit of the business or dividend is offered. Investor does not purchase any financial security. The principal amount contributed is not returned. Also no interest is paid on the same (Bradford, 2012), (Gutiérrez & Sáez, 2018). In case of reward model, the return offered could be anything ranging from a dinner with the entrepreneur (Pieniążek, 2014) to the display of the name of the investor in the film credit (in case of the investor, financing the making of a movie) (Kappel, 2009). However, in case of reward model, the reward is never the actual product or service, the development of which was funded by the investor (Gedda, Nilsson, & Såthén, 2016). In case of pre-purchase model, the return offered is very specific i.e., the product or service developed by the entrepreneur (Bradford, 2012). For example, if the investor has funded the manufacturer of a mobile phone, the investors would receive a mobile phone or the right to buy the mobile phone at a discounted price. The best example of reward funding based crowdfunding websites are ‘Kickstarter’ and ‘IndieGoGo’ (Mitra, 2012).

3) Lending Model:

In the lending model of crowdfunding, the investors loan out funds to the entrepreneur for a temporary period and expect repayment (Bradford, 2012). In some cases, interest is paid along with the repayment of the principal amount. ‘Prosper Market Place’, ‘Lending Club’, ‘Funding Circles’, etc. are examples of websites which offer interest to the investors (Mitra, 2012), (Moreno,
In other cases, interest is not paid and only the principal amount is returned. ‘Kiva’ is the best example of such website that does not offer interest (Mitra, 2012).

4) Equity Model:

In the equity model of crowdfunding, the investors are provided with a share in the profit of the business venture that they are funding (Bradford, 2012). ‘Equitynet’ was the first crowdfunding website that facilitated entrepreneurs to advertise their need for equity crowdfunding (Meyskens & Bird, 2015). The other examples of such websites are ‘SellABrand.com’ (Mitra, 2012) and CrowdCube (Hornuf & Schwienbacher, 2018). Since equity model of crowdfunding involves sale of security, the websites offering such models faced regulatory issues in USA and had to close shop (Bradford, 2012). Consequently in the year 2012, the US Congress enacted the Jumpstart Our Business Startups Act (JOBS Act), which facilitated the equity model of crowdfunding (Vismara, 2016).

4.0 Merits and Demerits of crowdfunding:

The crowdfunding method of financing has many merits when compared with other methods of financing business ventures. Some of them are outlined below:

1. The biggest advantage of crowdfunding is that it gives opportunity to first generation entrepreneurs to access funds which was hitherto not available to new entrepreneurs (Sigar, 2012).

2. Crowdfunding also permits entrepreneurs to market their products or service and obtain feedback. This is more so in the case of pre-purchase model of crowdfunding (Belleflamme, Lambert, & Schwienbacher, 2014)

3. Crowdfunding permits entrepreneurs to test the marketability of the products being developed by them. Crowdfunding is a technique of attracting a large number of investors towards a product idea. If large numbers of investors are attracted, it clearly indicates that the product/service being developed will find buyers (Valanciene & Jegeleviciute, 2013).

4. Investors who finance a business venture become a loyal customer and may agree to finance future ventures as well (Sadzius & Sadzius, 2017).

5. Crowdfunding permits entrepreneurs to overcome geographical barriers in the access of funds. Even if the focus of their venture is within their geographically community, crowdfunding enables them to raise funds globally (Bechter, Jentzsch, & Frey, 2011).

6. The entrepreneur is able to retain control over his business decisions. In other forms of funding, investors gain some form of control over the decisions made by the start-up/business concern. However, in case of crowdfunding the entrepreneur does not lose control over the decision making process (Valanciene & Jegeleviciute, 2013).

7. Since crowdfunding relies on internet for communicating the request of the entrepreneurs across the world, the time involved in searching for investors is greatly reduced when compared to other methods (Schwienbacher & Larralde, 2012). Thus time efficiency is improved.
8. The service fee charged by the intermediary website is relatively low when compared to bank loans or venture capital charges (Usha, 2017).

9. The cost involved in digitally collecting money from a large number of persons is significantly low. Hence, overhead costs get greatly reduced (Sadzius & Sadzius, 2017).

10. Crowdfunding has increased the competition in the financial service sector resulting in overall decrease of cost of services for entrepreneurs seeking funds (Sadzius & Sadzius, 2017).

11. Crowdfunding helps new business ventures to avoid accumulating debts which is usually common with bank loans and other forms of security (Usha, 2017).

12. Crowdfunding has resulted in the opening of many new business ventures due to availability of funds. This has resulted in greater economic growth and creation of new jobs (Ramos & Cacheda, 2015).

13. The risk taken by the investors are much lower compared to other investments due to smaller amount invested (Golić, 2013).

14. Crowdfunding is a new investment opportunity for investors. It provides a means for portfolio diversification for investors (SEBI, 2014), (Usha, 2017)

Crowdfunding model of financing has its demerits as well. Some of them are:

1. When entrepreneurs publish their business project in a website, access to which is open to all, there is always the risk of their idea being stolen by some cash rich entrepreneur / large corporations. Most first generation entrepreneurs lack resources, not only to protect their commercial ideas but also to fight legal cases in court in case of theft of their project/ideas (Valanciene & Jegeleviciute, 2013).

2. The entrepreneurs who accept crowdfunds will face significant administrative and accounting challenges. They must keep records of each and every investor and his investments. This laborious book keeping operation is a very costly affair (Golić, 2013).

3. It is possible for any person posing himself as a entrepreneur to commit fraud under the grab of crowdfunding (Golić, 2013). Since, each investor makes only a small contribution and may be located far way, the investor may not take legal action even if he notices the fraud.

4. Crowdfunding platform can be easily misused by both entrepreneurs and investors for the purpose of money laundering and related activities (Usha, 2017).

5. Crowdfunding is exclusively dependent on the website for connecting the entrepreneur and the investor. There is no real life interaction between the investor and the entrepreneur or between any of the players involved in the transaction. This makes it difficult for the investors to find out whether the business venture is genuine or not (Golić, 2013).

6. A large number crowdfunding websites use the “all or nothing” model. In such a model if the pre-decided target amount is not reached, the money collected is refunded to the investors. The entrepreneur will get nothing and he will have to start from scratch (Sadzius & Sadzius, 2017).
7. In case of crowdfunding there is very limited liquidity as there is no secondary market for
investors on this platform. It is very easy for an investor to invest money. However there is no easy
exit route as there is no liquidity(Usha, 2017).

8. Normally, the risk of financing new business ventures is borne by institutional investors
who have the necessary resources to assess the risk involved in funding a new venture. However,
in the case of crowdfunding this risk is taken by small time investors who do not have the
necessary skills to assess the risks before investing(SEBI, 2014).

9. In case of crowdfunding the entrepreneur does not offer collateral security even in the
case of lending model of crowdfunding. There are also no investor protection schemes. This
exposes the investors to huge risks(SEBI, 2014). The entrepreneur on the other hand can escape
liability and harsh consequences even if the venture fails.

10. Since crowdfunding is operated online and payments made through internet there is
always a risk of online frauds(Usha, 2017). Hence the intermediary website will have to invest
heavily on cyber security, thereby raising the costs.

5.0 Crowdfunding in India:

The crowdfunding model of financing business ventures is in its nascent stages in India.
As per a 2012 World Bank Report, there are only 10 crowdfunding platforms in India(Usha, 2017).
Examples of some of the most popular crowdfunding sites in India are ‘Catapoolt’, ‘IgniteIntent’,
‘Ketto’, ‘Start 51’, ‘Wishberry’, etc.(Usha, 2017). Of these crowdfunding sites, ‘Ketto’ is the only
Indian crowdfunding website that adopts the donation model and gives emphasis to social causes.
Most of the other sites offer some kind of return to the investor(Jhaveri & Choksi, 2014).

A study conducted by ‘Catapoolt’ suggests that the average contribution in India by an
investor per project is less than rupees three thousand and the average investor per project is
only twenty four(Jhaveri & Choksi, 2014). However, the greatest documented success achieved in
India through crowdfunding is in the South Indian film industry. In 2013, a Kannada film named
‘Lucia’ directed by Pavan Kumar was able to raise about Rs. 70 lakhs (about a quarter of the total
cost of producing the film) through the crowdfunding route(Economic Times, 2013).

6.0 Crowdfunding and its Regulation by Law:

The fundamental principle of law is that any person can carry out any activity which is not
prohibited or regulated by any law made by the competent legislature. If there are no laws
prohibiting crowdfunding activity, then any person can seek funding through crowdfunding
websites. Also any person can invest through crowdfunding websites. In USA, initially it was
thought that there was no law prohibiting any form of crowdfunding. But in 2011, Pro-Founder a
leading equity model crowdfunding website received a shut down notice from California
Department of Corporation. The said department contended that equity model of crowdfunding
involves sale of security and hence pro-founder can engage themselves in facilitating equity
model crowdfunding only after registering the website as a broker dealer under Californian
law(Bradford, 2012). Subsequently in 2012 the US Congress enacted the JOBS Act which permitted
intermediary website to offer equity model crowdfunding subject to certain regulations (Williamson, 2013).

In India, when the crowdfunding method of finance started to gain prominence, there arose a concern for regulating crowdfunding. To begin with Securities Exchange Board of India (SEBI), issued a consultation paper on crowdfunding in India. As per the said paper SEBI admits that it can regulate only security based (equity) model of crowdfunding. The said paper also suggests that lending model of crowdfunding can be regulated only by Reserve Bank of India (RBI). As per the said paper, equity model of crowdfunding is regulated by existing regulations of SEBI like SEBI (Alternative Investment Funds) Regulations, 2012 (SEBI, 2014).

Thereafter, RBI came out with a consultation paper seeking to regulate lending model of crowdfunding by treating the intermediary websites as a Non-Banking Financial Company (NBFC). (RBI, 2016). Thereafter, in October 2017, RBI issued a statutory circular (Master Direction) which is called as the Non-Banking Financial Company-Peer to Peer Lending Platform (Reserve Bank) Directions, 2017. As per the said direction, it is made mandatory for lending model crowdfunding websites to register themselves with RBI and comply with the directions contained therein (RBI, 2017).

Inspite of the SEBI/RBI regulations, crowdfunding could not be fully regulated particularly the donation/reward models of crowdfunding. The absence of a comprehensive law regulating all forms of crowdfunding was a source of concern for the genuine investors. It is at this juncture that the President promulgated the ‘Banning of Unregulated Deposit Schemes Ordinance, 2019’. It came into effect from 21st February 2019. The said Ordinance imposes a total ban on all forms of deposits being accepted from the public unless the deposit scheme is specifically permitted or exempted by the Ordinance. The Ordinance specifically permits the operation of schemes approved by SEBI, RBI, IRDA, EPFO, etc. Thus the promulgation of the Ordinance has changed the regulatory rules regarding crowdfunding, which in its essence is basically a deposit scheme. Hitherto, all schemes which were not banned/regulated could be operated. However, after the coming into force of the Ordinance, only those schemes which are specifically permitted can be operated. Hence this Ordinance, if subsequently converted into an Act of Parliament, would go a long way in regulating crowdfunding platforms in India.

7.0 Conclusion:

Thus, from the above analysis, it can be seen that crowdfunding has over the last decade and half emerged as one of the most important sources for funding small scale business ventures. The various models of crowdfunding provide young entrepreneurs with sufficient financial resources to fund their dreams and aspirations. It would not surprise anyone if a conclusion is drawn that the success of crowdfunding is primarily due to the exponential growth of Internet and ICT technology.

Just as crowdfunding started to become popular, government agencies across the world began to realise the need for regulating crowdfunding, so that the interests of all the participants i.e., the entrepreneur, the intermediary website and the investor, can be protected. The situation in India was no different. However, regulating crowdfunding in India became a very difficult task as crowdfunding took various forms like donation model, reward model, pre-purchase model, etc. Initially, it was felt that separate legislations were required to regulate each model of
crowdfunding separately. Consequently SEBI stepped in for the purpose of regulating equity model based crowdfunding, while RBI tried to regulate lending model of crowdfunding. However, other models of escaped regulation raising serious concerns of investor protection. Consequently, the President of India promulgated the ‘Banning of Unregulated Deposit Schemes Ordinance, 2019’ banning all forms of deposit schemes including crowdfunding other than those already regulated by RBI, SEBI, etc. This legislation may have the bonafide intention of protecting the interests of the investors, but it is possible that it may turn out to be a case of over regulation of crowdfunding which is a nascent but promising method of easily making funds available to young entrepreneurs.

8.0 References:


