THE CROWDFUNDING BUBBLE:
MYTH OR REALITY

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ABSTRACT

Today when the world is undergoing one of the most widespread financial meltdowns of the recent past crowd funding has emerged as an important source of financial funding for small and medium scale entrepreneurs. Due to the financial crisis the availability of credit has been reduced and financial firms have become extremely stringent about their lending rules and regulations. This paper aims at understanding the current scenario of crowd funding in general and issues that may arise in future if the system is not handled properly. The paper has been divided into four sections.

1.1 Historical Background of Crowd Funding: This section deals with the journey of crowd funding over a decade and the factors that shaped today’s crowd funding scenario.

1.2 How do the Crowd FundingPlatforms Work: In this section we try to discover the working of a crowd funding portal and explore the opportunities provided by them.

2. Comparative View of the US and EU Crowd Funding Scenario: This section deals with the comparative analysis of the US and EU laws and regulatory frameworks governing crowd funding.

3. The Crowd Funding Bubble: The section raises issues and concerns surrounding crowd funding and focuses on plausible solutions.

4. Conclusion and Suggestions: The last part of the paper lays an outline as to how the crowd funding scenario will emerge in future and throws light on the precautions that need to be taken.
1.1 THE HISTORICAL BACKGROUND OF CROWD FUNDING:

A lot of us think that crowd funding is a recent phenomenon triggered by the massive collapse of the economic structures across the globe initiated the 2008 Sub-prime crisis, but in reality it is not so. The process of crowd sourcing or crowd funding or peer to peer lending as we know it, has existed through centuries. With time and changes in technology we have witnessed a paradigm shift in the process of crowd funding. Earlier crowd funding was done within restricted geographic boundaries among individuals who are known to each other, but with the internet revolutionizing our world, geographic separation is no longer an issue for likeminded people to come together and invest in similar ideas. Many examples of crowd funding can be found in the form of self-help groups and cooperative societies where people come together and lend money for a cause or business and either share the profits generated out of the venture or charge some interest on it which is lower as compared to the existing market lending rates. This form of funding has helped a lot of cottage industries to revive and flourish in recent times and the biggest example of this phenomenon is the Grameen Bank in Bangladesh, a project by Dr. Yunus\(^1\) which has won him accolades worldwide (The Nobel Peace Prize, 2006). We can therefore say that crowd funding is a kind of microfinance by a group of individuals who have a vested interest in either monetary or emotional form. In general funders feel connected to the cause and therefore contribute to it.

The term crowd funding was first used by Michael Sullivan in 2006 when he initiated a project called ‘Fundavlog\(^2\)’ which was an attempt at creating an incubator for video blog related projects and funding (http://www.fundavlog.com). In simple terms if we have to define crowd
funding, we say that it is a collective effort of individuals who have a shared idea and who network to pool in their resources via internet to bring the idea to life. Tracing the genesis of crowd funding via internet we find that, it had initiated in the late 1990s when internet and social networking started growing. With social networking trending, every day more people started connecting to each other via internet. This phenomenon gave rise to the idea of charity fund raising through the internet. It enabled an individual or organization to reach numerous other individuals with geographic boundaries being no longer an issue. People now had an experience beyond the exchange of e-mails. Using social networking platforms people started meeting other individuals with similar ideas and hence sharing had a whole new meaning now. In the mid 2000 the era of entrepreneurship had taken the business world by storm. There were numerous dot com companies and business ventures initiated and a lot of them did very well. At this time venture capital and angel financing had become a flourishing investment business but both of them had one problem. If the financers were not convinced of the business idea they would not fund the project and with geographic restrictions it was difficult for individual to find funders who would believe in their ideas and fund it. The internet provided the solution in form of peer to peer lending platforms, which were microfinance platforms, an alternative to banking. Though these sites were not very successful as the microfinance industry had very tight regulations with strict vigil by the government world over as they were risky and a lot of fraudulent investment companies had run away with the people’s money. The reason for strict vigil by the state is perhaps best explained by the case of SKS\(^3\) Finance in India which raised money through public issue in the mid -2010 to help finance the Andhra Pradesh farmers for growing crops, but a year

later almost 200 farmers committed suicide as they could not repay the loan as they were being harassed by the debt collectors. This brought down the share prices of SKS Finance resulting in people losing money. In the late 2000s the consolidation of social networking sites using OpenID, that is allowing individuals to stay connected on various social platforms using one login ID revolutionized the experience. People not only wanted to lend money using the internet, they now wanted to be a part of that idea and share the experience of feeling connected to it and thus began the era of equity crowd funding which gave rise to crowd funding platforms. Crowd funding was no longer related just to charities and business project, it now had a wider reach and meaning. It is now used for volunteering work, political campaigns, financing music bands for tours, funding social developmental projects and many more (for example: http://www.gofundme.com, http://www.rockethub.com). Thus we can say that crowd funding is the brain child of the empowered social media. 

1.2 HOW DO CROWD FUNDING PLATFORMS WORK?

Crowd funding platforms are the interface used by entrepreneurs or fund seekers for collecting public funds via every day internet users to jumpstart their projects. Crowd funding platforms like Kickstarter\(^4\) and IndieGogo\(^5\) provide a plethora of services to the fund seekers. For example if we take the case of Kickstarter and explore the website we find that there are a wide range of categories such as films, publishing, design, fashion, technology and more are displayed...

\(^2\)A Social History Of Crowdfunding by Daniela Castrataro’ http://socialmediaweek.org/blog/2011/12/a-social-history-of-crowdfunding/#.UeQHjW3Nm3o

\(^3\)SKS raised more than $350 million for its public offering and on the first day of trading the stock went up 10.5%. Vikas Bijaj, Microlender, First in India to Go Public, Trades Higher, N.Y.TIMES, Aug. 17, 2010, at B4.

\(^4\)http://www.kickstarter.com Website last accessed on June 24, 2013 at 7:30 pm.
on the website under which the fund seeker can categorize his project. The website carries a description of the project in the form of write-ups, videos, photographs etc. along with the budget required to formalize the project. Time duration is set for the funding of the project to be completed as well. The progress in achieving the fund target and days remaining to achieve the target are displayed along with the project details. The investors can pledge their money using the platform in the form of donations. The funders are kept updated on the progress of the project through the crowd funding platform. Depending on the contribution by the funders in terms of valuable advice or participation in decision making and strategy building, at times the funders may end up being a part of the project and thereby get voting rights. Crowd funding eliminates the tedious task of project finance available with banks, venture capital or other microfinance companies which require more paperwork and effort (e.g the AIFMD\(^6\) regulations of EU). The pledgers are in general not looking for equity shares or profit sharing and thus they are rewarded in the form of emotional satisfaction, exclusive merchandise, tickets for the premiere of the play or movie funded or prelaunch experience of a product. The rewards can be designed in numerous ways as the system is not necessarily looking for monetary benefits. It is just the matter of sharing of ideas and bringing them to life with the combined effort of likeminded people with an emotional investment.

\(^6\) [http://ec.europa.eu/internal_market/investment/alternative_investments/index_en.htm](http://ec.europa.eu/internal_market/investment/alternative_investments/index_en.htm), Website last accessed on July 02, 2013 at 7:30 am.
2. COMPARITIVE VIEW OF THE US AND THE EUROPEAN CROWDFUNDING
SCENARIO:

The two major economic regions of the world where crowd funding has the widest reach and acceptability are the US and the European Union. According to the report published by Crowdsourcing, LLC\textsuperscript{7} in 2012 the largest concentration of crowd funding platforms are in the US which has 191\textsuperscript{8} crowd funding platforms and Europe which has approximately 186 crowd funding platforms. While analyzing the crowd funding scenarios in both these regions we find a lot of differences. In the following paragraphs we shall try to draw a clear picture of the crowd funding structure existing in these regions.

We shall first discuss the case of USA where crowd funding was promoted using the US, Jumpstart Our Business Startups Act commonly known as the US JOBS Act, 2012. Title III of JOBS Act legalizes crowd funding transactions that meet certain requirement for:

a) Issuers

b) Intermediaries (Funding Portals) and,

c) Investors

Prior to JOBS Act, crowd funding was related to artistic, creative or non-profit ventures where contributors were given souvenirs such as caps, t-shirts and other thank you gifts but no financial incentives as the Securities Act of 1933 makes it illegal for an issuer to offer or sell a security without registering with Securities Exchange Commission (SEC) unless the security meets one of the exemptions for certain securities or transaction involving securities in Section 3 and Section 4 of the Act. The JOBS Act creates an exemption for crowd funding transactions under Section 4 of the Securities Act of 1933. The crowd funding provisions provide entrepreneurs and small businesses the ability to raise capital without the costs and regulation of a registered
offering. The crowd funding provisions in the JOBS Act enable companies to raise capital up to $1 million in capital each year without registering with the Securities Exchange Commission though the intermediary must be registered with the SEC and SRO (Self Regulatory Organization) which helps to identify best practices and establish uniform procedures among all crowd funding platforms.

The Sec 302(a) of the JOBS Act amends Sec 4 of the Securities Act 1933 to include exemption for crowd funding transaction as Sec 4(6). Sec 4(6) limits an issuer’s crowd funding offering to $1 million and restricts the total investment amount of investors based on a) their annual income and b) the net worth. Investors with an annual income or net worth of $100,000 or greater may invest 10% of their annual income, up to a maximum of $100,000. Crowd funding issuers, intermediaries and investors must comply with Sec 4 A of the Securities act 1933. Sec 4 A establishes the eligibility requirement for crowd funding issuers and places a one year restriction on the re-sale of crowd funding securities by investor unless it meets one of the exemptions. The introduction of the JOBS Act in the US is indicative of the US government and financial system’s progressive approach in understanding of the potential of the crowd funding phenomenon. In the present economic scenario where investors have become extremely risk averse and where the equity market investment is no longer attractive, it is difficult for the government to attract investments and draw out public money. Crowd funding is aimed to strengthen the SME sector by encouraging more entrepreneurs to come forth and put their

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business ideas in motion by helping them reduce the tedious paperwork and cost of promoting the business idea to gather investment. The fund portal will be a one stop shop where interested parties can come together and collaborate about the idea and resources. A successful project will help the economy in producing more jobs and thereby creating money in the economy. This will help the government to counter the issues of unemployment and recession.

We now look into the crowd funding scenario in the European Union in light of the comparative study published by the European Crowdfunding Network in association with Osborne Clarke, June 2013. The comparative study was conducted on four European countries with diverse economic conditions with the perspective of coming out with a collective scenario of the European crowd funding climate. At one end of the spectrum are Germany and the UK which are financially stable and the other end of the spectrum includes Italy and Spain which are in the grip of severe economic recession. It is important that while analyzing the European scenario, we keep in mind that the European Union was formed to integrate the economies of the European countries to make the region an economic superpower with the concept of European Single Market in mind.

There are basically three models of crowd funding that are actively operational in the European countries: a) The Equity Model, b) The Lending Model and c) The Rewards or Donation Model.

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9http://www.osborneclarke.de/~/media/Files/publications/de/sectors/financial-services/2013/regulation-of-crowdfunding.ashx,
a) The Equity Model: In this model of crowd funding the investors are the shareholders of the project and function as normal equity funding schemes. Each country in the European Union has different financial regulations in place for dealing with equity crowd funding and therefore different regulatory authorities in place for providing conformity and license for crowd funding operations. Most of these regulations are pertaining to the crowd funding portals or platforms. The point of contention here is whether to treat the platform as financial service providers or not. For example in Germany the portals are considered as brokers and hence providers of financial services and need to register and obtain a license from the German Financial Supervisory Authority that is ‘Bundesananstalt für Finanzdienstleistungsaufsicht’- BaFin whereas in Spain the crowd funding portals are not considered to be providing financial services and operate outside the purview of CNMV (Companies Act and the Securities Exchange Commission) or the Bank of Spain. Also the equity model is not viable for operation in Spain as compared to Germany or UK as funding via equity requires the formation of Sociedad Anonima (‘S.A’) a mandatory compliance under CNMV. The cumbersome process in the above case makes it incompatible with the ideology of the process of crowd funding. Instead of the equity model, Spain uses the Joint Accounts Model regulated by Spanish Commerce Code, articles 239 to 243. We therefore find differences in the equity model operations across the various countries and hence arises the problem of uniformity in regulations in equity crowd funding in the European Union.

b) The Lending Model: The lending model of crowd funding is not as varied as the equity model in the European Union though it does have some differences. Most of
the countries put it under the ambit of the debt market regulations. The question now arises that whether the country treats debt as an investment or not. Taking our earlier example of Germany and Spain we find that Germany does not treat the lending model of crowd funding as an investment but as subordinated loans and hence does not consider it to be a part of Alternative Investment Fund- ‘AIF’. Brokers of subordinated loans are required to obtain a license under German Trade, Commerce and Industry Regulation Act (Gewerbeordnung) and acquiring a license makes the crowd funding platforms using the lending model a financial entity. In contrast in Spain the lending model is based on loans between individuals and it is not considered to be a formal crowd funding platform. These portals come under the purview of Act 2/2009 which regulates consumer contracting loans or mortgage and brokerage services for executing the contracts of loan or credit. The portals using this model are merely required to register themselves with the local regional registry and are not required to obtain any license and thus are not considered to be a financial entity. Here again we are confronted by the fact that there are differences among the member states with regard to defining financial instruments and status of financial intermediaries making it difficult to apply a uniform regulation for crowd funding throughout the European Union.

c) **The Rewards or Donation Model:** This form of crowd funding is the only one which is uniformly treated as non-investment financial instrument and hence does not come under the ambit of the financial regulatory bodies or financial services regulations of the member states. There is no requirement of obtaining license to conduct operations by portals under this model.
The European Union has recently structured a financial regulation regime known as European Alternative Investment Fund Managers Directive¹⁰ - ‘AIFMD’ which must be implemented by all member states by 22 July, 2013¹¹. The aim of the regime is to establish a uniform regulation among member states to handle Alternative Investment Funds - ‘AIF’ managed by Alternative Investment Fund Managers. AIFs include financial products like hedge funds and private equity. The earlier lack of AIF regulations is thought to be one of the root causes of the current financial crisis and hence the European Union has come up with the AFMID regime to regulate AIFs among the member states. Though the intention of the European Union is to establish a uniform regulatory system, the internal financial regulatory bodies of the member states are at many instances in conflict with the directives of AFIMD. For example Germany already has extremely strict regulations for crowd funding as compared to the other member states and even after implementation of AFMID regulations (On May 16, 2013, the German Federal Parliament, ‘Bundestag’ passed the Act) the process of investment through crowd funding is very tough as there are additional regulations to adhere to. This will make crowd funding impossible in future unless it is exempted from the ambit of AIMFD regulations. This is against the idea behind crowd funding and an impediment in the path of the European Union’s effort to make crowd funding easily accessible to all member states.

**Conclusion:** In view of the above discussions we have been able to establish two perspectives of the crowd funding scenario: a) The Nationalist Approach and b) The Confederate Approach.

The Nationalist approach which is highlighted by the example of USA is the one working in self-interest of the nation. It concentrates on developing the economy by internal sourcing of funds by liberalizing the financial transactions within the boundaries of the nation. In contrast the European Union is a confederation where member states work to integrate their economy to achieve the idea of a ‘European Single Market’. This is where there is a possibility of conflict in interest among member states. We take into consideration our earlier example of Germany and Spain, which are on two extreme ends of the economic spectrum of the European Union. The important question that arises here is that why would Germany open its economy to member states that are undergoing economic crisis and thereby subject itself to the same crisis? The economically stronger nations will thus start acting in self-interest and impose more stringent regulations to restrict the outflow of money to the weaker economies where there is a greater chance of losing the entire investment amount. This is in complete contrast to the European Union’s aim and objective of formation. Thus the idea behind crowd funding aimed at transcending geographic and national boundaries seems to be a distant reality.
3. THE CROWD FUNDING BUBBLE: ISSUES AND CONCERNS

Crowdfunding is a phenomenon which has taken the financial world by storm. It is like a mutating giant expanding at an uncontrollable speed. It is high time that we take notice of the potential risks and concerns so that it does not end up in another global economic meltdown. In the following paragraphs we shall discuss the major issues and concerns related to crowdfunding and try to analyze and predict their possible future impact while coming out with a plausible solution.

**Fraud:** This is one of the most common concerns of the funders. The reason behind it is that there is no personal contact between the issuer and funder. There is no knowledge of the business idea beyond what is given on the website. Funders are unable to see the progress of the project on the first hand basis because of geographical separation. Moreover in projects based on the donation model there is no requirement of license and registration under regulatory bodies making them a more potential risk of duping people of money as compared to the equity or debt model because the latter two come under the purview of one or the other regulatory bodies of the relevant region. For example many a times we come across requests for donations on the social networking sites for a cause like helping victims of a disaster or for helping a poor kid get an expensive life-saving treatment. Out of the compassion of our hearts we donate money but never hear anything after the donation from the fund seekers that whether the endeavor was successful or not. It could very well have been a fraud. A recent example of such a fraud was uncovered in India in which a group of individuals posted requests for donations on social networking sites to help the Uttarakhand victims of flash floods of June 2013 in the Himalayas and collected huge sums of money before being caught. The case is under investigation as of now. The only way to avoid frauds is to verify the authenticity of the fund seeker. The onus of this task needs to be
taken up by the crowd funding platform for which it can charge a fee. Crowd funding should only be allowed through registered crowd funding platforms and any one operating outside this system for the purpose of crowd funding should be immediately flagged by cyber security agencies.

**Money Laundering:** Crowd funding can be an extremely easy platform for money laundering. In most cases when the project is small and not of business intention, for example collecting money to sponsor a music band’s cross country tour or social volunteering work the contributing amount is often very less and varied across various fund investors so as not to raise a flag on the online transactions and since there is no restriction on overfunding a project, the system can very easily be used to convert black money to white money. It is therefore important that the legal status of the fund seeker and funder should be very clear and authentic and should require proper registration on the crowd funding portal. This will bring about transparency in the online fund transactions and make it easy to track any suspicious transactions back to the source.

**Duplication of Business Ideas:** The need of the hour is to constitute an international body which is a consortium of all crowd funding platforms so that there can be common database which contains all the information required on the various projects being funded across the globe especially innovative business ideas. This will eliminate the problem of duplication of business ideas and help to concentrate the funding on a single idea rather than distribute the resources diversely on the same idea in ten different places and each of them ending up being underfinanced.

**Setting Valuations- Data Analysis and Risk Mitigation:** The most important issue while creating a business idea’s plan of action and implementation is estimating the finance required.
Here in comes the requirement of research tools and feasibility analysis. Here again the crowd funding platforms can play an important role for which again they can charge a fee. The crowd funding platform should be able to run a feasibility analysis and a market testing exercise to establish the viability and validity of the project it intends to advertise. Often entrepreneurs end up over estimating or underestimating the finances of the project due to which the projects are unable to take off. This problem can be resolved by having a group on experts on board at the funding portal who are able to draw proper financial projections thereby lowering the risk of under financing of the project. The portals can also help the entrepreneur by providing consultation services by its experts to make the project a success. The more the no of successful projects funded by the platform the higher is the credibility established of the portal. This in turn will bring in more business for the portal thereby increasing its revenue.

Thus we can say that the success of the crowd funding lies in the fact that how well regulated and credible the crowd funding portals are. The crowd funding portals need to come together and take an initiative to regulate the system and keep it clean. This in turn will help them generate revenue and enjoy the satisfaction of making someone’s dream come true.
4. CONCLUSION AND SUGGESTIONS:

In light of the above discussion it can be said that crowd funding is in a way the answer to counter the current economic slowdown but caution should be advised as the entire system is still not very well regulated or structured across the globe. The developed economies are already taking measures to make crowd funding popular to encourage more entrepreneurs to come up with business ideas contribute in pulling the nation out of economic crisis. We have seen that even though we talk of global economic integration, it is a distant reality when it comes to crowd funding. The reluctance of the nations in terms of outflow of national funds is evident. Hence when we say that crowd funding transcends national boundaries and helps individuals with similar ideas to come together and invest in the idea, it is a too hopeful future that we are counting on and a distant reality. Crowd funding if liberalized on a global platform without proper regulatory framework would be like a weapon of financial mass destruction. Nations must come together and recognize the potential risks associated with crowd funding. International regulatory bodies need to be framed and the key agencies in the entire process need to be identified Awareness and education needs to be spread about the concept of crowd funding so that it does not become a puppet in the hands of the few. We need to recognize and respect the emotional connect and the sense of accomplishment which is achieved when a dream comes true.