

THE ROLE OF CROWDFUNDING IN ENTREPRENEURIAL FINANCE

Devashis Mitra*

PURPOSE

THIS study seeks to examine the relatively new trend in alternative financing; namely, crowdfunding and its role in funding start ups and new enterprises. Crowdfunding is the financing of a project by a group of individuals (collectively, “the crowd”) instead of professional “accredited” entities or individuals such as banks, venture capitalists or business angels.

Design/Methodology/Approach: *The study examines how crowdfunding works. The concept of crowdfunding is also examined in the context of the related concept of crowdsourcing. The study examines the global market for crowdfunding and the rationale of businesses to crowdfund or crowdsource their new ventures, given the challenges of capital access for fledgling enterprises. The market for crowdfunding is examined in the context of different crowdfunding models. In this context, the study also includes illustrations of enterprises that have adopted specific models given their strategic objectives.*

Findings: *The study finds that crowdfunding as a means of alternative financing is growing globally. Donation and reward-based entities still remain the largest group. However, equity based platforms are also raising funds in some European countries and Australia. Presently, equity crowdfunding is not legal in Canada and is sought to being legalized in the U.S. under the JOBS Act.*

Research Limitations/Implications: *The study has a number of implications for future research, for instance, whether crowdfunding does indeed provide benefits of clustering? Also, future studies can examine different revenue sharing models in the context of equity crowdfunding models.*

Practical Implications: *Insights on data pertaining to different crowdfunding models, garnered from crowdsourcing.org, can be useful to potential entrepreneurs and policy makers.*

Originality/Value: *Presently very few published academic studies of crowdfunding exist. Also, to my knowledge, there are none that provide a discussion on crowdfunding in Canada.*

Key Words: *Crowdfunding, Alternative Financing, Entrepreneurship.*

An Introduction to Crowdfunding

Fledgling businesses and start-ups often face significant challenges in accessing capital from traditional sources such as bank loans, venture capital or angel funds. Paucity of capital access prompts entrepreneurs to seek alternative financing venues. This phenomenon has spurred the global growth of

* Associate Dean and Professor of Finance and Entrepreneurship, Faculty of Business Administration, University of New Brunswick, Fredericton, N.B., Canada.

crowdfunding. Crowdfunding can be defined as the financing of a project or a venture by a group of individuals (“the crowd”). Funds are typically raised on the internet through relatively small contributions from a large number of people (see also Bradford, 2012).

Crowdfunding Vs. Crowdsourcing

In this context, it would be interesting to examine a related concept, that of “crowdsourcing”.

According to Schweinbacher and Larraide (2011), crowdsourcing enables a firm to outsource specific tasks essential for the making or sale of its product to the general public (the crowd) with the aid of an open call over the internet. Consumers “volunteer” to contribute to production processes and create value. Crowdfunding: can be viewed as combining concepts of crowdsourcing (i.e. seeking financing from the crowd) and microfinance (small amounts contributed; no collateral).

Why Crowdsourcing and or Crowdfund?

What are some benefits of crowdsourcing? A major benefit is thought to be the voluntary task-force of consumers that often helps save costs. Also, to the extent that the crowd may provide more insights faster than a small team of employees, this can in effect reduce the length of new product development. Crowdsourcing can also be very beneficial from a marketing standpoint since involving a committed crowd is likely to result in better customer acceptance, and also more awareness of the “newness” of a product. The central idea is that “collective intelligence or wisdom” creates efficiency, more so for diverse crowds (Schweinbacher and Larraide, 2011). However, there are differing views on the extent to which a crowd provides such collective wisdom.

How does Crowdfunding Work

Griffin (2012) points out that, crowdfunding is like posting a classified advertisement on a website like Craigslist.com with the difference that, through crowdfunding sites, entrepreneur can also advertise a business concept and request for funding from “the crowd”. Entrepreneurs provide a pitch, usually a business plan, detailing the business activities and objectives, and the entrepreneur’s plans for using the funds that are sought to be raised. The platforms also inform funders what, if anything, he or she will receive in return for the capital contribution. This is typically done through a terms and condition sheet.

Crowdfunding therefore essentially involves a sequence of processes whereby the entrepreneur posts a funding request on the crowdfunding platform or website, describing a proposed project. Depending on the nature of the project the entrepreneur may or may not provide a business plan. The entrepreneur also indicates what, if anything, individuals who contribute money to finance the business will receive in return (Bradford, 2012, Schweinbacher and Larrade, 2011). “All crowdfunding transactions are facilitated through internet-based crowdfunding platforms which also provide a convenient means for all exchanges of funds” (Burtch et. al., 2012).”

Types of Crowdfunding

In this section, I examine various models of crowdfunding that have been adopted by different platforms. For an excellent detailed discussion of the different types of crowdfunding models, see Bradford (2012).

Donation Sites: Contributors donate funds mostly for charities and other non-profits and sometimes for-profits as well (Griffin, 2012; Bradford, 2012). These represent a small proportion of overall crowdfunding activity (about 22% in 2011, please also see crowdsourcing.org). Two examples of donation sites are: (a) GlobalGiving.org which enables donors to directly contribute to development projects worldwide (<http://www.globalgiving.org/>) and (b) EpicStep.com (<http://epicstep.com/>) which is a donation platform for financing billboards. One of EpicStep’s well known successful initiatives that received good publicity in the media is the WikiLeaks billboard campaign in Los Angeles.

Reward and Pre-Purchase Sites These sites typically do not involve direct revenue sharing arrangements through, for instance, payment of interest or profit-sharing from the business. However, depending on the amount of contribution, they could offer different categories of **rewards**. Rewards could range from notes of thank you to small tokens of appreciation, such as key chains, to having the contributor's name on the credits of movies that are sought to be financed through crowdfunding. An increasing number of movies are being financed in this manner, including a sizeable proportion that were screened at the recent Sundance Film Festival (Bradford, 2012, Griffin 2012).

Sites offering the **pre-purchase** option enable contributors to receive the product that the entrepreneur is making, often at a reduced price (Griffin 2012). For instance, if a music album is being sought to be financed through crowdfunding, through the pre-purchase option, contributors would have the right to buy the album at a reduced price upon completion. Leading Reward and Pre-purchase sites include Kickstarter (<http://www.kickstarter.com/>) and IndieGoGo (<http://www.indiegogo.com/>).

Business models of crowdfunding platforms are typically based on fees that are charged for each project that is sought to be funded. Often, crowdfunding sites charge fees only if financing is successful. If fundraising is unsuccessful, entrepreneurs pay no fee. An example of a site that charges fees in this manner is Kickstarter (<http://www.kickstarter.com/>). Fees can range from 4 to 9 percent.

Lending Crowdfunding Sites

There are two categories of lending sites; those not offering interest and those that do offer interest (see Bradford 2012). Perhaps the most prominent example of a crowdfunding portal site that does not offer interest is Kiva (<http://www.kiva.org/>). Kiva provides funds to microfinance lenders, or "field partners" in 66 different countries worldwide. Entrepreneurs post loan-requests on the Kiva site. Lenders only receive their principal back; the field partners use any interest received to cover their operating costs (Bradford 2012).

There are also a number of lending crowdfunding sites that offer interest. Two U.S. based examples of such sites are Prosper and Lending Club. These are also known as peer-to-peer platforms. Lenders purchase notes issued by the sites which use those funds to lend through WebBank or Paypal to borrowers. In this respect, they function more as investors than lenders. Lenders get paid if borrowers pay back. Transaction fees and interest on loans depend on the borrowers "credit risk". Loans that charge interest typically are viewed as "securities" and, therefore, for regulatory purposes fall within the domain of securities regulation (see Bradford 2012). As we will be seeing in a later section, the issuance of securities by crowdfunding sites is still in the process of being legalized in the U.S. In Canada, at present crowdfunding sites cannot legally issue securities.

Equity Crowdfunding Sites

These exist mostly in Europe and to some extent in Australia. Equity crowdfunding sites offer investors a share of the profits of the business they are funding. Such sites do not exist in Canada because of regulatory issues pertaining to the sale of securities. Indeed, at present, these sites exist mostly outside North America. A prominent German site that has been successful with the revenue-sharing model is SellABand.com (<https://www.sellaband.com/>). This site raises funding through donations as well as investments to fund independent musicians seeking to complete albums.

The State of Crowdfunding Globally

According to the website, *crowdsourcing.org* (<http://www.crowdsourcing.org/>), as of April 2012, 452 crowdfunding platforms (or CFPs) were operating globally. In aggregate, CFPs had raised almost \$ 1.5 billion in funds in 2011. By and large, while the United States remains the largest market for fundraising the European market has been growing rapidly. Funds raised through crowdfunding initiatives grew at

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a 63% compounded annual growth rate (CAGR) over the last 3 years. (<http://www.crowdsourcing.org/>).

As of 2012, most CFP's belong to the reward-based category of CFPs, although equity-based platforms represent the fastest-growing category in terms of net year-on-year growth (<http://www.crowdsourcing.org/>). At present, there are no equity-based platforms in Canada or the United States. Not surprisingly, therefore, reward-based and equity based platforms are higher in numbers in Europe than in North America.

Crowdfunding platforms have been very active and, in 2011, ran over 1 million successful campaigns. Although the majority of campaigns were still donation or rewards-based, equity-based campaigns were picking up and were, on average, much larger in size in terms of funds raised. Lending-based campaigns had the smallest share. For instance, on equity-based platforms, about 21% of funds raised were for projects of \$250,000 or more in funding of which 80% exceeded \$25,000 (for a detailed discussion see the most recent report at (<http://www.crowdsourcing.org/>)).

Given the relatively larger sums are raised through equity-based platforms, these could be viewed as a viable option for raising capital to fund small business and start-up initiatives. The campaigns in the donation and reward categories are generally smaller in size.

Crowdfunding Type and Nature of Projects

Are different funding models more suitable for certain types of activities or initiatives? In general, according to [crowdsourcing.org](http://www.crowdsourcing.org/) (<http://www.crowdsourcing.org/>), crowdfunding enterprises that provide for financial return through equity- and lending-based platforms appear to be best suited for digital applications or computer games, films, music, or literature. On the other hand, based on the statistics provided by the website, donation- and reward-based crowdfunding models appear to be best suited for cause-based campaigns that appeal to funders' personal beliefs and interests, for instance, the environment, community or faith-based initiatives, or those pertaining to the performing arts.

Challenges of Capital Access

Can crowdfunding play an useful role given the well-known challenges associated with capital access for small and fledgling enterprises? Since businesses face a scarcity of capital access, they often, have to resort to "bootstrapping"; that is, rely on personal funds or funds from friends and family members, credit card debt, or second mortgages on their homes. The "capital funding gap" can have a societal impact. For instance, scarcity of funding could result in promising projects going unfunded costing an economy jobs and loss of potential innovations (Bradford, 2012). Also, often those looking for funding opportunities do not have sufficient information about potential sources of capital. This results in a problem of informational inefficiency that is fostered by the failure to match sources of capital with opportunities. The creation of geographical clusters can often help mitigate such challenges (Bradford, 2012) challenge. Crowdfunding platforms, by enabling virtual clusters on the internet, can potentially provide powerful benefits in this regard.

Benefits and Costs of the Crowdfunding Exemption

An often cited benefit of crowdfunding enterprises is that these facilitate capital formation, especially for very small startups that would otherwise not have access to fund-raising opportunities through, for instance, funding provided by angels or venture capitalists.

Another cited benefit of crowdfunding is that it also enables less affluent entrepreneurs access to capital that they may not get even through "bootstrapping" (Griffin, 2012). A limitation of the crowdfunding model relative to venture capital or angel funding is that the latter also, often, provide valuable mentorship to investee enterprises.

Since a fundamental tenet of the crowdfunding model is to seek funding from the public, if such funding is sought through the issuance of securities, then registering such securities through the provincial

securities commissions in Canada or the Securities and Exchange Commission becomes a requirement. However, proponents of crowdfunding exemption feel that this is not a viable option because the securities registration process can be prohibitively expensive. One way of being exempt is to offer securities as “private placements” to accredited investors. However, the nature of crowdfunding prevents security issues to be classified as “private placements” to accredited investors. At present, therefore, there is a great deal of discussion and debate on whether the potential benefits of crowdfunding in terms of facilitating capital formation outweigh the costs that pertain largely to investor risks associated with business failure or fraud. A counter-argument, however, is that a securities exemption would not open investors to new risks because they are already contributing through “non-securities” crowdfunding. Under this perspective, issuing securities could offer higher returns to offset those risks (see Griffin, 2012).

The JOBS Act (2012) in the United States

Following an intense lobbying effort by different interest groups, the Jump-start our Business Startups (or JOBS) Act was passed in the United States in 2012. The enactment, in effect, legalizes, under Title III, debt and equity-based crowdfunding. Until the passage of this Act, investors could not publicly solicit funds from “unaccredited” investors. The legislation is still in its formative stages and the Securities and Exchange Commission in the United States is in the process of designing many of the rules.

Some salient aspects of this Act are provided below (CATA2012):

- (i) Companies can raise up to \$1 million from investors and up to \$2 million if they provide audited financial statements
- (ii) Financial statements disclosure is not needed for enterprises in which the number of shareholders is below 1000.
- (iii) Investors with annual income of less than \$100,000 may invest up to the greater of \$2,000 or 5% of their annual income in such enterprises. For income above \$100,000 per year, and investment is permitted up to 10% of total salary but should not exceed \$100,000.

The JOBS Act is not expected to be fully effective until 2013.

What about Canada?

Securities-based crowdfunding is still not legal in Canada. However, Canada does have crowdfunding platforms that use donation, reward or pre-purchase models. An example is FundWeaver (<http://www.fundweaver.com/en>) that is aimed at funding Native Canadian ventures and projects. Another example is Podium Ventures that uses social networks to connect new high-tech ventures with accredited investors. Some other crowdfunding platforms based in Canada include Sokap and IdeaVibes.

Conclusions

This study has attempted the relatively new trend in alternative financing; namely, crowdfunding and its role in funding start ups in new enterprises. Crowdfunding is the financing of a project by a group of individuals (collectively, “the crowd”) instead of professional “accredited” entities or individuals, such as, banks, venture capitalists, or business angels.

The study examines how crowdfunding works. It has endeavoured to trace the link between crowdfunding in the context of the related concept of crowdsourcing. The study examines the global market for crowdfunding and the rationale of businesses to crowdfund or crowdsource their new ventures, given the challenges of capital access for fledgling enterprises. The market for crowdfunding is examined in the context of different crowdfunding models. In this context, the study has listed enterprises that have adopted specific models given their strategic objectives. Presently, equity crowdfunding is not legal in Canada and is sought to be legalized in the U.S. under the JOBS Act. These issues have been discussed in the study.

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