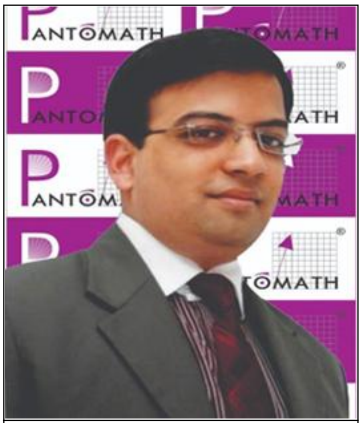
# Crowdfunding In Emerging Markets and Challenges



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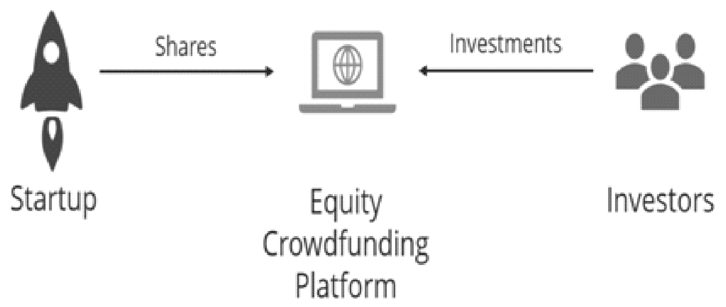
**Introduction**

Crowdfunding is a quicker new option for raising small funds. Let's try to understand what Crowd-funding is:

It basically is collection of funds from multiple investors via a web-based platform or social networking site. This source of funding is generally used by early stage start-ups. Well, it has been practiced in India since ancient times, mostly for cultural and religious causes called "Chanda" back then.

Crowdfunding is a new paradigm for young entrepreneurs to start a business.




**How does it work?**

A fundraiser typically involves three stakeholders - beneficiary, platform and donors. The beneficiary is the one who starts the campaign and needs the money. Many e-commerce websites running the crowdfunding platform host the campaign. The Donors are those who contribute to the cause through the platform.

**Modes of Crowdfunding**

| | |
|---|---|
| Donation Based | •Allows charities or those who raise money for social or charitable projects, to gather a community online and to enable them to donate to a specific project. |
| Leding Based | •Projects or businesses seeking debt apply through the platform uploading their pitch, with members of the crowd taking small chunks of overall loan. |
| Reward Based | •Enables people to contribute to projects and receove non-financial reward in return usually a tiered system where more you donate, the more reward you receive. |
| Equity Based | •Enables the crowd to invest for equity, or profit/revenue sharing in business or projects. This form of the model has been the slowest to grow due due to regulatory restrictions. |

**Benefits of Crowdfunding:**

Crowdfunding provides an alternate mode of financing for start-ups and the SME sector, and thereby allows an increased flow of credit in the real economy. After the Financial crisis in 2008 Banks have become increasingly constrained in their ability to lend money to ventures or start-ups which may have high-risk elements. Hence, there is a need for funding for SMEs through alternative sources. It is of little surprise that the Securities & Exchange Board of India (SEBI) has recognized the untapped potential in the Indian crowdfunding market. If regulated appropriately, crowdfunding can provide an excellent funding alternative for early-stage startups and ventures.

It is a good idea for an early-stage company to go for crowdfunding route, as it brings not only capital but also other benefits:


Source: Pinterest

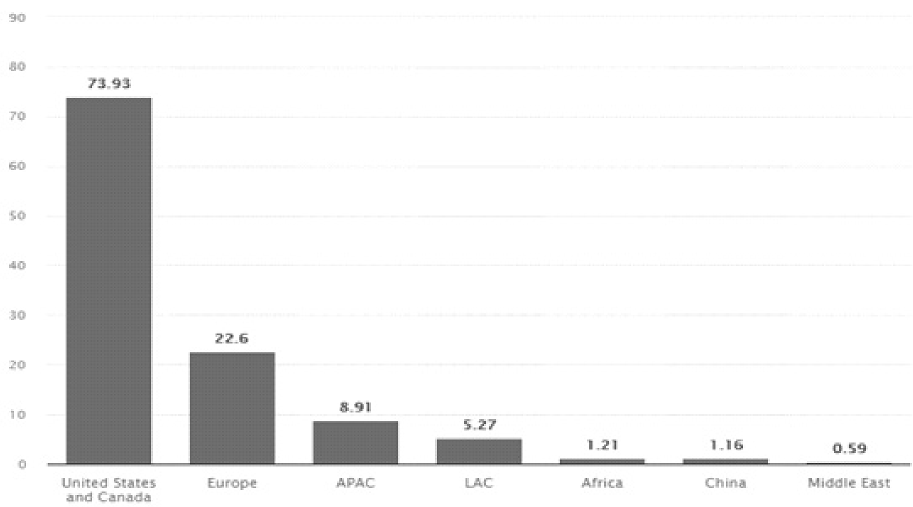
**Global perspective of Crowdfunding:**

The two countries currently dominating the world's crowdfunding market are the United States and the United Kingdom. China has historically been the leader in crowdfunding with over 70% share in global crowdfunding until 2018 but crowdfunding activities in China saw steep fall since then owing to stricter regulations. Without China, global crowdfunding has been increasing rapidly from US$ 44 Bn in 2015 to US$ 89 Bn in 2018 to US$ 115 Bn in 2020. Notably, lending-based crowdfunding forms over 90% of total crowdfunding market.

Owing to favorable regulatory policies, crowdfunding have seen massive growth in few countries. For e.g., In USA, Jobs Act which was passed in 2012 allowed entrepreneurs to raise capital from non-accredited investors via crowdfunding of upto $ 10,70,000. New Zealand treats equity crowdfunding as financial market service covered under the Financial Markets Conduct Act and is regulated by the Financial Markets Authority. In Australia, crowdfunding is governed by the Corporations Amendment (Crowd-sourced Funding) Act 2017. All these countries are regulating crowdfunding with various restrictions and regulatory & compliances requirements.

Many countries are still at nascent stage in crowdfunding with lack of acceptability & formal recognition. India currently forms less than 1% in overall crowdfunding globally.

**Volume of funds raised through crowdfunding worldwide in 2020 (US$ Billion)**




Source: Statista

**Crowdfunding in India:**

India is a developing country with an enormous economy. The capital formation power of crowdfunding is taking hold in this dynamic country. Donation-based crowdfunding and reward-based crowdfunding is very popular in India since ancient times. National Crowdfunding Association (NCFA) of India is an organization to promote crowdfunding in India. In light of a positive trend, in 2014, SEBI released a 'Consultation Paper on Crowdfunding in India'. There is no specific regulator for either donation crowdfunding or reward-based crowdfunding. However, it is important to note that general statutes such as the Income Tax Act, 1961, the Foreign Contribution (Regulation) Act, 2010 (FCRA), and the Foreign Exchange Management Act, 1999 (FEMA) would apply to all types of crowdfunding.

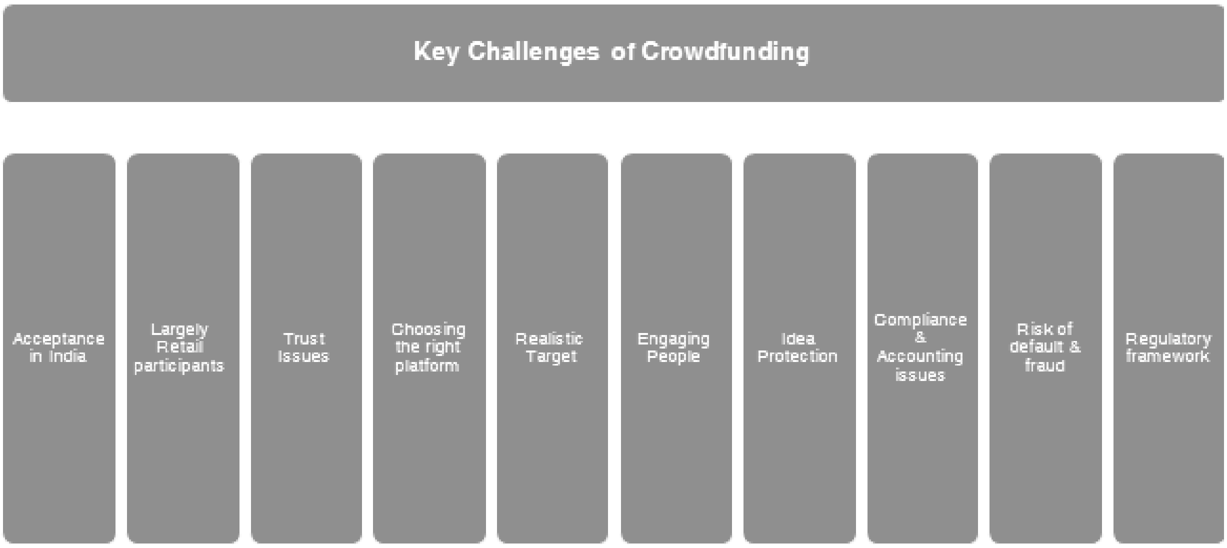
**SEBI Consultation Paper on Crowdfunding in India**

There have been enormous discussions on viability of Crowdfunding in India w.r.t legal, compliances, accounting, and risks perspective. Back in 2014, SEBI issued a consultation paper to bring forward few important issues which needs to be addressed or pondered upon before formalizing crowdfunding as a source of security-based funding for early stage companies.

| Topic | Point of Considerations |
|---|---|
| Who can be investor | Risks profile, understanding the pros and cons of crowdfunding investment, KYC |
| Investment limits | Limits based on number of investors, maximum permissible stake, minimum investment amount |
| Investment conditions | Risk acknowledgement document, Citizenship, Demat account holder, Relevant regulatory compliances |
| Who can raise funds | Limit of fund raise, nature of companies, diligence of issuing company/ directors/KMPs, Track record, Relevant regulatory compliances |
| Disclosure Requirement | One-time offer document, Basic details, Purpose of fund raise, Periodical updates, No information asymmetry |
| Who can set-up crowdfunding platform | Ensure integrity, experience & solvency requirements of key persons, robustness of platform, quality of investors/companies |
| Requirement of platform | Measures to reduce the risk of frauds, Adequacy of capital, human resources and technology, Transmit information to regulatory bodies, Conduct of due-diligence |
| Procedure for offering through platform | Formal and legalized process, filing & compliances, time period of offering |
| Secondary market transactions | Lock-in period for securities transfer, type of secondary buyer |
| Protection from cybercrimes | Repository of all the information and disclosures, Domain security, IT Audit |
| Tax Treatment | Relevant provisions under tax laws |

**Challenges of Crowdfunding**

While it is necessary to ensure that Start-ups/SMEs could raise funds at ease, it is equally important to ensure that no systemic risks are created wherein retail investors are lured by some unscrupulous players by substituting the existing framework, which has been developed over a period of time through experience and observation.




1. **Acceptance challenge in India**
   Though the concept of Crowdfunding is not new in India however, it is new at the country level. People in India are still not ready to invest money via an eCommerce platforms and the challenge of trust issues still exists due to the number of frauds. They're due to the lack of a regulatory body governing Crowdfunding this concept has not picked up at a faster pace in India.

2. **Retail investors at large**
   Presently, startups and SMEs are funded by Venture Capital Funds (VCFs) and Private Equity (PE) Investors whereas in crowdfunding these entities receive investments in smaller sums from a large number of investors. Hence, the risk-taking by VCF/PE (informed investors) is substituted with retail investors, whose risk tolerance level may be very low. Retail investors may not be able to understand the risk in these investments and will be unable to bear the loss of investments.

3. **Establishing Trust**
   Trust is probably the biggest issue when it comes to crowdfunding. A start-up applying for fund-raise is a new brand with less/no prior history. People know very little about these companies and hence resistance in funding the idea.

4. **Choosing the Right Platform**
   Due to the rise of crowdfunding, many businesses offer services to the business community and help manage campaigns on their portals however not all crowdfunding platforms are equal. On the surface, it might seem like they all offer the basic same service, but it is very important in selecting the right platform. There are several things to consider when choosing the right platform for you, including:
   - The popularity of the portal
   - Kind of campaigns being promoted by the portal
   - Footfalls on a daily and monthly basis portals can attract and the type of visitors
   - Cost for running the campaigns
   - Terms and conditions

5. **Realistic Target**
   Many companies focus on setting up the goal for raising money for crowdfunding, however one should first focus on setting up the right targets to create a brand image and excitement about the idea. If the right targets are not set then it can dissuade contributors or not gather enough attention to the campaign to meet goals.

6. **Engaging people**
   Engaging people is also a common fail point. The biggest mistake is, businesses create their campaign first and then try to generate interest. This is far too late and eats into the time to reach your set goal. Instead, one needs to build interest in the campaign a few months before the campaign starts. This can help boost larger goals.

7. **Protecting your Idea**
   In today's time protecting ideas has been a major issue. Once the idea is viral on social media and other sites it easily catches everyone's view. Some people might take advantage and can misuse the idea. Unless the idea is completely unique, never done before the idea, it can be difficult to claim sole ownership. The owner of the idea must take enough security for protecting the data and get copyright of the same.

8. **Managing Compliance and Accounting issue for reward funding**
   Crowdfunding involves a huge amount of uncertain money coming from different accounts of investors. Keeping a track record of the money received and the taxation angle of the same is to be considered.

9. **Risk of default and Fraud**
   There is no or less recourse to the investors against the issuer, in case of default or fraud. Funds are not directly solicited by the issuer and the issuer also does not come out with any offer document. Funds are solicited by the platform and such platform may or may not conduct proper due diligence of the issuer. If a platform is being temporarily shut down, or closed permanently, no recourse is available to the investors. As there being no governing body recovery of the money becomes difficult as the source is not traceable. Thus, there is a risk of misuse as well as cyber-security and/or identity theft.

10. **Regulatory framework for Crowdfunding in Various Jurisdictions**
    As of date, very few jurisdictions have come out with regulations for crowdfunding. Some jurisdictions are in the initial stages of introduction with concept papers for feedback of the industry. Two areas that have seen rapid growth in recent years are Peer-to-Peer lending and Equity Crowdfunding. Financial Reward (FR) crowd-funding globally has grown rapidly in the last 5 years. Collectively, US, UK, and China make up 96% of the overall FR crowdfunding market, with the USA accounting for 51%, China for 28% and UK for 17%.

**Indian Alternatives to Crowdfunding**

As SEBI is apprehensive to introduce crowdfunding in India, it has provided early-stage companies alternate routes to raise funds in a regulated manner with lesser compliances. In 2015, SEBI allowed early-stage companies to list on stock exchanges, for this purpose there have been relaxations in listing norms. Institutional Trading Platform was created by SEBI for this purpose which was later renamed as Innovators Growth Platform. Further, SME stock exchange is another platform by which small or mid-sized companies can raise funds via public issues.

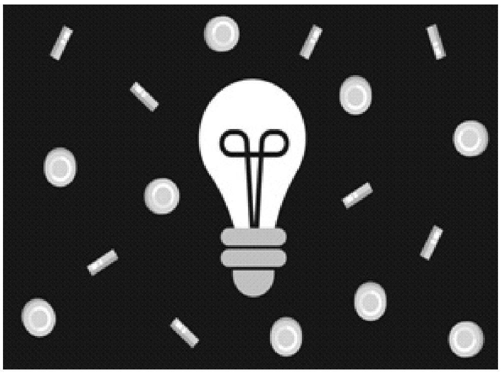
*Criteria for listing on Innovators Growth Platform*

(i) Companies should be intensive in use of technology, information technology, intellectual property, data analytics, bio-technology or nanotechnology.

(ii) At least 25% of the pre-issue capital of the Company should be held by qualified institutional buyers, family trust (net-worth more than Rs. 500 Cr.), regulated entities (Category III FPI etc.) or accredited investors.

**Conclusion**

Despite the evolution of VCs PE investors, it is not easy for an early-stage company to raise money. The Crowdfunding route entities would be able to solicit investment in smaller sums from a large number of investors. It provides new investment avenues and also provides new product portfolio diversification of investors. It seems to be the key to boosting the start-up ecosystem in India. The key factors for making a crowdfunding success are Idea should be clear, a compelling video, raise right amount funds as required, choosing the right platform, planning a proper marketing campaign, build a culture of trust. Foreign countries have already started implementing a crowdfunding regulatory framework.



In India, this concept has to be nurtured more with regulatory bodies focusing on it seriously so that a new industry grows fast.