# THE FINANCIAL CROWDFUNDING WITH DIVERSE BUSINESS MODELS

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**A B S T R A C T**

The Alternative Finance Industry of "Crowdfunding" is to collect relatively small contribution from large number of people in order to support the small and medium enterprises and startups. The financial market shows a significant growth in Asia volume grow by 320% to 3.4 billion. The financial model consist of Equity or Debt (peer to peer lending) based crowdfunding. The financial model basic feature of financial return on investment. The diversification in business model with the distinct approach of implement the financial model depend on their regulatory systems to encourage the crowd for invest in alternative financial industry and furthermore, these model ensure its financial return on high risk investment. The business model offered "Nominee and Non Nominee" structure in equity based crowdfunding where as in debt based crowdfunding business model are "Client Segregated Account, Fixed Loan, Notary and "Guaranteed" Return consist of (Offline Guaranteed Return or Automated Guaranteed Return)". The principle aim of article is to analyses the diverse business models in terms of its rational, benefits and drawbacks. Subsequently to find out whether these models are able to eliminate the risk of investment. In last part article summed up with appropriate conclusion and suggestion.

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## INTRODUCTION

The alternative finance industry come into force after 2008 crisis early stage finance problem faced by the artists, entrepreneur and start-ups because banks or financial institutions recognized as a traditional financial sources are unwilling to lend money or charge with an high interest rates. That give birth to the new financial market called as "Crowdfunding". The financial crisis (introduction of Basel III) norms and technological innovation is the two major factors for the growth of crowdfunding.

Currently crowdfunding market is \$16 billion in 2014, with 2015 to grow to over \$34 billion. Whereas venture capitalist the VC industry invests an average of \$30 billion each year. Within the ASEAN countries Malaysia is the 1$^{st}$ country to issue regulations on equity crowdfunding later on Securities and Exchange Commission of Thailand issue regulations on equity crowdfunding subsequently, Singapore also issued consultation paper on crowdfunding. There are some risk factors that still associated with the crowdfunding market. But companies are using differential approach apart from the regulation to eliminate the risk. These business models are widely famous in the United States (US) and United Kingdom (UK). Some of these business model are widely popular and are able to attract the investors at large. Currently, "crowdfunding" gain wide attraction across the Asia. The Asian crowdfunding volumes grew up by 320%, to \$3.4 billion raised. While as compare to the UK market only equity crowdfunding market doubled in size last year and is now worth over £50 million in 2015. The UK alternative finance market will grow to around £4.4 billion in 2015. Whereas overall financial market growth rate of 161% in 2014.

The concept of crowdfunding emerge as the global phenomena to achieve economic growth and creating alternative financial market to support SME and Start up. This article helps to understand the business models and their drawbacks from the UK, US and some other countries. The regulation pertaining to the crowdfunding markets are developing investors friendly approach whereas firms business models also working on a measures to attract investors by putting extra efforts to secure investors interest. But still there are some drawback with these business models. This article benefits the Asian investors may be in future investors have to deals with such business models. At appropriate places, this article also prefer to discuss cases, practices and experience from other countries.

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## CROWDFUNDING

### Defining "Crowdfunding"

As an alternative financial industry in order to support the small and medium scale enterprises and start up. Crowdfunding defined as a "an open call, essentially through the Internet, for the provision of financial resources either in form of donation or in exchange for some form of reward and/or voting rights in order to support initiatives for specific purposes." The process of crowdfunding explained in (*figure 1*) with all three major player of crowdfunding.

### Crowdfunding V. Crowdsourcing

The Internet based crowdfunding is a merger of two distinct antecedents called as crowdsourcing and microfinance. The 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, describes as a collective cooperation, attention, and trust by people who network and pool their money together, usually via the Internet, in order to support efforts initiated by other people or organizations.

### Three Main Player of Crowdfunding

#### *Creator*

The person who create or initiate the project in equity crowdfunding it will be referred as the issuer. The people or group entrepreneurs, artists, and others who initiate projects or ventures are labeled as "creators". Creator is the person who are able to raise capital and demonstrate demand through financial or non financial crowdfunding.

#### *Funder*

The Funders can be called as Crowdfunders or Investors. The people who invest their money in crowdfunding platforms support the ideas or innovations of creators projects they fund in a philanthropic way or on financial return or on pre purchase basis. The crowdfunders generally fund in smaller amounts than, say, angel investors, more investors are required to raise a given amount of capital.

#### *Platform*

Platform is a place where both funder or creator come together or it can be called an interfaces between founders and funders. Crowdfunding platforms are a novel place for fundraising activities, functioning as online intermediaries between entrepreneurs with ideas and the public with money and expertise. Platform is a place where both

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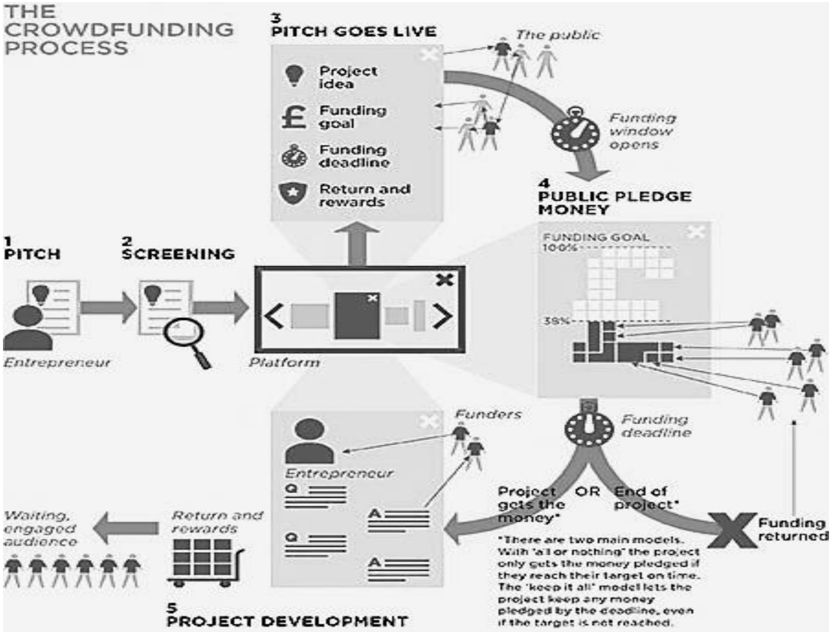
funder or creator come together or it can be called an interfaces between founders and funders.

**Figure 1** The process of crowdfunding.

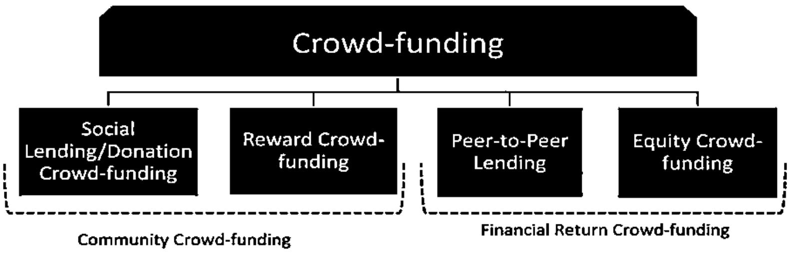


*Source:* SEC strategic and planning department

## CATEGORIES OF CROWDFUNDING

There are four main categories of crowdfunding: Equity crowdfunding, Debt or Peer to Peer lending based crowdfunding, Reward based crowdfunding and Donation based crowdfunding . In which two are financial model and others are non financial model as shown in (*figure 2*).

Figure 2: Financial and Non Financial Model.



*Source*: IOSCO Research Department

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### Financial model

Financial model define in terms of financial return on investment includes Equity crowdfunding and Debt based crowdfunding.

***a.*** ***Equity crowdfunding*** sites offers a share of the profits of the business they are funding and funders receive equity instruments or profit sharing arrangements.

***b.*** ***Debt or Peer to Peer Lending*** based crowdfunding can be defined as the use of an online platform that matches lenders/investors with borrowers/issuers in order to provide unsecured loans.

### Non Financial model

Non financial model are define in terms of return are only rewards or other benefit that includes Reward based crowdfunding and Donation based crowdfunding.

***a.*** ***Reward based crowdfunding*** is the “pre-selling” of products to early customers is a common feature of those crowdfunding projects. The platforms facilitate a hybrid approach and allow creators may be able to lower their cost of capital by “selling” goods that are otherwise difficult to trade in traditional markets for early-stage capital.

***b.*** ***Donation based crowdfunding*** contributions on donation sites are, as the name would indicate, donations. Investors receive nothing in return for their contribution, not even the eventual return of the amount they contributed. However, although the contributor's motive is charitable, the recipient's need not be donations can fund for-profit enterprises.

## FINANCIAL BUSINESS MODELS

There is the different sets of business models that platforms or firms are implementing as a tool to attract the investors interest by showcasing the investor protection with there business models.

### Equity crowdfunding business models

The platform offer equity crowdfunding are more flexible to update its operations and adapt its marketing and design quickly to an evolving business model there are few platforms have offered their

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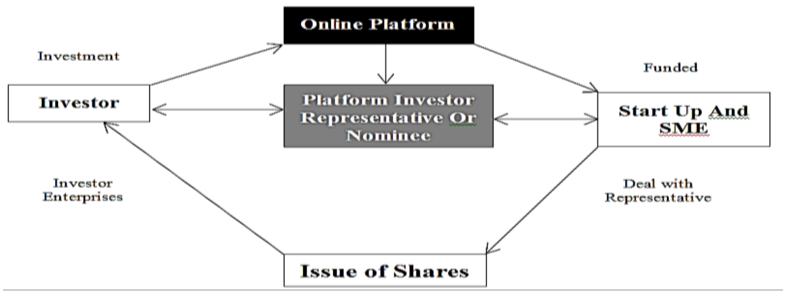
services internationally. Under the equity crowdfunding there are two famous business model called as *Nominee structure* or *Non Nominee model*. There are very few equity crowdfunding platforms due to the strict regulatory requirements that are in place to regulate public equity offerings. By law, most platforms can offer this type capital raising to sophisticated investors only under defined jurisdiction or to a limited number of individual investors for example, in China an equity raising made to less than 200 individuals does not need to fulfill the public equity raising requirements as set out by the China Securities Regulatory Commission and in Singapore also there is a cap of 150 investors (but that by passed by using nominee model) under the Thai and Malaysian regulations there are no such cap on the investors. The Types of Investors are defined by the regulatory authorities of but most of the investors are classified as a retail investors which also includes individual investors.

### A. Nominee structure model

Under this model nominee company collects a funds and issue shares in itself to the investors and that nominee company then invests in the company seeking finance, which in turn issue shares to the nominee. That platform is the legal shareholder in the relevant company's shareholder register, but platform hold those shares on behalf of the various individuals who had invested in the company through that particular platform. The effect of this structure is that while platform holds the shares, the full economic interest including the benefits or individual tax reliefs are passed through to the underlying investors. This arrangement is very similar to a trustee relationship, as well as to the structures used by stockbrokers and other types of intermediary platform. This model is basically called as the Seedrs nominee structure model of investment explain in (*Flow Chart 1*).

Flow chart 1:




*Source*: Replica of Seedrs Nominee model

Investors invest money in any company though seedrs online platform. The platform collect all funds together of those investors who like invest in that particular company. The platform investor representative turned out to be the nominee of all investors. This representative act like an single investor or face for other investors.

*Advantage for the investors* in administrative efficiency, Nominee takes decisions for the investors, Rights of the crowd consolidated in the hands of the nominee, giving the crowd more bargaining power.

*Disadvantage for investors* with nominee structure like Loss of unfair prejudice protection at company level (as the investors are not legal owners of the shares), Not a party to the shareholders' agreement (at company level) and Nominee will be able to take certain decisions on behalf of the crowd by way of majority decision (but the investor may be in the minority).

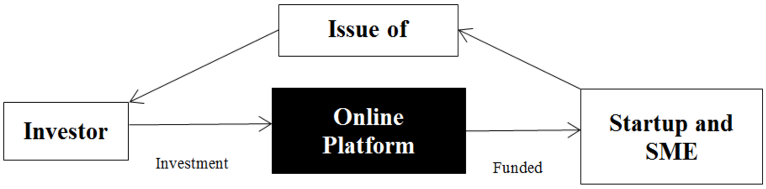
*Advantages for company* are single name (the nominee) on the cap table, The nominee should able to make decisions more quickly than the crowd, Arguably more attractive to a VC, and nominee take care of much investment paperwork.

*Disadvantages for company* is right of the crowd consolidated in the hands of the nominee, giving the crowd more bargaining power.

**B. Non nominee structure model**

It can be called as a “Non Nominee Structure” or “Direct Shareholder Structure” where the each investor becomes a legal individual shareholder of whatever business they choose to back. All but the largest investors receive *“Class B”* shares. This model also allows the fundraisers to tap in to valuable feedback and ideas from the crowd as they have direct communication with their shareholders. Its an crowdcube model they argue that it gives individual investors a greater sense of autonomy and ownership, without any kind of middleman or intermediary as explained in flow chart 2.

Flow chart 2. Non nominee structure




*Source*: Replica of non nominee model

*Advantage for company* is the (limited) rights of the crowd are not consolidated in hands of a nominee. Company is able to use the corporate opportunities for self dealing.

*Disadvantages for company* like potentially hundreds of shareholders are on the cap table and sign the shareholders' agreement and secondly, Company deals with most of the paperwork (rather than the nominee). The downside is that they have to deal with hundreds or even thousands of investors in some cases and this is not a simple task for any small to medium sized enterprise.

*Advantage for investors* is each investor is a shareholder in the company (with very limited minority (unfair prejudice) protections) and each investor is a party to the shareholders' agreement (if there is one). It gives individual investors a greater sense of autonomy and ownership, without any kind of middleman or intermediary and their associated fee.

*Disadvantages for investors* like Shares may be non-voting and may lack adequate (or any) anti-dilution protection. This essentially means that they have no voting rates when it comes to big company decisions because of the minority shareholder.

**Market Growth of Equity crowdfunding**

In UK the average growth rate of equity crowdfunding is 410%. Equity based crowdfunding grew by 201% in 2014, the fastest growing models up by 295% to £332 million raised in 2015. Equity–based crowdfunding, whereby investors can diversify their portfolio and invest in both early stage (e.g. pre seed, seed and start up) ventures as well as growth–stage companies, continues its rapid expansion with a 201 per cent year on year growth rate and facilitated £84 million in predicted total transaction volume for 2014. As per the Research Firm Massolution Growth rate in equity-based crowdfunding grew 182% to $1.1 billion in 2014. Almost 95 percent of the funded UK equity–based

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crowdfunding deals were eligible either for the EIS (Enterprise Investment Scheme) or the SEIS (Seed Enterprise Investment Scheme) schemes. Almost 62% of Investors are retail investors with no previous experience of early stage/venture capital investment.

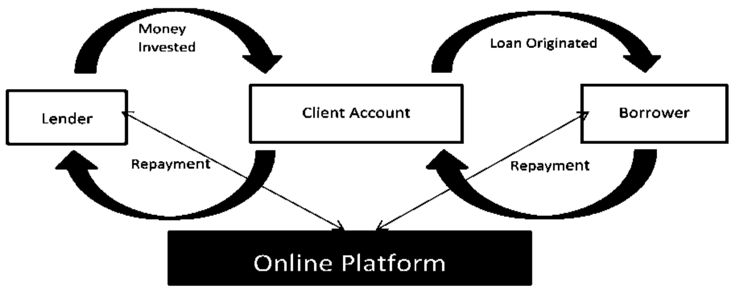
**Debt Based Crowdfunding Models**

Is another model of financial return in crowdfunding category it can also be classified as a lending based crowdfunding or debt based crowdfunding. There are some other forms like, Peer to Peer "Business Lending" and Peer to Peer "Consumer Lending". Peer to Peer "Business lending" is a debt–based transactions between individuals and existing businesses which are mostly Small and Medium Enterprises(SMEs) with many individual lenders contributing to any one loan whereas, Peer-to-peer "Consumer Lending" is an individuals using an online platform to borrow from a number of individual lenders each lending a small amount; most are unsecured personal loans. Peer-to-peer lending websites data on the size of the overall industry is sparse, peer-to-peer lending was estimated to have reached approximately $647 million in 2009 and was expected to grow to $5.8 billion by 2010.

**A. Client segregated account model**

This is an individual lender is matched to an individual borrower through an intermediary platform, and a contract is set up between the individuals with little participation by the intermediary platform. As shown in (*flow chart 3*).

Flow chart 3: Client segregated account model




*Source*: IOSCO Research Department

All funds from lenders and borrowers are separated from the platform balance sheet and go through a legally segregated client account, over which the platform has no claim on the event of the platform collapse. The platform use these fund to match borrowers with lenders, allowing the lenders some choice as to whom they finance or with bidding option. The platform then handles the administration of the loan and repayments. As it is a trust, it is legally distanced from the platform itself thereby preventing loss to the investors if the platform were to fail. An example of this business model would be Afluenta, based in Argentina.

*Advantage for investors* there is no middle man direct benefit or profit to investors. Investor able to get refund even if platform fail. That's help the investors in terms of protection that he can deal directly with the borrower on event of failure.

*Disadvantage for investors* On the event of default lender have go through the traditional process of law. Auctions tie up with the investors funds because auctions typically last 7 or 14 days. During this time your money is not earning any interest and your bid may be knocked out by a lower rate. This means that investors may bid multiple times during an auction, with no guarantee their bid will be successful. Confusing and complex to understand auctions can be confusing and unattractive, especially for new investors. Unattractive to borrowers many business owners are put off by the lack of certainty around the cost of their loan.

### B. Fixed interest lending model

Under this model loans will be issued with an interest rate assigned by a risk band and loan term. Sensible states its long-term object is to pre-approve loans even before they hit the screen. There is no option of variation in interest rates on particular loan because interest rate is decided on basis on creditworthiness and the term of loan. The platform also determine the grade level for borrower on the basis of creditworthiness as shown in (*figure 2*).

Figure 2: Grade level for borrowers

| Term | A+ | A | B | C | D | E |
|---|---|---|---|---|---|---|
| 6-12 months | 6.0% | 9.0% | 10.0% | 11.3% | 13.5% | 17.4% |
| 24-36 months | 8.0% | 9.2% | 10.2% | 11.6% | 13.8% | 17.7% |
| 48-60 months | 8.3% | 9.5% | 10.6% | 11.9% | 14.1% | 18.1% |
| Funding Circle average rate[1] | 8.6% | 9.7% | 10.7% | 12.2% | 13.4% | 18.3% |

*Source*: Funding circle fixed interest rate model.

This particular model introduce by the Funding circle in September 2015. The similar fixed interest model is adopted by Sensible Lender on February 2016, a UK peer to peer lending platform, has made the jump from auctioned interest rates to fixed rates set by the online lender.

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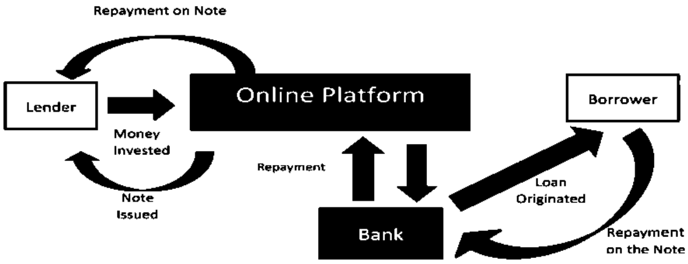
*Advantage for investors* the lenders will be presented with fixed interest rates based on borrower risk and can choose which companies to invest in on a first-come, first-serve basis. Its simple and easy to understand, the creditworthiness is the deciding factors for rate of interest or if borrower interested to reduce the interest rate he has to maintain the creditworthiness for a long time.

*Disadvantage for investors* the interest rate is based according to the risk of the loan, rather than the availability of investor funds. The Rates will be set according to the risk band and the length of the business loan. There are still missing guidelines on what basis the risk of the loan is determine whether it was on the credit history or the risk about the project. If it was the credit history of the borrower so the risk can be determine but if the risk about the project. So what the factors or the basis of determining the risk about the project is still unclear and excessive platform interference.

### C. Notary model

Under this model platform acts as an intermediary between the lender and the borrower, matching them to each other. The lender then bids on the loans they want in their portfolio once the amount of money required is reached the loan is originated. However, instead of originating the loan themselves, a bank originates the loan. The platform then issues a note (the name "notary" stems from the issuance of notes instead of contracts) to the lender for the value of their contribution to the loan. This note is considered as a security in many jurisdictions. The investor has made an investment in a note, not an actual loan, and hopes that the borrower will repay so that the note will be paid by the platform. This model is popular in the US, particularly with platforms such as Prosper and Lending Club as shown in (*flow chart 4*).

Flow chart 4: Notary Model




*Source*: IOSCO Research Department

*Advantage for investors* shifts the risk of loan non-payment to the lenders themselves and away from the bank originating the loan, Investor are able to invest in big projects or able to project finance.

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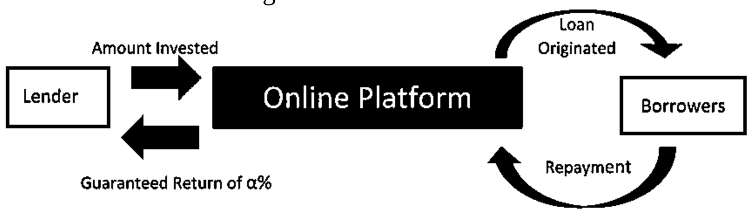
*Disadvantage for investors* Investors do not make loans directly to borrowers, excessive power is in the hands of banks or platform (middle man), Lender have to rely on the platform about the credit ratings of the borrower, lenders don't have the ability to determine interest rates instead, the site sets an interest rate based on borrower performance, On the event of default lender have to wait up till the platform or the bank start proceedings.

### D. "Guaranteed" return model

Under this model allows lenders to invest in peer-to-peer loans through the intermediary platform at a set rate of return on the investment guaranteed by the intermediary platform but there are two other models called as a Offline Guaranteed Return Model or Automated Guaranteed Return Model as shown in (*flow chart 5*).

Flow chart 5: Automated guarantee return model




*Source*: IOSCO Research Department

Under Offline mode the use of direct channels and through face to face sales techniques in the locality of the borrowers. The borrower is then manually assessed for creditworthiness. After this, the loan is listed on the online platform and lenders can choose to invest in the loan. This is the most popular model in China, and is the main model used by CreditEase. Under Automated Guaranteed Return Model, with the TrustBuddy International AB. The lender pays into a client account the amount they wish to invest overall. The platform then automatically lends this money to borrowers it has chosen through a metric created by the platform itself.

*Advantage for investors* Under this model there is a low risk on investment, fixed return on investment interest on particular, offline model manual assessed for credit worthiness of the borrowers or direct in touch with borrowers and no concept of middle men in investment.

*Disadvantage for investors* Investors have to rely on platform assessment about the creditworthiness of the borrower that create significant doubt whether the platform assessment is done with certain standard. What if the platform failed like Trustbuddy international.

Trustbuddy international filed for the bankruptcy there is the suspected misconduct that compelled the platform to shut down operations charges. The cause of failure are misconduct, lack of liquidity and inability to operate a regulated operation, TrustBuddy cannot move forward with the business.

## MARKET GROWTH OF DEBT BASED CROWDFUNDING

The surging alternative finance market in Europe has reached nearly €3 billion ($3.9 billion) in 2014, a jump of 144%, and small-business peer-to-peer loan volume in France alone grew almost 4,000% last year, to reach €8.2 million ($10.6 million), crowdfunding in Europe is becoming a major factor in the finance sector as shown in figure 3.

Figure 3: Growth of peer to peer lending from 2010 to 2015.


*Source*: Last Quarter Peer to Peer FA Data.

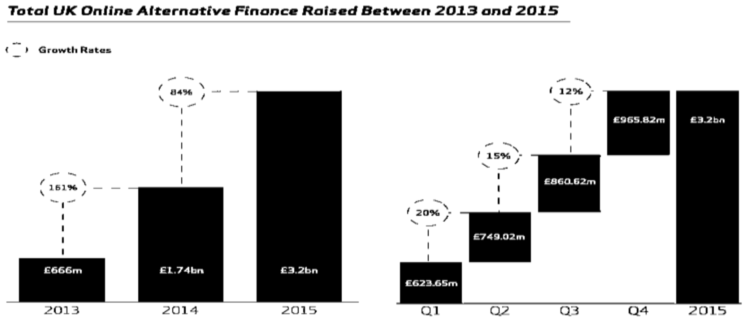
The growth of the peer to peer lending is expected to grow to $150 billion by 2025, according to accounting firm PwC.

## ALTERNATIVE FINANCIAL MARKET GROWTH

The UK alternative finance grows by 84% to £3.2 Billion in 2015. Online alternative finance grew 84% to £3.2 billion from £1.74 billion in 2014 as shown in (figure 4). The SMEs were the biggest beneficiaries as approximately 20,000 raised about £2.2 billion on digital platforms during the year. The total alternative lending hit £1.82 billion or 3.43% of gross national bank's lending to SMEs. The lending still continues as the largest sector by volume. Equity crowdfunding continues to grow rapidly jumping 295% to £332 million from only £84 million in 2015. This segment of crowdfunding now represents 15% of all UK seed and venture funding. The hottest sector is the Real estate. The combination of debt and equity drove this category to £700 million in 2015. The

Institutional investors are playing a larger role in alternative finance with 32% of consumer lending and 26% of business lending being driven by big money.

Figure 4: Raise of Alternative finance in UK.




*Source*: Report by crowdinsider

In the UK peer to peer lending growth rate in business lending average growth in 2012 -14 is around 210% the major business sectors includes Manufacturing, Professional and Business Services, Retail and Construction. In business model the investor range of £1000 - £3000 comprises maximum 30% of the investment and minimum range of investment amount is below £500. In consumer lending average growth rate in 2012- 14 around 108% includes Car/Vehicle purchase, Home improvement, Debt consolidation (e.g. paying off credit cards overdrafts). In consumer lending the investors range of £5000 - £20000 comprises maximum 31% of the investment amount and minimum range of investment is below £100.

## CONCLUSION

The alternative financial system is alternate to the traditional financial model like banks, financial institution etc. The growth of the alternative finance market depend on the investors friendly and protective approach. There are certain issues with regard to these market is still unresolved. The private entrepreneurs or online portals business models are try to establish business model that able to create more investors friendly approach. The Financial return business models under equity or debt based crowdfunding facing both advantage and disadvantage. The crowdfunding is under the developing phase its premature to conclude which business model is best model for the crowdfunding industry. There issues of credit rating because the credit rating is the deciding factors for the investors to invest in particular industry. Its important to maintain certain measures and guideline for the platform to define credit rating for the borrower. Secondly crowdfunding is on the concept of

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free market the interference of the platform operator in managing the funds for the investors but restricting the interference of the platform operator further imposed duty on the investors to do due diligence with regard to the project and must aware of the fact that investment may get failed.

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