Managing Risk in Business Centric Crowdfunding Platforms

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Abstract

Crowdfunding is a rapidly growing phenomenon and is becoming a viable alternative to traditional financial institutions for small business fund seekers. Crowdfunding involves harnessing small individual investments from a large number of investors. This paper explores four key risks associated with crowdfunding: Money Laundering, IP Theft, Fraud, and "Failure by Success." The paper then outlines key research questions for the next stage of the research, which will empirically investigate how crowdfunding platforms self-govern against these risks.

Author Keywords

Crowdfunding; Risk; Regulation; Self-Governance.

ACM Classification Keywords

Reliability; Management.

Introduction

This paper defines crowdfunding as "… an open call, mostly through the Internet, for the provision of financial resources either in the form of donation or in exchange for the future product or some form of reward to support initiatives for specific purposes."[2] Prior research has argued that there are four different types of crowdfunding available to fund seekers, namely, debt-based crowdfunding, equity-based

Crowdfunding Types

- **Debt-based crowdfunding**. Direct peer-to-peer lending between two parties.
- **Equity-based crowdfunding**. Crowd investment in a company in exchange for a percentage stake in the company (or product line).
- **Rewards-based crowdfunding.** Funding a project (usually a product) for a reward related to the project (e.g. pre-sales or perks).
- **Charity-based crowdfunding.** Donating money to charity using a crowdfunding platform.

crowdfunding, rewards-based crowdfunding, and charity-based crowdfunding [6]. Although crowdfunding is a relatively new phenomenon it is already having a major impact in the financing world [7] [11].

This paper focuses on equity-based, lending-based and rewards-based crowdfunding as these are the types of crowdfunding commonly associated with business fundraising. Charity-based crowdfunding cannot be used for business fundraising. Crowdfunding for business represents a disruptor in the financial world. Indeed, traditional sources of finance may see crowdfunding as a threat [8]. Peer-to-peer lending platforms have been seen to offer the fund seeker lower cost capital than the traditional sources of finance and offered good returns to investors [7]. Fund seekers can also retain more control of their business by crowdfunding rather than using traditional financing methods [5].

Where there is risk, there is a need to protect those who are at risk through both internal and external governance mechanisms. Internal mechanisms come from the individual crowdfunding platforms and external mechanisms come from the community.

The remainder of this paper is structured as follows. First, each of the four types of crowdfunding that were identified in prior research are explained. Next, crowdfunding is examined as a disruptor to traditional financial service institutions. Next, the risks associated with crowdfunding are theorized. The paper then discusses how such risks are regulated in the traditional financial services sector. The paper concludes with a research agenda and research questions for the next phase of the work.

Crowdfunding and how it disrupts

The four types of crowdfunding are briefly described in the side bar. Traditionally if a fund seeker was seeking finance, they would have to go to the traditional sources of finance. Crowdfunding has changed this and given fund seeking entrepreneurs a new way of accessing finance. The following is how the different types of crowdfunding disrupt the traditional sources of finance.

Debt-based crowdfunding

While larger banks are not really effected by P2P lending, smaller banks and credit unions may be priced out of the market by crowdfunding firms with lower interest rates. For example, Prosper.com offer return rates between 5.5% and 10.7% to investors whereas most retail banks (in 2017) offer on average 1.5% on a deposit account. For the fund seeker, LendingClub for example can offer rates as low as 6%, whereas bank based business loans can cost up to 9% (AIB (Ireland) in 2017).

Equity-based crowdfunding

Traditional venture capitalists and business angels may be overlooked as fund seekers go straight to the crowd in the hope of giving up a smaller proportion of their business. For the investor, it means that they have the chance to own a piece of a new and upcoming company with the hope of it being sold on in the future for a large return on investment [10]. For the fund seeker, equity will allow them to get the same amount of investment but by giving away less of their business that they would be forced into if they were to go to the traditional sources of finance.

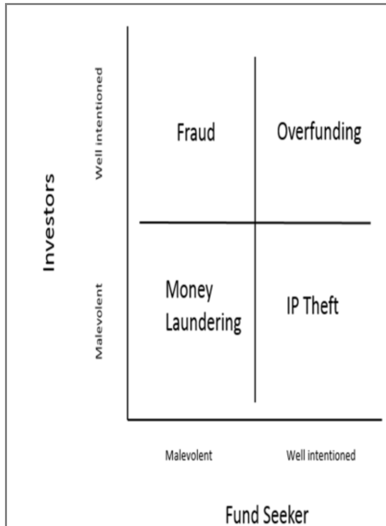

Figure 1: Risks that can occur in crowdfunding platforms.

Rewards-based crowdfunding

Rewards crowdfunding allow seekers to look for investment in their company by creating new relationships with the market. Rewards may be in the form of pre-sales, merchandising or exclusive product variants [1]. Again fund seekers hold full control of the business.

Charity-based crowdfunding

Charity-based crowdfunding does not push anyone out of the market, but actually improves the charity's catchment area. As such, crowdfunding makes the charity market broader and more inclusive. This also introduces new risk as charitable givers may have trouble judging the legitimacy of remote charities [12].

Crowdfunding Risk

This study argues that in any crowdfunding platform there are both well-intentioned and ill-intentioned fund seekers and investors, and that four types of risk emerge from their interactions. Figure 1 summarizes these interactions and the resulting risks. When different combinations of these users come together there are different types of risk that can occur.

Fraud

The combination of an investor with good intentions and an ill-intentioned fund seeker can have a number of outcomes. One of the main fears is that the project is simply a scam where the entrepreneur tries to profit from well-intentioned investors.

IP Theft

From the fund seeker's perspective, Intellectual Property (IP) is critical to the endeavor and must be managed correctly. When a well-intentioned entrepreneur and the ill-intentioned investors clash in the crowdfunding space, the risk of IP theft or abuse increases.

Money Laundering

When there is an ill-intentioned investor and there is an ill-intentioned fund seeker, the risk that can occur here is money laundering. Ill-intentioned users could use the site as a cover to move illegally acquired money.

"Failure by Success"

When the combination of well-intentioned investors and well-intentioned entrepreneurs comes together, this may lead to a very successful project, but can also lead to the phenomenon we are terming "failure by success". Prior research highlights the possibility of a project being too successful, leading to stretch goals and strategic deviations resulting in delays or failure to deliver [9].

Governance

In the traditional sources of finance, such as banks and credit unions, all of the above risks are protected against. To prevent against fraud, mechanisms such as 'Know Your Customer' (KYC) checks and raising awareness of fraud help to combat it. For IP theft there is non-disclosure agreements between both parties as well as privileged communication. In the case of money laundering, the mechanism of KYC is also employed, along with this the traditional sources of finance use 'Suspicious Transaction Reports' (STRs). There is no real mechanisms in place against failure by success, we argue that this risk is unique to crowdfunding.

In traditional financial institutions regulatory and legislative systems seek to protect parties from these

risks, however when it comes to crowdfunding, there is not much specific regulation and the general regulation that exists is not always sufficient [3]. Indeed, as crowdfunding is an emerging phenomenon, it lacks well defined regulatory and legislative safety nets [4].

Conclusion

We conclude with four research questions that guide the next stage of our work, an empirical study of self-governance mechanisms in crowdfunding:

- How does a crowdfunding platform self-govern to protect the platform provider, fund seekers, and investors from fraudulent behavior?
- How does a crowdfunding platform self-govern to protect the platform provider and fund seekers from IP theft?
- How does a crowdfunding platform self-govern to protect the platform provider from the risk of money laundering?
- How does a crowdfunding platform self-govern to protect the fund seekers and investors from "failure by success"?

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