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Crowdfunding Platforms: Ecosystem and Evolution

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Crowdfunding Platforms: Ecosystem and Evolution

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ABSTRACT

Crowdfunding is the practice of seeking support from a large number of backers, each funding a small amount, in order to reach a specific funding goal. This monograph examines: (1) the field of crowdfunding, (2) how it has evolved, (3) the impact crowdfunding has on the fields of innovation, marketing and finance and (4) the factors that can affect crowdfunding outcomes.

We view crowdfunding as complementary and transformative, increasing the efficiency of several existing processes such as idea generation and testing, fund raising and collection. We combine practitioner perspectives and research findings to provide insights on this subject. We explore the crowdfunding ecosystem and the role that project creators, backers and the platform play in the entire crowdfunding process.

We provide a comprehensive review of current academic research in crowdfunding that focus on three key components of the crowdfunding process: (1) project design and description, (2) project creator and backer characteristics and (3) platform design and architecture, and explore how different properties of these crowdfunding components impact the crowdfunding process and affect crowdfunding outcomes.

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We further provide an overview of new developments in crowdfunding (such as new crowdfunding models) and suggest trends (such as privacy issues) that may shape the crowdfunding ecosystem in the future.

Preface

Crowdfunding has become an important aspect of society today. It has been said to have supplanted traditional financial institutions and has given new life to ventures. The intent of this monograph is to allow you to understand crowdfunding in its current context, how it is affecting society, how it functions and factors that can impact successful interactions between the crowdfunding project creator and the people who fund these projects.

In Section 1, we will detail how crowdfunding first came about and how it has evolved over time. We will discuss the key participants of crowdfunding and how crowdfunding as a concept has grown and changed since its inception.

In Section 2, we move on to discuss an important question that the crowdfunding industry has been asking – whether crowdfunding is disruptive to traditional financial institutions or does it transform the entire financial intermediary field. We delve into the ways that crowdfunding could be seen as disruptive, the additional roles they take on that caters to overlooked segments of the market and examine how crowdfunding may have transformed financial mechanisms.

As crowdfunding is a broad term used to describe multiple models of crowdfunding, we present the four common models of crowdfunding – donation, reward, equity and loans. As each crowdfunding model is used for different purposes, there are important distinguishing factors that need to be taken into account when addressing these different types of crowdfunding. We discuss this in Section 3.

Once you have a grasp on crowdfunding, its evolution, place in society as well as the different forms of crowdfunding, we turn to factors that can affect crowdfunding. There are three main players in the crowdfunding process – the project creator, the backer and the platform. The space where these players interact is on the crowdfunding project page created by the project creator on the platform which will be accessed by the potential backer. As such, factors that can affect crowdfunding can be categorized under three main classes: (1) factors that are specific to the crowdfunding users, namely the project creators and backers, (2) factors found within the crowdfunding campaign page itself, and (3) factors built into the platform design and policies. We use Sections 4, 5 and 6 respectively to explore how some of these factors have an impact on crowdfunding outcomes.

Finally, we end the monograph discussing how crowdfunding may be progressing, with a few nascent models entering the crowdfunding sphere as well as how the impact of new technology can affect crowdfunding. Since crowdfunding has become mainstream, there have been multiple cases of fraud and other ethical issues that have arisen as well. We wrap up by delivering views on multiple issues on ethics, responsibility and decision agency in crowdfunding.

We hope that this monograph will give you a clearer understanding on the crowdfunding industry, how far it has come and its trends that can allow you to predict how it will develop in the coming years. With this knowledge as a foundation, you will be able to leverage on the opportunities that develop as the crowdfunding industry continues to grow.

1

The Crowdfunding Ecosystem and Its Evolution

In February 1997, fans of Marillion found out that the UK rock band will not be able to tour the United States due to the bankruptcy of their U.S. record label. Many fans were disappointed. This was when a suggestion made by a fan on an online messaging board started to gain traction. The message, crafted by Jeff Pelletier from Massachusetts suggested that the fans raise funds themselves to bring the band over to the U.S. (Golemis, 1997).

While there was a strong spontaneous response online, the band members themselves felt that the hype generated would wear off soon and that the costs of the overseas tour would be a tough obstacle to work around. However, as more contributions came in from different parts of the world from North America, South America, Europe and all the way to Australia, the band started to take things seriously and started planning. First, they nominated a superfan and friend Jeff Woods to oversee the fundraising and fund collection. Woods is a familiar face to Marillion fans as he has been to 46 of their shows and had even proposed to his wife on stage in one of their shows. Then, after knowing that the funds would be in good hands, the band started to organize their tour to the U.S.

The contributions made by the fans online managed to raise $60,000 for their tour and to thank the contributors of the funds, Marillion sent out 1,000 autographed copies of a live CD recorded during the U.S. tour.

Due to their success in the U.S. tour and several issues that they had with record companies, the band decided to reach out directly to the fans when producing their next album in 2001, Anoraknophobia. The group approached their fans through e-mail, asking if they would buy the next CD in advance for £16. For the 12,674 people who pre-ordered, they would receive a deluxe CD, an additional bonus CD and their name printed on the sleeve of the CDs. At this point, the band now had all the funds paid up front without even recording yet (Strähle and Bulling, 2018).

This revolutionary phenomenon at that time served as the precursor to what we know today as crowdfunding. Although there have been instances of crowdfunding before, with Alexander Pope appealing for people to fund his translation of the Greek masterpiece, the Iliad in 1713, and more famously Mozart, who got enough funding from 176 backers for a performance at a concert hall in 1783, Marillion was the first to have used crowdfunding on a digital platform (Medium, 2017). Within the next two decades, this concept has taken hold within multiple industries from music to technology design and even academic research. The crowdfunding concept has expanded to include various different forms of crowdfunding; however, they all share the same core function – to fund a large sum using small amounts from multiple individuals. These are a few examples of crowdfunding campaigns in recent years:

> In February 2018, three adults and fourteen children were the victims of a school shooting at Marjory Stoneman Douglas High School in Parkland, Florida. To assist the families of the victims in covering the costs of the funerals and other expenses, a crowdfunding page was set up on a platform called GoFundMe by the Broward Education Foundation. People interested in donating funds to the families of the victims can go to the campaign page and contribute any

amount they wish. Within 24 hours, the crowdfunding page collected over $750,000. At the end of the crowdfunding campaign, the site has raised more than $10 million for the families of the victims. This has helped support the victim's families through the tragedy.

In 2012, a smartwatch company seeking funding to grow looked to venture capital for a cash flow infusion. However, venture capital firms were hesitant to fund the business even with the promise of equity in the company. With that option not being viable, founder Eric Migicovsky decided to approach the consumers directly. He created a campaign around his product – the Pebble smartwatch, on the crowdfunding platform, Kickstarter. Consumers that are interested can contribute funds and if the amount they contribute exceeds a certain tier, they will receive items. For instance, if a consumer pledges $99 or more, they will receive a black pebble watch which will be shipped to them after the campaign. Contributing above $125 will allow them to receive a pebble watch with their preferred color. This has led to 68,929 people backing the campaign and pledging a total of over $10 million. From this successful campaign, Pebble watch has managed to use the funds to expand their company.

A brewery in London, Camden Town Brewery, is set on expanding and building a custom brewery for their brand of lager in 2015. The owner, Jasper Cuppaidge, requires £1.5 million for the new brewery. Going online to the crowdfunding platform, Crowdcube, he created a campaign where he was willing to offer 5.37% equity for the funds. At the end of his campaign, he received more than £2.7 million from 2172 investors. After the campaign, Anheuser-Busch InBev, purchased the business for £85 million, making it a profitable crowdfunding exit for a small independent business.

As joint franchise owners of a health and wellness chain, Massage Envy, Lari Jarvis and Nathan McFarland were looking for funds to build a new spa. Previously for their

> other spas, they have been using small business loans from the bank. However, there were many requirements that had to be met and documentation needed before they qualified for the loan. When deciding to open this new spa, to avoid the hassle of loaning the funds from the bank, they decided to use a platform called LendingClub. They received their loan after multiple people decided that the rate of return were attractive enough for them to act as creditors.

Companies that utilize this form of funding range from independent creators to small enterprises and even multinational corporations. As seen from the previous examples, multiple crowdfunding platforms have emerged, each catering to different markets and services. These include Kickstarter, Indiegogo, Prosper, Crowdrise, GoFundMe, Sellaband, Experiment, Patreon, Fundable, Funding Circle, Drip and many more. Furthermore, its impact is not limited to the magnitude of platforms that have sprung up around it, but also by the amount of funds that are raised. Crowdfunding has grown exponentially year on year by 23.3% with current estimates taken from the International Monetary Fund, World Bank, UN and Eurostat (Statista, 2020). This growth has been projected to reach $93 billion by 2025 (World Bank, 2013). Due to the potential crowdfunding wields, not only individuals but international organizations have embraced crowdfunding, viewing it as an alternative financing option. For instance, the World Bank's Climate Technology Program has examined how crowdfunding can help finance green technology in developing countries (World Bank, 2015) and the increased need for regulating crowdfunding due to the prevalence of crowdfunding as a growing segment of fintech around the world (World Bank, 2019). With the influence crowdfunding wields in the current business climate, there is a need to trace back to how this alternative financing model transcend industries, how has the crowdfunding model grown and evolved across time and what we can expect from it in the near future.

1.1 The Crowdfunding Environment

In the world of financing, how can ideas and concepts created by an untested individual without the appropriate resources or collateral be fully funded in a matter of days? Why has this become increasingly prevalent? The answer lies in the rapid pace at which the internet has proliferated society. The growth in internet access has paved the way for the three main actors in Crowdfunding to seek each other out easily – the project creator, the backer and the platform.

The project creator provides the idea or the concept that requires funding. This idea can range from a tangible product such as the Pebble watch to an intangible purpose such as comforting the victims of the families in a disaster. It can be large in scale, like the creation of a business, to something more mundane, such as requiring money to create a potato salad. There is no limit in the scope of what a project creator can crowdfund and the creator's purpose in crowdfunding is to persuade others why it is important for their particular idea to receive funding. This nascent idea is akin to a spark and whether this spark can transform from an idea into reality is dependent on another actor in the crowdfunding ecosystem – the backer.

The backer is an individual who has decided to contribute to the project creator's idea. In crowdfunding, this contribution comes in the form of money. Backers can have multiple motivations for why they choose to contribute to a crowdfunding project. In some crowdfunding cases, the backer will not receive any returns from this contribution – such as when the backer contributes to a crowdfunding project to help others in need of help or to support a project creator that they believe in. In other cases, the backer will receive returns from the contribution, this return can come in the form of rewards for contributing a specific amount – such as a tangible product, an intangible reward such as recognition, monetary returns or returns in equity that allows for control of a business. The interaction between multiple backers and the project creator is what creates value in crowdfunding as the exchange of funds for the actualization of the idea constitutes the main merit of crowdfunding as projects can now be funded, not by a single entity with a large capital, but with multiple smaller entities with small amounts of capital.

The platform is an often overlooked, yet integral part of crowdfunding. Crowdfunding success stories tend to focus on the project, the idea, or concept being funded as well as the number of people who are funding the project. The contributions made by the platform tend to be overshadowed. However, it is the presence of the platform that allows the interaction between the project creator and the backer to happen in the first place. The core of crowdfunding lies in its ability to bring together funds from multiple people from different regions to support an idea and the platform supports this by providing three main functions: (1) it removes geographical and temporal barriers, (2) it provides a framework for interactions that parties can trust and (3) it matches backers with project creators.

As the platform exists online, it transcends geographical locations. Furthermore, there is a period where potential backers can decide whether they are inclined to contribute and when they would like to contribute. This means that a potential backer from London can easily view crowdfunding projects from all over the world. This backer may decide to back a crowdfunding idea based in New York that was launched 30 days ago. The platform handles this entire transaction seamlessly, bypassing the temporal and geographical barriers. The platform also provides a framework that governs how these interactions should take place. This framework offers rules and regulations that guide any interaction that takes place on the platform, providing stability which can lead to consumer trust. It also serves as an important catalyst in the crowdfunding process as they perform another important function, matching backers to projects that they may be interested in. The more accurate the matching process, the more likely backers will contribute to projects that they are interested in. As such, the platform itself does contribute significantly to the entire crowdfunding process and has a role that is arguably more critical than the roles played by the project creator and the backer.

Aside from each of these three integral actors in crowdfunding, it is important that we understand the entire crowdfunding process. The crowdfunding process is similar for most platforms. The project creator creates a campaign on the platform. The campaign page would have details of the idea that the creator is seeking funding for, the funding amount required and how long the campaign will last. Potential backers access the crowdfunding page and decide if they want to contribute. Once projects meet the dateline, the page stops accepting contributions. The crowdfunding project is a success if the funds contributed by backers exceeds the funding amount required. For most platforms, the creator may only get the funds if the project is successful. Some platforms do allow creators to collect the funds if the project is unsuccessful. If returns were promised in the campaign, the backer receives these returns after the project has ended. In deconstructing the entire crowdfunding process, it seems simple enough. However, crowdfunding has been developing into a sophisticated and legitimate source of alternative financing and has become an established financial channel that requires governmental legislation.

The internet has provided a radically expanding field where crowdfunding is facilitated. Without the internet, project creators will be unable to present their ideas to the masses and will have to seek traditionally ways of financing – through loans, venture capital or angel investors. Backers too, would not be able to fund projects individually as most do not have sufficient capital to fund a project fully and may need to join an institution such as a hedge fund in order to invest in projects. As these institutions aim to generate high returns, projects that do not promise high returns would not be considered for investment. So it is no wonder that the spread of internet access is indicative of the spread of crowdfunding as well, with crowdfunding starting out in the developed regions, with North America, Europe and Australia generating high funding volume with $1.6 billion, $945 million and $76 million respectively before 2013 (Massolution, 2013), before extending to the rapidly developing countries with countries in Asia overtaking the European crowdfunding volume and generating over $10 billion in 2015 (Massolution, 2015).

Although crowdfunding seems to have huge potential in affecting the fintech sector, it is not a panacea for all funding woes. There is a need to objectively looking at crowdfunding, what it can offer and how it has changed. Some questions we would want to ask are: Has the core of crowdfunding has evolved over time? Are there new components that have transformed what it means to crowdfund? Are there new restrictions that crowdfunding needs to face for it to stay relevant in society?

1.2 Growth and Change of Crowdfunding as a Concept

As previously mentioned, crowdfunding has gradually changed from a laissez-faire concept to one that is increasingly institutionalized. Prior to the rise of platforms dedicated to crowdfunding, the crowdfunding landscape was smaller and the backers that contributed knew the project creator at a more personal level. Connections then were more tightly knit. Using our previous example, Marillion crowdfunded their concerts due to the fans that have already known the band before the crowdfunding campaign. However, as crowdfunding developed, dedicated platforms have emerged and have transformed crowdfunding into several different categories depending on the rewards obtained or the motivation of the project. Crowdfunding platforms now exist for all kinds of ideas across multiple countries. Unlike the period before crowdfunding became mainstream, crowdfunding projects now receive funding from backers that may not have heard about the project before the crowdfunding campaign. With the rise of dedicated platforms, crowdfunding has entrenched itself into modern society and has become a viable option for financing. Given the diversity of crowdfunding models available now, it is imperative that we get a grasp on the crowdfunding concept so that we are prepared for any future changes and developments that may arise in the crowdfunding model.

As crowdfunding has become more mainstream, countries have sought to regulate crowdfunding. There is a worry that backers may be prone to deceptive maneuvering by firms due to their lack of financial knowledge (Gaynor *et al.*, 2015). This is especially the case when companies can decide on their level of transparency when campaigning for funding. The United States has passed the Jumpstart Our Business Startups (JOBS) act that allows businesses, under certain regulations, to crowdfund for equity, soliciting large sums of money from large numbers of investors (Stemler, 2013). The European Union has presented a proposal for the regulation on crowdfunding that lays out rules on information disclosure, governance, risk management and supervision from the regulatory authorities in 2018 (European Commission, 2018). There are similar regulations in other countries such as China as well, with the Administrative Measures for Private Equity Crowdfunding Draft by the Securities Association of China spelling out rules that govern how crowdfunding can be used for businesses (Li, 2016). Aside from businesses, there have been regulations that have sprung up to protect consumers from this new form of transaction as well. Due to the possibility of fraud in crowdfunding where rewards that were promised failed to deliver, laws have been developed in recent years to address these issues. A precedence has been created with the legal case between the Federal Trade Commission and a project creator in 2015. The creator was found to be deceptive and had to provide restitution to his backers (Federal Trade Commission, 2015). Similarly, there are consumer protection laws in the European Union acquis that have been made applicable to crowdfunding as well (Armour and Enriques, 2018).

From this, we can easily see that crowdfunding has become entrenched in our society. The growing scope and importance of crowdfunding on business and the world stage and its substantial potential will create new opportunities and challenges for society. To leverage these new opportunities and to resolve challenges that may arise, it is essential for us to have a deeper understanding of crowdfunding. To begin with, we will explore how crowdfunding has disrupted the financing industry and how this disruption may actually be transformative in nature.

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