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Developing a Policy Framework for Emerging Crowdfunding Ecosystems

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ABSTRACT Crowdfunding is a concept that refers to an open call for finances, often for innovative or unique projects and campaigns. Crowdfunding platforms act as intermediators between supporter and project, investor and investee, or lender and lendee. The platforms intermediate this process by arranging the payment process between the parties. This brief outlines the benefits of crowdfunding for improving access to financing for small and medium enterprises, and offers policy recommendations for countries that aim to encourage the growth of their crowdfunding ecosystem.

INTRODUCTION

Crowdfunding is an online financing tool for innovative companies, projects and people.[1] The process of collaborative funding on crowdfunding platforms brings the supporters together with the recipients of funds.[2]

Crowdfunding can be found both offline and online, although putting more emphasis on online activities. Companies, individuals, non-profit organisations and public institutions can be recipients of a crowdfunding campaign. The project must have an innovative feature to attract a crowd. Crowdfunding is classified as follows:[3] 1) *Donation-based Crowdfunding*: for charitable projects; 2) *Reward-based Crowdfunding*: for pre-selling; 3) *Equity-based*

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Table 1: Uses of Crowdfunding

Type of CF	Who uses them
Donation-based CF	• Non-profit organisations and charities for social welfare projects • Public institutions and municipalities for Civic Crowdfunding • Private persons for personal causes ("Friendraising")
Reward-based CF	• Solo entrepreneurs for creating new business opportunities • Startups for financing prototypes • Creative organisations and artists for reaching audiences
Equity-based CF	• Startups for obtaining seed funds • Medium-size companies for financing during the growth phase • Real estate developers for financing new projects • Energy developers for energy plants • Public institutions to finance infrastructure projects
Lending-based CF	• Solo entrepreneurs to finance new business ventures • Private individuals financing personal expenses via loans • Companies financing business strategies via loans

Crowdfunding: for high-risk investments; and 4) *Lending-based Crowdfunding*: for low-risk investments.

Table 1 lists the typical uses of crowdfunding. The type of crowdfunding used depends on the average amount which is possible to raise. Equity campaigns for startups and for real estate projects, for example, have the highest campaign amounts on average. Meanwhile, reward- and donation-based crowdfunding campaigns have the lowest campaign amounts on average.[4]

TAXONOMY OF CROWDFUNDING

Crowdfunding platforms (CFPs) are of central importance for crowdfunding—they serve as intermediary between project and supporters. In some cases, platforms also display projects which they develop on their own. The platform facilitates payments between supporters and projects. Platforms work with fees, which they charge to supporters.

The *project owner* prepares and implements the campaign. Texts, images, pitch videos and other communication material are submitted to the platform. The *supporter* enters an agreement with the project to transfer a certain amount of money via the platform to the project owner under certain conditions set by the platform.

The *campaign* includes all activities of the project to reach potential supporters. These can be activities on the platform, in social media and traditional media, e-mails and events. The *(funding) goal* is the amount of money indicated by the project owner. The platforms often have maximum funding goals, which depend on local regulation and other conditions of crowdfunding. The *(funding) period* is a certain time span in which the funding objective is to be achieved. Some platforms have a fixed funding period, while others allow projects to choose their own. *Rewards* are tangible or intangible items given to the supporter during reward-based crowdfunding.

Most crowdfunding platforms follow an "*all or nothing*" (AON) approach, which means that the funding goal is binding. The platform only transfers the money to the project when the project campaign reaches its funding goal. The most prominent global platform is the US-based Kickstarter, where the funding goal is set by the project and the platform monitors the achievement. Some platforms offer a non-binding funding goal and pursue a "*keep it all*" (KIA) approach. The most prominent of these is the US-based platform Indiegogo, where the funding goal is also set by the project, but the platform transfers any money received directly to the projects. This can be highly useful in some cases, e.g. if a project does not need a certain amount of money, but every amount helps to make it better or more progressive. The keep-it-all approach is often used in donor-based crowdfunding.

CROWDFUNDING ECOSYSTEMS

Crowdfunding Platforms are part of a regulatory and technological ecosystem and it has been part of policy analysis for quite some time now. The European Crowdfunding Network in 2013 discussed measures to improve the CF Ecosystem across Europe, leading to an extensive dialogue in the European Crowdfunding Stakeholder Forum of the European Commission on how to generate more cross-border transaction in CF.[5] The European Crowdfunding Hub analysed the European CF Ecosystem and developed an Alternative Finance Maturity Index, which consisted of criteria such as the diversity in Types of Platforms and the existence of bespoke Crowdfunding regimes.[6]

The Start-Up Tab.io developed CAMFI (Alternative Finance Index)[7] which uses market data and prices on secondary markets to estimate the maturity of an CF. The Stockholm School of Economics developed a classification for a Fintech Market and criteria for a working CF ecosystem, which includes criteria such as Self-Regulation and Institutionalized Dialogues with the Regulator.[8]

Building on previous research mentioned above, this brief proposes the following classifications:

- *Seed Stage Crowdfunding Ecosystem*
- *Growth Stage Crowdfunding Ecosystem*
- *Mature Stage Crowdfunding Ecosystem*

Seed Stage Crowdfunding Ecosystems are not without regulatory frameworks pertaining indirectly to the operation of Crowdfunding platforms. At the most basic level, all platforms have to comply with Know-Your-Customer rules to avoid money laundering, financing of terrorism and other related activities, or fraudulent behaviour. To comply with these rules, platforms either have to identify both supporters and projects, or cooperate with a financial institution. In Growth Stage Crowdfunding Ecosystems, the

Table 2: Characteristics of Maturity of CF Ecosystems

Seed Stage	Growth Stage	Mature Stage
Dominant Type of CF		
Donation-based	Reward-based, emerging equity and lending-based	Equity- and Lending-based
Role of International Platforms		
International platforms dominate volume; local platforms nascent	Local platforms compete with international platforms, are creating niche services	Local platforms are more successful than international platforms
Crowdfunding Regulation		
No bespoke CF Regime	CF Regime incorporated in Capital Markets Regime	Specific CF Regime
Crowdfunding Associations		
Very little informal dialogue between platforms	Formal network of platforms	Associations of platforms with self-regulation

status of Crowdfunding platforms is addressed in the Capital Markets Regime, sometimes eliminating the need to cooperate with a licensed financial service provider regime, sometimes specifying the regulation regarding the protection of investors and the avoidance of conflict of interest between platform and investor. In Mature Stage Crowdfunding Ecosystems, the bespoke Crowdfunding regime, a specific legal status is introduced for platforms or Crowdfunding Service providers. The specific legal status is developed for mostly equity-based and lending-based Crowdfunding platforms and introduces rights and duties of the platforms, often coupling the specific status of these platforms with exemptions for digital management of the investor relationship. For instance, in the European Union, the licence to provide Crowdfunding services across border is coupled with a more flexible obligation with regards to investor information and withdrawing the obligation to issue a so-called prospectus about the project.

The maturity of Crowdfunding ecosystems can also be seen through the lens of the relationship between platforms and regulators. Regulators in Seed Stage CF Ecosystems are not aware of the need to regulate the market. In Growth Stage CF Ecosystems, regulators have become aware of the need, but are still in discussion about the right regime. Sometimes CF has been regulated by adapting other market rules. In Mature Stage CF Ecosystems, a specific CF Regime is in place.

RECOMMENDATIONS TO SUPPORT CF ECOSYSTEMS

Policy Coordination and Cooperation

A government aiming to support the crowdfunding ecosystem could appoint a central department either at the Ministry of Finance or the Ministry of Economy (or their counterparts) to interact with stakeholders. The role of this coordinating body could be to collect and link best practices for the use of crowdfunding in all agencies and to work with CF platforms and industry networks.

It is also important to establish a database of best practices, platforms and industry data. Some efforts can already be seen, such as the collaboration of the University of Cambridge and the World Bank or the private sector initiative AlliedCrowd. The Centre for Alternative Finance at the Judge Business School of the University of Cambridge (UK) is currently developing a database of Alternative Finance regulation in a majority of the jurisdictions across the world, which would essentially make it easier to conduct a cross-border comparison of regulation.[9] AlliedCrowd has been developing a database of platforms available in developing countries and has consulted governments in the creation of an Alternative Finance Ecosystem.[10]

Building upon existing regional initiatives can fast-track the development of political frameworks for Crowdfunding. The Association of Southeast Asian Nations (ASEAN), for instance, has provided a framework for Equity-Crowdfunding in the region and the University of Cambridge has provided a detailed analysis of East Africa, funded by UKAid through Energy4Impact and in partnership with East African countries.[11]

These activities to grow the Crowdfunding Ecosystem could focus on developing the crowdfunding ecosystem as a whole, not just platforms. Platforms are essential in the crowdfunding ecosystem, but industrial networks, consultants, universities, Fintech startups[#] offering digital identification services are also necessary.

Activities could also focus both on the development of local actors and on supporting access for international actors. Mature CF ecosystems benefit from a variety of stakeholders. Supporting international platforms that gain access to a country strengthens the trust of donors, investors and lenders. Local platforms can collaborate with international platforms and develop new niches and local capacities.

Seed stage of CF Ecosystems

To better understand the ecosystem, a local CF agency should map local CF Platforms, their contact details, their CF model, fees, and large projects. In general, increasing financial literacy helps the emergence of a CF ecosystem, and increases market stability and consumer awareness. Programs should therefore focus on online financial literacy.[12]

Crowdfunding consultants play an important role in the development of a crowdfunding ecosystem. They can help project owners find the right platform, prepare the campaign and provide legal advice. Crowdfunding academies help consultants receive certificates for their knowledge and thus signal this knowledge to the market. The AltFin Lab of the United Nations Development Programme (UNDP), for instance, has organised several crowdfunding academies[13] where UNDP staff and local campaigns have been informed about the basics of crowdfunding, the differences

Fin-Tech denotes start-up companies providing digital financial services

between crowdfunding platforms and the elements of a campaign. The European Union's CrowdfundPort project, for its part, organises training sessions in Central European countries.[14] The project first developed a series of training modules, which were then localised and used by the project partners.

Growth Stage of CF Ecosystem

The promotion of industry meetings and research networks plays an important role in strengthening confidence in a CF ecosystem. These industry networks develop and improve standards, such as industry standards concerning fair marketing practices, disclosure of selection mechanisms (to increase transparency regarding the filtering and selection of projects on the platforms) and transparency with respect to fees charged by the platform. Independent research institutions, both private and public, provide data on market developments, industry maturity, success rates of projects, and campaign strategies. The government could facilitate these efforts by organising regular meetings between government representatives, industry representatives and researchers. In Malaysia, for instance, the Securities Regulator Agency regularly invites all relevant stakeholders to discuss the emerging crowdfunding framework.[15]

It is also important to support national and regional crowdfunding associations in developing codes of conduct and self-regulation. The African Crowdfunding Association aims to partner with UKAid to develop quality standards for the emerging industry and to develop a quality label, but needs further institutional support.[16] The European Crowdfunding Network was supported in its initial phase by the European Commission through tenders for research and data collection.

Co-Financing of Crowdfunding Projects can help the growth of an CF ecosystem. Matching funds schemes can create a transparent method for selecting projects; leverage public grants with private contributions, thus making the public grants more effective; and use the social media communication of the projects to increase the outreach of public grants. For each Euro/USD gathered by the Crowdfunding Campaign, the grant "tops up" the campaign with a similar amount. An example was the British Energy4Impact program. Through Energy4Impact and the program CrowdPower,[17] it was possible to receive a co-financing grant for renewable energy-crowdfunding projects in Africa. Established in 2015, Crowd Power has supported some 253 campaigns predominantly on platforms based in the UK, with projects in developing countries focusing on improving the access to renewable energy sources and raised more than three million British pounds.

Increasing the capacity of regulators is important when there is no bespoke regulation on Crowdfunding. Regulators could be informed about CF, different types of Crowdfunding and Alternative Finance. The Milken Institute together with FSD Africa is supporting regulators in Eastern Africa in developing regulator capacity for Crowdfunding.[18]

Setting up a Public Register of Companies active in the space of Alternative Finance could help the regulator to understand the market better. For instance, the Malaysian Securities Commission set up a Public List of Registered Companies.[19]

Mature Stage of CF Ecosystem

The development of a regulatory framework is an important milestone in the creation of a mature CF ecosystem. Platforms and projects in international contexts face a wide range of legal grey areas: money laundering, anti-fraud, customs and taxation, investor protection, financial supervision, rules on issuing and trading securities, and rules on brokering loans.[20] The Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ) in Morocco supported the Ministry of Finance in developing a legal framework for crowdfunding.

A regulatory framework should provide a dynamic and flexible approach to crowdfunding legislation, while being stable enough to strengthen investor confidence and sustainable business models of the platforms.

The crowdfunding regulation should be created in a separate crowdfunding regime specifically designed to strengthen the CF ecosystem. If the crowdfunding regulation is part of the global securities regulation, the platforms will often have to deal with regulation that is not aimed at them but at other parts of the financial sector.

The crowdfunding regulatory frameworks should consist of two parts:[21] General rules and detailed rules of regulators. The basic provisions should be covered by legislation, such as the definition of a CF platform, as well as the rights and obligations of a platform. A more detailed provision should be laid down in the rules of the regulatory authorities to allow the regulatory authority to be flexible and adapt to market changes. These rules may include, for example, thresholds, reporting obligations or exemptions. The crowdfunding regulation should be harmonised transnationally, preferably regionally. Points for harmonisation could be definitions, concepts, thresholds, and types of investment vehicles that can be used on CF platforms. Harmonisation efforts could also be used for the mutual recognition of licenses, in particular for cross-border activities.

The regulation should contain a set of transparency rules to be respected by the platforms and the ownership and legal status of the platform should be clear. Possible conflicts of interest should be taken into account, in particular when the owners or team members finance projects on their own platform. There should be a transparent fee structure and a clear process when a platform no longer exists. The platform should inform openly about possible risks.

Platforms should be required as licences, e.g. with local authorities. Licensing could include monitoring good standards and the requirement to acquire the knowledge to operate a platform. Lending-based CF may require capital requirements depending on the volume of credit. The licence should be subject to reporting requirements, e.g. on anti-money laundering activities.

It is possible to limit the use of the crowdfunding framework to certain services and products. These service and product restrictions may relate to business processes of the platform, project limitations, investor limitations and investment vehicle limitations. However, a balance also needs to be found between limiting the scope of the crowdfunding regulatory framework and enabling the industry to grow dynamically.

It is also necessary to ensure adequate project monitoring. Platforms should be required to carry out due diligence of the project, to carry out background checks on project owners, to review the creation of companies using the platform, or to identify the recipient of a loan if it is a private individual. Project monitoring should also include that the projects comply with all disclosure requirements and that the promotion of the crowdfunding campaign is not misleading. However, project monitoring should not lead to platform liability if the project fails economically.

Adequate investor/creditor supervision is also important. The platform must supervise the investment/lending process and ensure the implementation of caps. It must manage the entire financing process, including the completion of financing and over-financing. It must provide a process for managing customer enquiries and a dispute resolution process. It is necessary to distinguish between the limited liability of the platform and the full liability of the issuer. If a platform operates within the crowdfunding framework, it should be necessary to limit the platform's liability. At the end of the day, the crowd should decide on the feasibility of projects and thus also bear the risk of project failure.

To strengthen the ecosystem of alternative financing, it might be possible to create a regulatory framework that would be reviewed regularly, for example every three years, to analyse whether the ecosystem of mass human financing is still competitive. Some countries have also experimented with sandboxes, allowing Fintech platforms to facilitate certain rules for financial market players in the early stages of Fintech.

A currency volatility fund could help attract international investors by hedging against currency fluctuations. A first loss fund could also help to attract international investors by guaranteeing the investor protection against a certain level of losses. The Swedish development agency SIDA supports the Swedish Crowdinvesting Platform Trine with an investment protection system. The system protects an investor's first investments made through the crowdfunding platform with 60 percent protection. In the event of a project failure, the investor receives back at least 60 percent of the outstanding amount. Investments are protected only in Tanzania, Rwanda, Kenya, Uganda and Zambia. The loan period is a minimum of six months and a maximum of four years.[22]

To strengthen the confidence of supporters in transnational crowdfunding campaigns, development organisations could use their knowledge of the local situation to investigate projects. Certification of projects would lead to a quality label. Especially in equity-based crowdfunding, platforms can benefit from support in project due diligence. Local partner organisations could be trained to review local entrepreneurs, which in turn would strengthen investor confidence. The German Crowdfunding Association, the European Crowdfunding Network, the Estonian Fintech associations and many other Crowdfunding associations have developed their own quality label.[23] The African Crowdfunding Association aims to become a self-regulatory organisation that monitors the platforms. It cooperates with African regulatory authorities so that the operating licence is dependent on the implementation of the quality standards developed by the association.

The Quality Label could also focus on the Social or Environmental Impact of Investment Projects. The German Forum for Sustainable Investments, the German Association of Startups and the German Association of Business Angels developed guidelines for green investments in the project "Green Up" which also resulted in a label for financial intermediaries and platforms.[24]

From a tax point of view, unclear provisions on small amounts invested in a local crowdfunding project and reimbursing interest payments to investors are an obstacle to cross-border transactions. Tax incentives for diaspora payments could help channel more diaspora money from consumption into long-term local investment. The UK, for instance, has developed a tax incentive system used by equity-based and lending-based platforms, such a system could also be implemented for cross-border transactions.[25]

CONCLUSION

The subject of crowdfunding has captured the attention of entrepreneurs and policymakers across the world. The global crowdfunding volume was recorded at US$ 350 billion in 2017,[26] surpassing the global net official development assistance of US$ 146 billion in the same year[27] and close to reaching the global volume of remittances towards developing countries of US$ 464 billion, also in 2017.[28]

Crowdfunding is not only an instrument to generate donations for charitable projects and to alleviate poverty, but could also help provide funding for innovative initiatives such as start-ups, alternative energy projects or infrastructure projects. The participative nature of crowdfunding is well established: "Citizens could themselves suggest, design and monitor projects that would be of greatest benefit, submit these to an online platform for potential support and even pledge their own resources (financial or human) to back their ideas".[29]

Crowdfunding can help small and medium enterprises obtain access to financing, especially in Africa. Small and systematic steps are more important than large-scale policy initiatives. Local platforms and international platforms can together develop a crowdfunding market.[30] What is necessary is a joint strategy to boost the CF ecosystem, as outlined in the previous section.

Public crowdfunding strategies are still emerging, even in developed countries. In Germany, the Coalition Contract featured Crowdfunding prominently, but a general crowdfunding strategy is not yet in sight.[31] The Dutch, Swedish and the British governments, for instance, have collaborated closely with platforms to develop policy tools to facilitate cross-border crowdfunding, especially with a focus on emerging economies. The Dutch development minister led the efforts to use crowdfunding for an initiative to support women in developing countries.[32] While public support from the minister does not replace a crowdfunding strategy, it certainly helps develop a systematic and long-term strategy to support the CF ecosystem. Political support can help to select an appropriate set of recommendations as outlined in this article.

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