CROWD FUNDING AND ALTERNATIVE FINANCING: INNOVATION IN FUNDING STARTUPS

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Abstract
The startup ecosystem has long been defined by the struggle of entrepreneurs seeking capital to bring their ideas to life. These financing models, which include equity Crowd funding reward-based Crowd funding, Peer-to-Peer lending, and Donation-based Crowd funding, have significantly disrupted traditional funding methods. The Tradition funding methods, such as venture Capital, Angel Investment, and Bank Loans, have historically dominated the landscape. Crowd funding platforms democratize access to capital, allowing startups to bypass traditional venture capital (VC) or Bank Loans. This research paper explores the role of crowd funding and other alternative financing methods in transforming the startup landscape, the growth, challenges, analyzing the advantages and disadvantages of these models, and offering insights into their future potential in fostering entrepreneurship.

Introduction

Starting a business has always been an inherently risky and capital-intensive endeavor. While traditional funding methods such as venture capital (VC), Angel investing, and Bank Loans have been the go-to for many entrepreneurs, these methods often come with barriers that make them inaccessible to a significant portion of the startup community. Crowd funding and other Alternative Financing solutions have risen to prominence, offering new more flexible avenues for raising capital.

In response to this challenge, alternative financing models, particularly crowd funding have emerged as disruptive forces in the financing ecosystem. Crowd funding and other alternative funding models have democratized access to capital, allowing businesses to raise funds from a wide pool of investors, including individuals who may have been previously excluded from traditional investment channels. Crowd funding and other alternative financing solutions have risen to prominence, offering new, more flexible avenues for raising capital. These innovative models have not only democratized access to funding but have also created opportunities for individuals and small businesses who were previousiy excluded from traditional financial markets.

This paper explores the growth of crowd funding and alternative financing, analyzing how these new mechanisms have revolutionized the startup ecosystem. We will also investigate the benefits and challenges associated with these financing methods, funding startups, focusing on their evolution, types, advantages, challenges, and impact on the startup landscape, as well as their potential future trajectory on a global scale.

Overview of Crowd funding Models

"You can have the greatest idea in the world, but if you don't have the money to make it happen, it's like having a Ferrari with no gas."

Daymond John

Capital fuels the journey from a blue-print to a thriving startup business, vital for entrepreneurs across various sectors like Tech Services, Manufacturing, and emerging fields such as Gen AI and Clean Tech. In today's diverse ecosystem, finding source is as crucial as the innovation itself. This is where innovative funding solution like crowd funding come into play, offering more than just capital they provide a platform for startups for validation and engagement with potential customers.

Crowd Funding

Crowd funding is a type of fundraising method that involves a business listing its product or we can say it's a modern approach to raise fund that involves collecting small amount of money from a large number of people to support a project or venture. By leveraging the power of the crowd, individuals and businesses can access capital that might otherwise be unavailable through traditional financing channels.

There are many Crowd funding plat forms for startup to list their product or project on. Crowd funding platforms serve as intermediaries, connecting project creators with potential investors. These platforms offer a range of tools and services to facilitate the fundraising and build a community around the project.

Crowd Funding is the practice of funding a project or venture by raising money from a large number of people, typically via the internet. Crowd funding is a form of crowdsourcing and alternative finance. In 2015, over US$34 billion was raised worldwide by crowd funding.

The term crowd funding was coined in 2006 by entrepreneur and technologist, Michael Sullivan, to differentiate traditional fundraising with the trends of native Internet projects, companies and community efforts to support various kinds of creators. Crowd funding has been used to fund a wide range of for-profit entrepreneurial ventures such as artistic and creative projects, medical expenses, travel, and community-oriented social entrepreneurship projects. Although crowd funding has been suggested to be highly linked to sustainability, empirical validation has shown that sustainability plays only a fractional role in crowd funding. Its use has also been criticized for funding quackery, especially costly and fraudulent cancer treatments.

History

Funding by collecting small donations from many people has a long history with many roots. Books have been funded in this way in the past; authors and publishers would advertise book projects in praenumeration or subscription schemes. The book would be written and published if enough subscribers signaled their readiness to buy the book once it was out. The subscription business model is not exactly crowd funding, since the actual flow of money only begins with the arrival of the product. However, the list of subscribers has the power to create the necessary confidence among investors that is needed to risk the publication.

War bonds are theoretically a form of crowd funding military conflicts. London's mercantile community saved the Bank of England in the 1730s when customers demanded their pounds to be converted into gold – they supported the currency until confidence in the pound was restored, thus crowd funding their own money. A clearer case of modern crowd funding is Auguste Comte's scheme to issue notes for the public support of his further work as a philosopher.

The "Première Circulaire Annuelle adressée per l'auteur du Système de Philosophie Positive" was published on March 14, 1850, and several of these notes, blank and with sums, have survived. The cooperative movement of the 19th and 20th centuries is a broader precursor. It generated collective groups, such as community or interest-based groups, pooling subscribed funds to develop new concepts, products, and means of distribution and production, particularly in rural areas of Western Europe and North America. In 1885, when government sources failed to provide funding to build a monumental base for the Statue of Liberty, a newspaper-led campaign attracted small donations from 160,000 donors.

Crowd funding on the internet first gained popular and mainstream use in the arts and music communities. One of the earlier instances of online crowd funding in the music industry was in 1997, when fans of the British rock band Marillion raised US$60,000 in donations through an Internet campaign to underwrite an entire U.S. tour however this was not crowd funding in its true sense as it wasn't asked for by the band and only reluctantly taken.

Types

The Crowd funding Centre's May 2014 report identified two primary types of crowd funding:

1. Rewards crowd funding, in which entrepreneurs pre-sell a product or service to launch a business concept without incurring debt or sacrificing equity/shares.
2. Equity crowd funding, in which the backer receives shares of a company, usually in its early stages, in exchange for the money pledged.

Reward-based

Reward-based crowd funding has been used for a wide range of purposes, including album recording and motion-picture promotion, free software development, inventions development, scientific research, and civic projects.

Many characteristics of rewards-based crowd funding, also called non-equity crowd funding, have been identified by research studies. In rewards-based crowd funding, funding does not rely on location. The distance between creators and investors on Sell band was about 3,000 miles when the platform introduced royalty sharing. The funding for these projects is distributed unevenly, with a few projects accounting for the majority of overall funding. Additionally, funding increases as a project nears its goal, encouraging what is called "herding behavior". Research also shows that friends and family account for a large, or even majority, portion of early fundraising. This capital may encourage subsequent funders to invest in the project. While funding does not depend on location, observation shows that funding is largely tied to the locations of traditional financing options. In reward-based crowd funding, funders are often too hopeful about project returns and must revise expectations when returns are not met.

Equity

Equity crowd funding is the collective effort of individuals to support efforts initiated by other people or organizations through the provision of finance in the form of equity. In the United States, legislation that is mentioned in the 2012 JOBS Act will allow for a wider pool of small investors with fewer restrictions following the implementation of the act. Unlike non-equity crowd funding, equity crowd funding contains heightened "information asymmetries." The creator must not only produce the product for which they are raising capital, but also create equity through the construction of a company. Equity crowd funding, unlike donation and rewards-based crowd funding, involves the offer of securities which include the potential for a return on investment. Syndicates, which involve many investors following the strategy of a single lead investor, can be effective in reducing information asymmetry and in avoiding the outcome of market failure associated with equity crowd funding.

Digital security

Another kind of crowd funding is to raise funds for a project where a digital security is offered as a reward to funders which is known as Initial coin offering (abbreviated to ICO). Some value tokens are endogenously created by particular open decentralized networks that are used to incentivize client computers of the network to expend scarce computer resources on maintaining the protocol network. These value tokens may or may not exist at the time of the crowd sale, and may require substantial development effort and eventual software release before the token is live and establishes a market value. Although funds may be raised simply for the value token itself, funds raised on block chain-based crowd funding can also represent equity, bonds, or even "market-maker seats of governance" for the entity being funded. Examples of such crowd sales are Augur decentralized, distributed prediction market software which raised US$4 million from more than 3500 participants; Ethereum block chain; and "the Decentralized Autonomous Organization".

Debt-based

Peer-to-peer lending

Debt-based crowd funding, (also known as "peer-to-peer", "P2P", "marketplace lending", or "crowd lending") arose with the founding of Zopa in the UK in 2005 and in the US in 2006, with the launches of Lending Club and Prosper.com. Borrowers apply online, generally for free, and their application is reviewed and verified by an automated system, which also determines the borrower's credit risk and interest rate. Investors buy securities in a fund that makes the loans to individual borrowers or bundles of borrowers. Investors make money from interest on the unsecured loans; the system operators make money by taking a percentage of the loan and a loan servicing fee. In 2009, institutional investors entered the P2P lending arena; for example in 2013, Google invested $125 million in Lending Club. In 2014, in the US, P2P lending totaled about $5 billion. In 2014, in the UK, P2P platforms lent businesses £749 million, a growth of 250% from 2012 to 2014, and lent retail customers £547 million, a growth of 108% from 2012 to 2014. In both countries in 2014, about 75% of all the money transferred through crowd funding went through P2P platforms. Lending Club went public in December 2014 at a valuation around $9 billion.

Litigation

Litigation crowd funding allows plaintiffs or defendants to reach out to hundreds of their peers simultaneously in a semi-private and confidential manner to obtain funding, either seeking donations or providing a reward in return for funding. It also allows investors to purchase a stake in a claim they have funded, which may allow them to get back more than their investment if the case succeeds (the reward is based on the compensation received by the litigant at the end of his or her case, known as a contingent fee in the United States, a success fee in the United Kingdom, or a pactum de quota lit is in many civil law systems). LexShares is a platform that allows accredited investors to invest in lawsuits.

Donation-based

Donation-based crowd funding is the collective effort of individuals to help charitable causes. In donation-based crowd funding, funds are raised for religious, social environmental or other purposes. Donors come together to create an online community around a common cause to help fund services and programs to combat a variety of issues including healthcare and community development. The major aspect of donor-based crowd funding is that there is no reward for donating; rather, it is based on the donor's altruistic reasoning. Ethical concerns have been raised to the increasing popularity of donation-based crowd funding, which can be affected by fraudulent campaigns and privacy issues.

Alternative finance

Alternative finance refers to financial channels, processes, and instruments that have emerged outside of the traditional finance system, such as regulated banks and capital markets. Examples of alternative financing activities through 'online marketplaces' are reward-based crowd funding, equity crowd funding, revenue-based financing, online lenders, peer-to-peer consumer and business lending, and invoice trading third party payment platforms.

Alternative finance instruments include crypto currencies such as Bit coin, SME mini-bond, social impact bond, community shares, private placement and other 'shadow banking' mechanisms.

Alternative finance differs to traditional banking or capital market finance through technology-enabled 'disintermediation', which means utilizing third party capital by connecting fundraisers directly with funders, in turn, reducing transactional costs and improve market efficiency.

Growth

Alternative finance has grown into a considerable global industry in recent years following the financial crisis, according to various reports, particularly for small and medium enterprises. For instance, the European online alternative finance market is estimated to have reached nearly €3bn in 2014, and is projected to reach €7bn in 2015. For the United Kingdom, according to the University of Cambridge and Nesta, the UK online alternative finance market reached £1.74bn in 2014. In comparison, the alternative finance markets in France and Germany reached €154m and €140m respectively in 2014.

Regulation

Alternative finance activities such as equity crowd funding and peer-to-peer lending are now regulated by the Financial Conduct Authority in the United Kingdom from 1 April 2014. Peer-to-peer lending investment will be eligible for an Innovative Finance ISA from 2016. In the US, under the Title II of the JOBS Act, accredited investors are allowed to invest on equity crowd funding platforms from September 2013. The SEC then announced the updated and expanded Regulation A mandated by the Title IV of the JOBS Act to allow non-accredited investors to participate in equity crowd funding

Evolution of Crowd funding and Alternative Financing

The concept of crowd funding has roots that can be traced back to the early 2000s when platforms like Kick starter and Indiegogo first introduced the idea of raising small amounts of money from a large number of individuals. The advent of the internet and social media provided the necessary infrastructure for this model to gain traction. By 2012, crowd funding had moved beyond creative projects to encompass a wide array of industries, including technology, healthcare, and social enterprises.

In addition to crowd funding, other forms of alternative financing, such as peer-to-peer (P2P) lending, equity crowd funding, and revenue-based financing, have been developed in response to the needs of entrepreneurs seeking capital. Each of these models provides different structures for investors and entrepreneurs to connect, invest, and receive returns.

Research Objectives

1. **To analyze the growth and development of crowd funding and other alternative financing mechanisms**: Examine the rise of crowd funding platforms and their role in fostering innovation in startup financing.
2. **To explore the impact of alternative financing on startup success**: Investigate whether startups funded through alternative means (crowd funding, peer-to-peer lending, etc.) are more successful than those using traditional methods.
3. **To assess the challenges and risks of crowd funding and alternative financing for both startups and investors**: Identify key challenges related to trust, platform sustainability, and investor protections.
4. **To examine the regulatory landscape and its influence on the development of alternative financing models**: Analyze how global regulations are adapting to new funding models and their impact on innovation and market entry.
5. **To identify trends and predict the future of alternative financing in the startup ecosystem**: Based on current data and case studies, forecast the potential trajectory of crowd funding and similar mechanisms in the coming decade.

Research Gap

1. **Limited Comparative Studies**: While there are many studies on the success of crowd funding, there is a lack of comprehensive comparative research that contrasts the effectiveness of crowd funding with traditional funding sources like venture capital, angel investing, and bank loans.
2. **Insufficient Focus on Long-Term Outcomes**: Most research focuses on short-term fundraising goals or the success/failure of individual campaigns. There is limited research on the long-term outcomes of businesses that have used crowd funding or alternative financing, including business sustainability, growth, and profitability.
3. **Investor Perspective**: A gap exists in understanding the motivations and behaviors of investors in crowd funding platforms. Most studies focus on entrepreneurs' experiences, but investor insights into decision-making, risk evaluation, and investment patterns need more attention.
4. **Regulatory Landscape**: Though some research has touched on the regulatory challenges of crowd funding, there is limited literature that evaluates the global diversity in

regulations, and how these differences affect the expansion and operation of crowd funding platforms across borders.

5. **Ethical and Social Impacts of Crowd funding on Emerging Economies:** There is a gap in the research regarding how crowd funding affects emerging economies, especially in terms of ethical concerns, social impact, and financial inclusion. Understanding the broader impact of crowd funding in such regions is critical for determining its true potential.

Advantages of Crowd funding and Alternative Financing

The rise of crowd funding and alternative financing methods has had several key advantages for startups:

1. **Democratization of Capital Access:** Crowd funding allows a wider range of individuals to participate in funding startups, removing many of the traditional barriers to entry for entrepreneurs. Small businesses, women entrepreneurs, and those from underrepresented communities are now able to raise capital that may otherwise have been out of reach.
2. **Market Validation:** Crowd funding platforms serve as a testing ground for new products and services. If a startup is able to raise significant funds on a platform, it can be seen as a sign of market demand and validation. This can be a powerful tool for entrepreneurs in the early stages of their business development.
3. **Reduced Dependency on Traditional Institutions:** By bypassing traditional funding sources such as venture capitalists or banks, entrepreneurs have greater control over their businesses without being subject to external pressures, such as giving away significant equity or meeting debt obligations.
4. **Community Engagement:** Crowd funding not only provides financial backing but also helps businesses build an early community of customers and advocates. Engaged backers become loyal customers who can offer feedback and help spread the word about the product or service.

Challenges of Crowd funding and Alternative Financing

Despite the advantages, crowd funding and alternative financing methods present challenges:

1. **Overcrowded Market:** The increasing popularity of crowd funding has led to a saturation of the market, making it difficult for new startups to stand out. Entrepreneurs must now compete for attention, which requires a strong marketing strategy and a compelling story to capture the interest of potential backers.
2. **Risk of Failure:** There is a high rate of failure associated with crowd funding campaigns. Many campaigns do not reach their funding goals, and even those that do may struggle to convert backers into long-term customers or investors. This failure risk is compounded by the lack of due diligence on platforms, which can lead to fraudulent or mismanaged campaigns.
3. **Regulatory Concerns:** Crowd funding, especially equity crowd funding, is subject to various regulations in different regions. While platforms like the JOBS Act in the U.S. have helped open the door for equity crowd funding, the regulatory landscape is still developing, and entrepreneurs and investors must be aware of the legal implications.
4. **Limited Funding Amounts:** While crowd funding can be effective for raising seed capital or funding specific projects, it may not provide the large sums needed for significant growth or expansion. As a result, many startups may need to seek additional funding through traditional means once they outgrow the crowd funding stage.

Impact on the Startup Ecosystem

The impact of crowd funding and alternative financing on the startup ecosystem has been profound. These models have:

- **Expanded Investment Opportunities:** Crowd funding has opened the doors to millions of small investors, expanding the pool of potential capital and providing new avenues for investment.
- **Globalization of Startups:** Online crowd funding platforms allow startups to access a global pool of investors, breaking down geographical barriers and enabling entrepreneurs to raise funds from anywhere in the world.
- **Fostering Innovation:** The ability to secure funding without traditional gatekeepers has empowered entrepreneurs to pursue unconventional ideas that may not have attracted interest from traditional investors. As a result, crowd funding has become a key driver of innovation.

The Future of Crowd funding and Alternative Financing

The future of crowd funding and alternative financing appears promising, with several trends likely to shape its trajectory:

1. **Increased Regulation:** As the industry matures, governments are likely to implement

more regulations to ensure fairness, transparency, and protection for investors and entrepreneurs alike.

2. **Integration of Technology**: Advancements in block chain, smart contracts, and AI are expected to streamline the crowd funding process, increase trust, and provide new ways for entrepreneurs to raise capital.
3. .**Hybrid Models:** We are likely to see the rise of hybrid financing models that combine elements of crowd funding, traditional venture capital, and angel investing. This could allow for more diverse funding structures and tailored investment opportunities.

Global Trends in Crowd funding and Alternative Financing

The growth of crowd funding and alternative financing has been most notable in countries with developed technology ecosystems and strong regulatory support. The United States, United Kingdom, and Europe have led the way in terms of platform development, investor participation, and legal frameworks. However, emerging markets in Asia, Latin America, and Africa are rapidly catching up, with local platforms catering to regional needs and priorities.

1. **Regulatory Frameworks**

Regulatory environments for crowd funding vary significantly between countries, with some nations embracing these alternative financing methods more rapidly than others. The United States, through the JOBS Act, legalized equity crowd funding for non-accredited investors, paving the way for platforms such as Seed Invest and We funder to flourish. Similarly, the European Union's regulations around crowd funding and P2P lending have helped stimulate growth in the sector, with specific regulations introduced in 2020 to create a single market for cross-border investments.

Conversely, countries with less developed financial regulations, such as India and Brazil, are still working through the nuances of how to regulate crowd funding activities. The lack of clear legal frameworks can create challenges for both investors and entrepreneurs, raising concerns around fraud, transparency, and investor protection.

2. **Technology and Block chain Integration**

The rise of block chain technology has also opened up new possibilities for crowd funding and alternative financing. Initial Coin Offerings (ICOs), Security Token Offerings (STOs), and Decentralized Finance (DeFi) have introduced new ways to raise capital and interact with investors. Blockchain allows for transparent transactions, decentralized control, and the creation of digital assets that can represent shares or other forms of value.

The integration of block chain into crowd funding models has the potential to reduce costs, increase investor confidence, and enable cross-border funding opportunities. However, regulatory uncertainty around crypto currency and digital tokens poses challenges to the widespread adoption of these models.

3. **Crowd funding for Social Causes and Innovation**

Social enterprises and impact-driven startups are leveraging crowd funding to finance innovative projects that address pressing global challenges, such as climate change, social inequality, and public health. Platforms like GoFundMe, Patreon, and Kick starter have become powerful tools for entrepreneurs seeking to bring solutions to social problems. These models not only generate funding but also build communities around shared values, fostering greater engagement and long-term support.

Conclusion

Crowd funding and alternative financing methods have revolutionized the way startups raise capital, offering entrepreneurs greater access to funding and empowering them to innovate without relying on traditional financial institutions. These innovative financing methods are reshaping the global entrepreneurial landscape, with various models tailored to different business needs and goals. While challenges remain, including market saturation and regulatory concerns, the future of crowd funding holds great potential.

As the ecosystem matures, we can expect more diverse and flexible funding models, opening the door for even greater entrepreneurial innovation and success. By utilizing a variety of data collection methods, this paper has provided a comprehensive view of crowd funding’s impact and future trajectory. However, the challenges associated with regulatory uncertainty, investor protection, and fraud remains significant and require further.

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