

Entrepreneurs' Financing Sources and Crowdfunding as Newly Emerged Source of SMEs Financing

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Abstract

Entrepreneurship is a procedure regarding the formation of Small and Medium Enterprises (SMEs) that are the main source of creation of wealth, investments, eradication of unemployment and brings new ideas in emerging as well as developed economies. SME's financing methods differ from country to country. However, leading sources are financing through banks and alternative or non-bank financing sources. Present research explores crowdfunding as one of emerging sources for financing entrepreneurs. It is an online fundraising from a large number of people (crowd) through the intermediation of crowdfunding platforms. Unfortunately, not much concentration is given in the SMEs sector of Pakistan. Banks prefer lending to large scale companies. Lending process from banks is too formal and complicated. For this reason, SMEs cannot afford costly and complicated lending processes and seek alternative financing sources. Crowdfunding as a financing source for SMEs is a quite a new concept, and very few studies have dealt with this concept. Present research is different in the context of application of crowdfunding in Pakistan, hence descriptive and exploratory research methods are used.

Key Words: Entrepreneurship, Crowdfunding, SMEs, Fundraising, Business angels, Venture Capitals.

1. Introduction

Crowdfunding is deemed as a financing source for start-ups and

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entrepreneurs. The prevalent form of crowdfunding is a somehow a recent concept. Very few studies have dealt with this concept in the perspective of entrepreneurs' financing sources where it has proved to be the best solution as an alternative financing source.¹ In common parlance, the sector of Small and Medium Enterprises (SMEs) deal with it. Entrepreneurship refers to the activity of setting up a business or businesses, taking on financial risks in the hope of profit.² An entrepreneur is someone "...who sets up a business or businesses, taking on financial risks in the hope of profit."³ In other words, entrepreneurship is basically concerned with the consumption of resources in managing and assuming the risks of an enterprise and maximizing the profits from the business venture.⁴ The entrepreneur is usually deemed as an innovator of new ideas, goods, services and business.⁵

Entrepreneurship is a procedure regarding the formation of SMEs and business projects while SMEs symbolize the firms or businesses in small and medium sizes. SMEs and entrepreneurship are assumed as the source of jobs or employment creation, financial development, and financial revolution.⁶ SMEs are considered as the backbone of economies around the globe and are important means of financial development.⁷ In Pakistan these SMEs play an important character in the development of innovative trade and industry. Unfortunately, Pakistan's SMEs contribution is less in contrast to the other countries however, their impacts cannot be denied. The

¹ Laila Sabagh, "The SEC's Regulation Crowdfunding: The Issuer's Dilemma" *Administrative Law Review Accord* 2, no. 2(2017): 115.

² *English Oxford Living Dictionary*, 12th ed., s.v. "Entrepreneurship."

³ *Ibid.*

⁴ Esuh Ossai Igwe Lucky, "Is Small and Medium Enterprise (SME) an Entrepreneurship?" *International Journal of Academic Research in Business and Social Sciences* 2, No.1(2012):345.

⁵ *English Oxford Living Dictionary*, 12th ed., s.v. "Entrepreneur."

⁶ Lucky, "Is Small and Medium Enterprise (SME) an Entrepreneurship?" 346.

⁷ UK Essay, "Major Sources of Finance and Funding for SMEs," last Edited December 5, 2017, <https://www.ukessays.com/essays/business/major-sources-of-finance-for-smes.php>.

reason behind the underdevelopment of the SMEs sector is that not much importance and attention is given by financial authorities in this sector which makes it complicated.⁸ In this scenario, crowdfunding has emerged as one of the important sources of SME's financing.

2. Notion of Crowdfunding

Crowdfunding is, like its name denotes, funding little amounts of money from a great number of investors (crowd). In contrast to financing through banks, crowdfunding accumulates money from the large number of public.⁹ Crowdfunding has been defined as, “[t]he practice of funding a project or venture by raising many small amounts of money from a large number of people, typically via the Internet.”¹⁰ It is practiced through online platforms in which an individual or group of persons can get the funds from crowd for the purpose of financing a business or project. These platforms or online portals are also called crowdfunding platforms. They work as intermediary institutions. For instance, crowdfunding platforms collect funds from the crowd and then distribute them to the entrepreneurs or small size businesses who initiate project campaigns with new ideas.¹¹ These platforms are run through the internet which becomes the source of communication for the project initiator (small and medium entrepreneurs) and the crowd (investors).

⁸ Madiha Shafique Dar, Shakoor Ahmed and Abdul Raziq, “Small and Medium-Size Enterprises in Pakistan: Definition and Critical Issues,” *Pakistan Business Review* 19, No 1(2017): 47.

⁹C. Steven Bradford, “Crowdfunding and the Federal Securities Laws,” *Columbia Business Law Review* 1, (2012):5.

¹⁰ *English Oxford Living Dictionary*, 14th ed., s.v. “crowdfunding”.

¹¹Sentot Imam Wahjono and Muhammad Nasir Etl, “Islamic Crowdfunding: A Comparative Analytical Study on Halal Financing,” *International Journal of Business and Finance Research* 39, No 1(2017):2.

3. SME's Financing Sources

Financing sources of SMEs can be classified into two types: bank financing sources and alternative or non-bank financing sources. The bank financing sources consist of bank loans, bank overdrafts etcetera. On the other side, non-bank sources consist of personal savings, family and friends, angel investors, venture capital, crowdfunding, hiring, and leasing, trade credits and grants. Further detail of entrepreneur's financing sources is given below:

A. Bank Financing Sources

Bank Loans

Bank loan is a sum of money borrowed from a bank through which the borrower is obliged to payback on specified date and time. The refunding of the loan will depend on the volume, duration of the loan and the percentage of interest. Repayment of loans includes the interest which serves as the fee charge. If the borrower needs further loan, the bank will not be agreeable to enlarge the loan without an enlarging security.¹²

Bank Overdraft

An overdraft is settled money in which a client can obtain cash through his current account. Bank overdraft is an excellent resource of short term finance to support a business. The charges differ from the bank's loan; however, they are correlated with the interest's percentage of the banks. One benefit of overdraft is that it is speedy to business when compared to a loan. However, overdraft is not so beneficial for small size businesses as interest rate is very high; moreover, the business is not authorized to

¹²Robert Makorere, "The Role of Microfinance", *Global Business and Economics Research Journal* 3, no 4 (2014):6.

overdraw beyond the overdraft limit. If small firms do so, the bank may punch the business by means of a hefty charge for going beyond the limit.¹³

B. Non-Bank Financing Sources

Personal Savings

Commonly, personal savings are the initial point for the majority of SMEs where the possessor uses them for the purpose of commencing his/her business.¹⁴

Friends and Family

Second most common source of SMEs is financing through friends and family. In the beginning of a business, generally friends and family are creating an investment in the possessor management as much as in the corporation. Primarily, SMEs are expected to rely upon their personal funds and interior equity finance such as family funds.¹⁵

Business Angels

Business angels (BAs) are also identified as angel investors. They are well off persons who invest in some probable high growth businesses.¹⁶ They are the type of investors who provide their skills, expertise, information, and

¹³ UK Essays, "Major Sources of Finance and Funding for SMEs," Last Edited December 5, 2017,

<https://www.ukessays.com/essays/business/major-sources-of-finance-for-smes.php?vref=1> (Accessed October 3, 2018).

¹⁴ Ibid.

¹⁵ Khaled Alhabashi, "Financing For Small and Medium Enterprises: The Role of Islamic Financial Institutions In Kuwait," (PhD Thesis, University of Gloucestershire, 2015),

33, http://Eprints.Glos.Ac.Uk/3428/1/Financing%20for%20Small%20and%20Medium%20Enterprises%20The%20Role%20of%20Islamic%20Finance%20Institutions%20in%20Kuwait%204-10%202015-Signed_Redacted_Signature%20only.Pdf (Accessed August 5, 2018).

¹⁶ UK Essays, "Major Sources of Finance and Funding for SMEs," Last Edited December 5, 2017, <https://www.ukessays.com/essays/business/major-sources-of-finance-for-smes.php?vref=1>, (Accessed October 3, 2018).

interactions in the projects they invest in. They act like private investors who are ready and willing to invest in new small and medium enterprises in order to support these small businesses and gain profits simultaneously.¹⁷ Normally business angels are involved at the initial stage of the business. These BAs may invest in the form of groups, investment clubs or on an individual basis. The famous example of business angels is “The British Business Angel Association” (BBAA) which offers assistance in planning and introduction of commerce proposals.¹⁸

Venture Capitals

Venture capital is also known as private equity investment. Venture capital does not consist only of investment through funds, but it also consists of skills and time. It is the primary and distinctive source of funding for SMEs who do not have access or have limited access to get loans through traditional capital markets. It is an alternative financing source, but not perfect and small businesses do not get successful through this source unless they have potential to give extraordinary returns to the venture capitalists.¹⁹

Difference between Venture Capital and Angel Investor

The angel investors and venture capital are most familiar alternative sources of funding and also have a number of similarities like both tend to prefer companies connected with technology and science. Likewise, both have a

¹⁷ Veland Ramadani, “The importance of Angel Investors in Financing the Growth of Small and Medium Size Enterprises” *International Journal of Academic Research in Business and Social Sciences* 2, No. 7(2012): 306.

¹⁸ UK Essays, “Major Sources of Finance and Funding for SMEs,” Last Edited December 5, 2017,

<https://www.ukessays.com/essays/business/major-sources-of-finance-for-smes.php?vref=1>, (Accessed October 3, 2018).

¹⁹ John B. Maier, “The Role of Venture Capital in Financing Small Business” *Journal of Business venturing* 2, no 3 (1987): 207, [https://doi.org/10.1016/0883-9026\(87\)90009-7](https://doi.org/10.1016/0883-9026(87)90009-7).

number of points to differentiate them.²⁰

Angel Investors	Venture Capital
Angel investors prefer to fund the companies that are at an earlier stage of development. ²¹	Venture capitalists may come at a later stage than business angels when a company has been growing up and operating for a bit. ²²
Angel investors invest their personal money.	Money invested by Venture capitalists comes from pension funds, corporations, and other sources.
Angel investors may or may not desire to take seat on the company's Board of Directors.	Venture capitalists require a seat on the company's board of directors.
Angel investors invest less than one million.	Venture capitalists invest more money, usually at least two million.

Hire Purchase and Leasing

In leasing and hire purchase, the new business acquires an asset without giving full price. The company uses such assets for a fixed period of time after which one party may agree to sell and another party may agree to buy at a reduced price or to return it. In a lease agreement, the company possesses the equipment but does not own them. The utensils or machinery is returned to the landlord, at the end of year. Some benefits of leasing utensils consist of having and benefiting from an asset without giving the

²⁰ Business, "Difference between An Angel Investor and Venture Capitalist" Last Modified August 28, 2018,

<https://www.business.com/articles/angel-investors-vs-venture-capitalists/> (Accessed October 3, 2018).

²¹ Growthink, "What's the Difference between Angel Investors and VCs," <https://www.growthink.com/businessplan/help-center/what-difference-between-angel-investors-and-venture-capitalists> (Accessed October 3, 2018).

²² Secure Docs, "The Differences between Angel Investors & Venture Capitalists" Last Modified November 9, 2017, <http://www.securedocs.com/blog/the-differences-between-angel-investors-venture-capitalists> (Accessed October 3, 2018).

full cost.²³

Trade Credit

Not surprisingly, due to complicated processes and higher expenses and less availability of bank loans, SMEs turn towards purchasing the products from other businesses (suppliers) to run their business. In trade credit, supplier provides out his manufactured goods to a customer and in return expects to receive sale price and agreed ratio of interest of that product at a later date. The majority of trade creditors permit for a time of 30 days or for a long duration prior to payment are made, this may permit the business to utilize money in the short term. Trade credit may be truly important to individuals, small size businesses who have small resources to start their business.²⁴

Grants

Grants are frequently accessible from local councils and other government institutions. For instance, the government may make rules to support needy businesses or individuals for the purpose of the development of innovative business.²⁵

Crowdfunding

Crowdfunding is, like its name denotes, funding little amounts of money from a great number of investors (crowd). In contrast to financing through banks, crowdfunding accumulates money from the large number of

²³ UK Essays, "Major Sources of Finance and Funding for SMEs," Last Edited December 5, 2017,

<https://www.ukessays.com/essays/business/major-sources-of-finance-for-smes.php?vref=1> (Accessed October 3, 2018).

²⁴ Ibid.

²⁵ UK Essays, "Major Sources of Finance and Funding for SMEs," Last Edited December 5, 2017,

<https://www.ukessays.com/essays/business/major-sources-of-finance-for-smes.php?vref=1> (Accessed October 3, 2018).

public.²⁶ Crowdfunding has been defined as, “The practice of funding a project or venture by raising many small amounts of money from a large number of people, typically via the Internet”.²⁷ Likewise, the present research explores this kind of financing source, thus the subsequent part of this chapter would discuss it in detail.

4. Crowdfunding as Newly Emerged Source of SMEs Financing

Crowdfunding has emerged as an alternative source of fundraising. This notion has the potential to challenge the regulatory frameworks of banks and other securities regulation.²⁸ As discussed above, for the purpose of starting the business, SMEs need financial support through which they can grow and advance their business. However, lack of financial resources is considered as the main problem for the development of SMEs. The SMEs suffered the largest crash of the global financial disaster in 2008. Moreover, during that time, financial load was put on SMEs and essential resources for their business were not provided. In this regard SMEs remained without the access of bank loans and other credit sources from the financial industry while crowdfunding supported SMEs in this situation.²⁹

Banks, according to Bill Gates, are unproductive, particularly for the underprivileged. Even the deficiency of the simplest structure of banking rejects an individual to transmit and save money according to their will.

²⁶C. Steven Bradford, “Crowdfunding and the Federal Securities Laws,” *Columbia Business Law Review* 1, (2012):5.

²⁷ *English Oxford Living Dictionary*, 14th ed., s.v. “crowdfunding”.

²⁸ Vitale, M, “Crowdfunding: Recent International Developments and Analysis of Its Compatibility with Australia’s Existing Regulatory Framework,” (2013):3, <http://papers.ssrn.com/sol3/papers.cfm?abstract id=2324573>,(Accessed October 3, 2018).

²⁹ Vitale, M, “Crowdfunding: Recent International Developments and Analysis of Its Compatibility with Australia’s Existing Regulatory Framework,” (2013):3, <http://papers.ssrn.com/sol3/papers.cfm?abstract id=2324573>,(Accessed October 3, 2018).

Consequently, Bill Gates quotes banks as: “Banking is necessary, banks are not”³⁰. In this situation, it is important to ponder whether SME should only rely on bank loans or to find alternative sources of financing. The reply of this point is the last one, as it is undoubted that without available and reasonable monetary support lots of companies will not be competent to build up their innovative ideas and businesses. For this reason, alternative sources of financial support are needed to originate and practice, and crowdfunding is one of them.³¹

Consequently, crowdfunding is known as an alternative means of financing.³² It is also a recent method of investment through private equity, which is primarily based on start-up companies and entrepreneurs who are in the want of financial resources to carry on or develop their business process through different sources.³³

Crowdfunding originated from the idea of “crowdsourcing” and signifies one aspect of the same phenomenon that consists of crowd voting and crowd formation.³⁴ The word “crowdsourcing” originates from “crowd” and “outsourcing,” focusing on the meaning of farming out particular performances to a crowd of external and internal individuals.³⁵ Furthermore,

³⁰ Medium Corporation, “Banking Is Necessary, Banks Are Not.” Last Modified March 22, 2016, <https://medium.com/@ozanpayments/banking-is-necessary-banks-are-not-says-bill-gates-e1fbb02516c8> (Accessed October 3, 2018).

³¹ Zorica Golic, “Advantages of Crowdfunding as an Alternative Source of Financing of Small and Medium-Sized Enterprises,” *Preliminary Communications* 8, (2014): 40, DOI: 10.7251/ZREFIS1408039G.

³² Jordana Viotto da Cruz, “Beyond Financing: Crowdfunding as an Informational Mechanism.” *Journal of Business Venturing* 33, (2018): 2, DOI: 10.2139/ssrn.2870545.

³³ Marco Eckhardt, “Equity Crowdfunding in Finland, an Alternative Investment Option,” (Master Degree Thesis, International Business, 2016), 5, <https://www.theseus.fi/bitstream/handle/10024/110711/Degree%20Thesis%20Equity%20Crowdfunding.pdf?sequence=1> (Accessed October 3, 2018).

³⁴ Leimeister, J. M., “Crowd sourcing: Crowdfunding, Crowd Voting, Crowd Creation,” *Magazine for controlling and management* 56, No 6 (2012): 388.

³⁵ Kleeman et al., “Under Paid Innovators: The Commercial Utilization of Consumer Work through Crowdsourcing,” *Science, Technology and Innovation Studies* 4, No 1 (2008): 6.

crowdfunding is wholly embedded in crowdsourcing which declares that it is stemmed from micro finance that is actually closely linked to Micro lending.³⁶

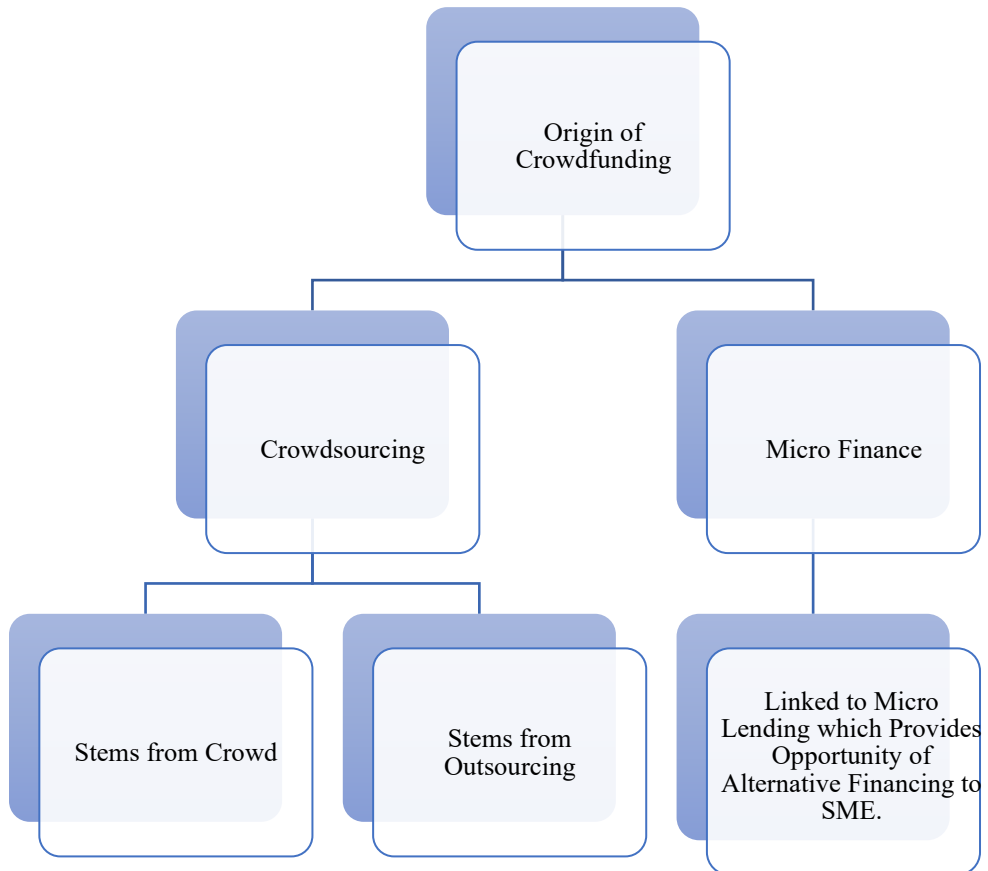
Micro lending is a notion which introduces the innovative ideas of small size businesses and gives an opportunity to those individuals who do not have access to avail traditional financing from recognized institutions. This new type of investment source arose in a structured mode at the time of financial crisis when various problems were suffered by artisans, start-up enterprises and other small business companies in collecting funds.³⁷ At the time of the financial crisis, banks formed complicated monetary formalities which became the source of extreme risk on a worldwide level.³⁸ Conventional banks were less agreeable to provide financial support to small size enterprises at that time, and SMEs started to seek other financial sources. This attracted numerous individuals to seek for alternatives and, specifically, a smaller amount of financial mediation among the investor and investee.³⁹ Furthermore through diagram origin of crowdfunding can be explained as:

³⁶ Ethan Mollick, "The Dynamics of Crowdfunding: An Exploratory Study". *Journal of Business Venturing* 29, No 1(2014):1.

³⁷Info Dev Innovation and Entrepreneurship, "Crowdfunding's Potential for the Developing World," Last Modified October 24, 2013, https://www.infodev.org/infodev-files/wb_crowdfundingreport-v12.pdf, (Accessed October 3, 2018).

³⁸ Ron Martin & Jane Pollard R., eds., "Handbook on the Geographies of Money and Finance, Crowdfunding: Understanding Diversity," (United Kingdom: Edward Elgar, 2017) 1.

³⁹Info Dev Innovation and Entrepreneurship, "Crowdfunding's Potential for the Developing World," Last Modified October 24, 2013, https://www.infodev.org/infodev-files/wb_crowdfundingreport-v12.pdf, (Accessed October 3, 2018).



The Crowdfunding concept was not introduced in the internet era, but the internet has just made things easier.⁴⁰ Despite the absence of internet facilities in the ancient era, nominal and similar history of crowdfunding can be traced since the 1700s and currently it is being emerged and practiced through online platforms in the entire world.

Even though crowdfunding looks to be a very recent phenomenon, history of crowdfunding can be traced since the 1700s. The earliest

⁴⁰ The Next Web, "The Past Present and Future of Crowdfunding," Last Updated January 9, 2014,

<https://thenextweb.com/insider/2014/01/09/past-present-future-crowdfunding/>. (Accessed December 15, 2018).

documented instance of crowdfunding can be found since the 1700s in Ireland. At that time, it was more identified as micro lending, which gave opportunity to avail loans for the families who have small amounts of income in rural regions of Ireland. The alleged Irish Loan Fund was from one of the greater programs, which was started by Jonathan Swift who had described that there were many individuals with small amounts of income and those who do not have experiences to achieve loans, were supported through this fund. With the passage of time, this lending form was improved and by the 1800s more than 300 such types of programs were established.⁴¹

A familiar name that emerged along with lot within the background of micro financing is Dr Mohammad Yunus (Bangladeshi economist), who started a research project jointly with his graduate students in 1976 and the purpose of this research project was to bring opportunities for individuals that are in need of financial support and eventually he won the Nobel prize.⁴² The result of his project became so victorious and it had more than 30,000 members after 5 years of establishment of this project.⁴³

Internet based campaigns were started from the mid of 1990 and two websites were launched at that time, which were “six degrees.com” and “AOL instant messenger.com” through these websites people started to make online profiles and purpose of these profiles to get connection with their friends to share information and remain in touch with them. Likewise, donation fundraising was introduced in 2000 and people started to supply

⁴¹ Marco Eckhardt, “Equity Crowdfunding in Finland, an Alternative Investment Option,” (master’s degree Thesis, International Business, 2016),11, <http://www.theseus.fi/bitstream/handle/10024/110711/Degree%20Thesis%20Equity%20Crowdfunding.pdf?sequence=1>, (Accessed October 3, 2018).

⁴²Info Dev Innovation and Entrepreneurship, “Crowdfunding’s Potential for the Developing World,” Last Modified October 24, 2013, https://www.infodev.org/infodev-files/wb_crowdfundingreport-v12.pdf, (Accessed October 3, 2018).

⁴³ Ibid.

the funds on charity bases. Example of a charity fundraising site is Justgiving. It was a challenge for fundraisers, but it remained under practice more than 11 years, and some UK registered charities have also benefited from it.⁴⁴

In 2005, the earliest micro lending website was known as Kiva.org.com. This website attracted lenders from everywhere, collected small loans in especially personalized form and then encouraged entrepreneurs in the course of several projects by supporting through this small amount of large people. The receiver pays back this loan with a high rate of interest. But sometimes interest may or may not be included in paying back the loan.

In 2007 “Lending Club” (a crowdfunding portal) launched and it was the second peer-to-peer lending site. These internet-based technologies were not only becoming the source of live chatting with friends, but social networks were introducing such types of platforms that were capable of supporting a wide variety of collective requests by SME.⁴⁵

In 2008, Indiegogo platform was co-founded by Danae Ringelmann and Slava Rubin founded as necessity for a way to avoid the conventional routes to funding.⁴⁶ In 2009, one of the existing most famous portals introduced its website Kickstarter.com. Kickstarter authorized a group of people to create new ideas and support appealing projects with nominal

⁴⁴ *Social Media Week*, “A Social History of Crowdfunding,” Last Modified December 12, 2011, <https://socialmediaweek.org/blog/2011/12/a-social-history-of-crowdfunding/> (Accessed October 3, 2018).

⁴⁵ *Social Media Week*, “A social History of Crowdfunding,” Last Modified December 12, 2011, <https://socialmediaweek.org/blog/2011/12/a-social-history-of-crowdfunding/> (Accessed October 3, 2018).

⁴⁶ *Fortune*, “Will Indiegogo's New Personal-Cause Site Help It Stand Out in the Crowd?” Last Modified December 15, 2014, <http://fortune.com/2014/12/15/indiegogo-life/> (Accessed October 3, 2018).

donations. The project funded under Kickstarter platform provides reward to the supporters if the funding target and project becomes successful. This type of funding is also called reward-based crowdfunding.⁴⁷

On April 5, 2012, Jumpstart Our Business Start-ups Act (JOBS Act 2012), was signed by President Barack Obama and the assured goal of the JOBS Act 2012 was “to enlarge job conception and financial development by enhancing access to the public investment markets and financial supporting for growth of small and medium size companies”. Beside this, universal solicitation bans and general marketing restrictions for private securities offerings, given under Securities Act 1933, has also been eradicated through the JOBS Act 2012.⁴⁸

5. Contemporary Practices of Crowdfunding

In 2017, crowdfunding opportunities were more prevalent than ever and the most famous crowdfunding platforms are Kickstarter Prosper and Lending club.⁴⁹ These portals show that new technological infrastructure and the social approaches are now existing, and ready to furnish crowdfunding its momentum.⁵⁰ In addition, websites such as Indiegogo and fundable have also a much higher reach today than they once did, and these websites encourage individuals to come up with innovative ideas. Thus,

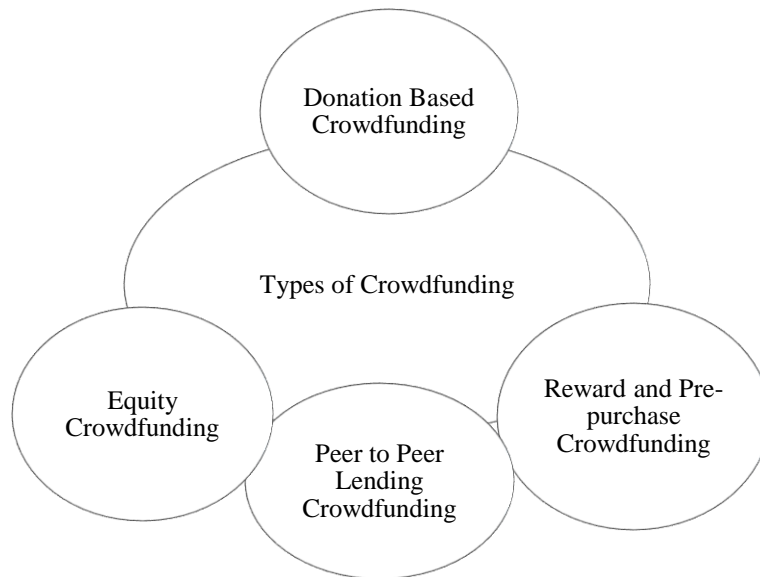
⁴⁷ Marco Eckhardt, “Equity Crowdfunding in Finland, an Alternative Investment Option,” (Master’ Degree Thesis, International Business,2016),14, <https://www.theseus.fi/bitstream/handle/10024/110711/Degree%20Thesis%20Equity%20Crowdfunding.pdf?sequence=1> (Accessed October 3, 2018).

⁴⁸ William P. Lane, “Titles II or III: Where Will the Wisdom of the Crowd Take Investors?” *Catholic University Law Review* 66, 3(2017): 723.

⁴⁹Kiwi Report, “The Story of Crowdfunding,” Last Modified December 31, 2017, <http://kiwireport.com/the-story-of-crowdfunding/>, (Accessed October 3, 2018).

⁵⁰ *Social Media Week*, “A Social History of Crowdfunding,” Last Modified December 12, 2011, <https://socialmediaweek.org/blog/2011/12/a-social-history-of-crowdfunding/> (Accessed October 3, 2018).

crowdfunding has revolutionized the world of small business.⁵¹ We can classify crowdfunding into the following five kinds, (1) the donation model; (2) the reward model; (3) the pre-purchase model; (4) the lending model; and (5) the equity model.⁵²



Types of Crowdfunding

5.1 Donation-Based Crowdfunding

Donation has been defined by the Oxford dictionary as, “something that is given to a charity, particularly an amount of funds.”⁵³ In donation-based crowdfunding, lenders get back nothing in return for their contributions and not even the ultimate return of the sums they donated. On the other hand, though the donor's purpose is charitable, the recipient's (entrepreneur who is raising funds) objective need not be likewise. Contributions may finance

⁵¹ Ibid.

⁵² C. Steven Bradford, “Crowdfunding,” *Columbia Business Law Review* 1, (2012):8.

⁵³ *English Oxford Dictionary*, s.v. “Donation”, <https://en.oxforddictionaries.com/definition/donation>, (Accessed May 17, 2018).

for-profit enterprises as well.⁵⁴

5.2 Reward and Pre-Purchase Crowdfunding

Reward and pre-purchase models are also types of crowdfunding. Both models are almost similar to each other, and often come into view jointly on the same sites. In the reward model, investors expect something in the return for charity or contribution. However, that reward does not consist of interest and investors are not offered earnings of the company. The reward can be diminutive, like a key chain, or it can be in the form of giving respect, importance, and credit etcetera. For example, writing the name of an investor in a movie. Generally, the product itself is given to the investors as reward but often entrepreneurs give rewards in the form of personalized thank-you, notes or small branded gifts for instance, T-shirts or travel mugs. These smaller rewards include below the price level for the real product.⁵⁵

The pre-purchase model is similar to the reward model. Investors do not entertain monetary returns such as interest and as alternative investors only get the access to products that the entrepreneur is manufacturing. For example, if the project initiator is making an evo *charji* device, contributors would get the evo *charji* device or the right to buy the evo *charji* device at a bargaining price upon completion.⁵⁶ Kickstarter and Indiegogo are the most important reward or pre-purchase crowdfunding sites.⁵⁷

⁵⁴ C. Steven Bradford, "Crowdfunding," *Columbia Business Law Review* 1, (2012):14.

⁵⁵ The Simpler Dollar, "Everything You Need to Know about Crowdfunding," Last Updated December 13, 2017,

<https://www.thesimpledollar.com/crowdfunding/> (Accessed October 13, 2018).

⁵⁶ C. Steven Bradford, "Crowdfunding," *Columbia Business Law Review* 1, (2012):14.

⁵⁷ *Ibid.*,16.

5.3 Peer to Peer Lending-Based Crowdfunding

The lending form of crowdfunding is often called peer-to-peer lending. Peer-to-peer lending is related to loans. In which investors provide amounts on a short-term basis and expect for return. In a few cases, contributors are promised interest on the capital they loan. In other cases, they are merely entitled to get the return of their principal.⁵⁸

Two most important peer-to-peer lending sites are Prosper and Lending Club. Both websites are interest based. The loans supplied on these sites may be for business objectives. Most of the loans are offered to private individuals (SMEs) and the trend to give loans for small businesses through the above-mentioned sites is also increasing. Functions of Prosper and Lending Club sites are similar, but they are not equal platforms. Borrowers like private individuals or enterprises advertise their ideas on these websites and potential lenders re-examine the ideas of project initiators (entrepreneurs) and choose to whom they want to fund. The lowest investment amount for every loan application is \$25.⁵⁹ Borrowers are charged a certain commencing fee for every loan by Prosper and lending club site. Prosper and Lending Club indicates all of the conditions and interest rates with detail. Every lender charges the lowest percentage of interest he is willing to acknowledge.⁶⁰

Kiva is a non-interest-based site. It is, no doubt, the most important crowdfunding site via lending model. Nowadays, Kiva is being called as; “the hottest non-profit site on the globe”.⁶¹ Kiva website completely introduces characteristics of enterprises, amount of loan that has been

⁵⁸ Ibid.,20.

⁵⁹ C. Steven Bradford, “Crowdfunding,” *Columbia Business Law Review* 1, (2012):20.

⁶⁰ Ibid.

⁶¹ Ibid.,20.

requested, and explanation of purpose of using loan etc. Crowd can then go into the Kiva site, browse profiles of entrepreneurs with the facility to read all descriptions of the small and medium size companies, area, and other features, and can select an entrepreneur to whom they are willing to give a loan.⁶² After completion of the project, Kiva raises and distributes this money back to lenders. Lenders on the Kiva site merely get their principal money back.⁶³

5.4 Equity Crowdfunding

In contrast to the donation-based and rewards-based crowdfunding, Equity crowdfunding gives an opportunity to become part owners of the company through their shares. Equity crowdfunding is also identified as crowd investing. Equity crowdfunding happens when bulk of individuals give small amounts of funds to small size businesses through online platforms and it is defined as “a form of fundraising in which SMEs make an open call to sell a particular quantity of equity or bond-like shares in a company on the Internet platforms, hoping to attract a great series of investors”.⁶⁴

6. Crowdfunding in Pakistan

Crowdfunding is not being practiced in Pakistan because SECP has named crowdfunding as a false scheme and alleged that there is apprehension of

⁶² Digital Innovation and Transformation, “Kiva: A Crowdlending Twist on Traditional Microfinance,” Last Modified October 30, 2015, <https://digit.hbs.org/submission/kiva-a-crowdlending-twist-on-traditional-microfinance/>, (Accessed October 3, 2018).

⁶³ C. Steven Bradford, “Crowdfunding,” *Columbia Business Law Review* 1, (2012):21.

⁶⁴ Wiley Online Library, “Signalling in Equity Crowdfunding,” Last Modified March 24, 2015, <https://onlinelibrary.wiley.com/doi/epdf/10.1111/etap.12157> (Accessed October 3, 2018).

fraud, money laundering and terrorism financing through such schemes.⁶⁵ In 2017, SECP warned the public that they should not be misled by fraudulent activities and should not involve themselves in the investments schemes which are launched by non-corporate bodies or individuals through electronic media, emails and mobile text messages. Furthermore, SECP pointed to an “Innovative Crowd Funding Project Pvt-Ltd Pakistan” and notified that no company with the same name is registered under SECP.⁶⁶ SECP further clarified that crowdfunding is not allowed in Pakistan and no company can raise funds through this scheme.⁶⁷

7. Conclusion

After reviewing the financing sources for the small and medium enterprises, it is concluded that SMEs could play an important role in reducing unemployment and poverty and are also considered as backbone for the development of economies. Financing sources of SMEs are classified as alternative or non-bank financing sources, and bank financing sources. Non-bank sources consist of personal savings, family and friends, Angel investors, venture capital, crowdfunding, hiring, and leasing and grants. On the other side, bank sources consist of trade credit, bank loans, bank overdraft etcetera. Unfortunately, not much attention is paid to the SMEs sector of Pakistan. Banks prefer lending to large scale companies. Lending process from banks is too formal and complicated. For this reason, SMEs cannot afford costly and complicated lending processes and seek alternative financing sources. Crowdfunding is the best solution as an alternative

⁶⁵ More news, “SECP Declares Crowdfunding Illegal in Pakistan,” Last Updated March 30, 2017, <https://www.morenews.pk/secp-crowdfunding-illegal-pakistan/> (Accessed October 3, 2018).

⁶⁶ Ibid.

⁶⁷ Securities and Exchange Commission of Pakistan, “SECP Warns Public about Crowdfunding”, Last Updated March 27, 2017, <https://www.secp.gov.pk/wp-content/uploads/2017/03/Press-Release-March-27-SECP-warns-public-about-crowdfunding> (Accessed October 3, 2018).

financing source, so, it should also be practiced in Pakistan as such as it is being practiced on international level. It is recommended that SECP must permit its practices in the country as it is being practiced and regulated on an international level.
