Deloitte.

Crowdfunding 101

Understanding the associated fraud risks

October 2016

Forensic

The emergence of social media platforms, increasing internet penetration, and rising mobile connectivity have all resulted in the creation of a new and innovative entrepreneurship ecosystem known as 'Crowdfunding'. Crowdfunding, in its simplest sense, is solicitation of funds (in small amounts) from multiple investors through a web-based platform or social networking site for a specific project, business venture or social cause. While crowdfunding is not a new model, the use of the internet for crowdfunding, however, is a relatively new concept in India and is still at a nascent stage of growth in the country.

Globally, crowdfunding is a $16 billion industry (and as per estimates, in 2016 with a total investment volume of $34.4 Billion industry[1]), having executed over a million successful campaigns. In comparison, the market in India is minuscule, projected at approximately $50 Million[2]. Crowdfunding can largely be split into three main types - rewards/ donation crowdfunding[3], debt crowdfunding[4], and equity crowdfunding[5]. Each of these platforms can help improve access to finance for growing businesses; as they mature in scale, however, they do come with inherent fraud risks that organizations need to be mindful of. Lack of specific regulations, a small and fragmented market and, often guaranteed, quick high returns are just some of the factors that may inadvertently contribute to the risk of fraud in crowdfunding. Some of these fraud risks can translate into affecting an organization/ individual, leading to a fraud incident. In our experience, some of the probable fraud schemes in this space are:

- **Money laundering**
  Fraud is not limited to only those raising money through the platform. Perhaps less obvious, but nonetheless present, is the risk of money laundering. Funds received electronically under the guise of a legitimate crowdfunding offering would be easier to integrate into the financial system than if the transaction were conducted in cash. A similar process could be used to funnel money out of the country to fund terrorism. Illegitimate money can also be laundered by starting a fake campaign and using multiple fake accounts, thereby avoiding regulatory scrutiny. For example, in 2012 the crowdfunding platform Gittip announced[6] that the service had been hijacked as a vehicle for money laundering by a mysterious, anonymous user who had registered on the site.

- **Diversion and siphoning of funds on fake/ inflated projects**
  Given the very nature of a crowdfunding platform, investors in a crowdfunding project may, at times, have limited visibility/ transparency to the authenticity

[1]http://economictimes.indiatimes.com/small-biz/money/tight-government-regulation-paucity-of-innovation-limiting-crowdfunding-startups-in-india/articleshow/52197344.cms
[2]http://articles.economictimes.indiatimes.com/2014-04-20/news/49266205_1_aditi-gupta-rs-5-lakh-platforms/3
[3]Supporters pledge money in return for rewards, or simply make donations
[4]Investors loan their money and receive interest on their loans in return (also known as "peer to peer lending")
[5]Investors receive shares in a business, and share in the success of that business
[6]http://motherboard.vice.com/blog/thieves-launder-money-by-crowdfunding-themselves--2

of the project they are financing. Fraud can manifest itself in many different ways. Misappropriation can be easy to pull off through false websites. The funds raised can be used for purposes other than what was initially disclosed. While each investor should perform a due diligence on the idea, creator and online platform, this can, at times, be difficult to perform effectively for several reasons. Many of the people participating in crowdfunding are not subject matter experts, but instead, average people interested in the venture or idea. Additionally, formal business plans and audited statements are typically not available; thus, it is hard to accurately assess given information asymmetries, minimal public disclosure, and few comparable benchmarks.

- Identity theft/ Cyber security risks
  Crowdfunding may be vulnerable to the risk of cyberattacks in view of the online nature of crowdfunding. Such cyberattacks may come in varied forms, such as overloading a platform's infrastructure, confusing accounts, etc. Like with any online financial transaction, phishing schemes can be used to illegally gain access to personal and financial information, such as credit card and banking information. Hacking of the payment gateway or using stolen credit card information can result in direct revenue losses for the platform. Other cyber risks such as 'man in the middle attacks[7]' may also result in identity theft of the users on a crowdfunding platform.

As we have seen, while crowdfunding encourages experimentation, innovation, and promotes out-of-the-box ideas which may not receive funding through traditional routes/institutions, the platform also has potential fraud risks associated with it. Due to the anonymity created by the online aspect of crowdfunding platforms, investments in crowdfunding activities could be subject to higher risks of fraud in which case the investor may lose his/her investment in entirety.

While crowdfunding has gradually evolved from a relatively obscure and adhoc source of financing for small businesses to an established, legitimate, and popular method of raising capital, there is clearly a strong rationale for regulatory oversight. In India, there is currently no specific crowdfunding law or regulation that exists. While the Securities and Exchange Board of India (SEBI) had released a consultation paper[8] in July 2014 that attempted to propose a legal, structural and regulatory framework around crowdfunding in India, this has now been temporarily shelved. Recently, however, SEBI has issued a notice, warning investors about unauthorized equity based crowdfunding platforms, questioning their legality[9]. Thus, as of now, contract law and specific sections of the Indian Penal Code, 1860 amongst other laws govern the actions within crowdfunding, which is limited to only reward and donation based crowdfunding.

Crowdfunding markets have been operating in many countries for several years with few reported instances of fraud. However, as the market expands, there will inevitably be attempts to circumvent regulations and defraud investors.

In our view, some important precautions to take before investing in a crowdfunding campaign are:

- Exercise and carry out adequate due diligence
  At an organizational level, take the time to carry out a due diligence to understand who you are dealing with, taking into consideration elements such as profile of the management team, their business experience, past history, proposed business potential, nature of the project, execution capabilities, etc. Consult experts or advisors to obtain the necessary advice to help make a meaningful investment.
- Be wary if it seems too good to be true
  You must avoid projects or ventures which promise exceptional returns that seem 'too good to be true'. Always understand that a superficial return promised on a project may not be viable given practical business considerations.
- Monitor closely
  Effective scrutiny and periodic monitoring of projects, especially when investing in high value or relatively unknown projects, should be carried out to ensure the appropriate utilization of investor funds. Periodic performance evaluation with a budgeted plan (e.g., delivery date, certification, refund policy, etc.) is a recommended step to identify indicators of any potential wrongdoing at an early stage. This could be a tough task at an individual level and is largely dependent upon the tools provided by the crowdfunding platform itself to a user. However, at times, platforms do usually let contributors (to a campaign) directly contact the campaign initiator/ creator to help establish a relationship between the two parties. Thus it falls on the individual/ user to regularly follow up (with the creator) and get timely updates from him/ her. Some platforms also allow their users to request refunds for projects which they are not satisfied with.

While there are, undoubtedly, risks present in crowdfunding, it is nevertheless a huge boon for emerging growth companies to help obtain necessary financing in order to expand nascent operations. Specific laws or regulations in this area should therefore necessarily try and seek a balance between investor protection while also providing the desired impetus for growth. In the meantime however, investors should exercise all possible precautions to avoid any potential fraud risks while backing a crowdfunding campaign.

Acknowledgement
We acknowledge the effort put in by Karan Bhasin in preparing this document.

[7]In cryptography and computer security, a man-in-the-middle attack is an attack where the attacker secretly relays and possibly alters the communication between two parties who believe they are directly communicating with each other.
[8]http://www.sebi.gov.in/cms/sebi_data/attachdocs/1403005615257.pdf
[9]http://economictimes.indiatimes.com/small-biz/money/crowd-control-sebi-warning-turns-off-crowdfunding-tap-for-startups/articleshow/54202702.cms

Contact us

For more details, reach out to:

Rohit Mahajan
APAC Leader
Partner and Head, Forensic
Financial Advisory, Deloitte India
Tel: +91 22 6185 5180
Email: rmahajan@deloitte.com

Rohit Goel
Director
Forensic
Financial Advisory, Deloitte India
Tel: +91 124 679 2340
Email: rogoel@deloitte.com

Deloitte.

Deloitte Touche Tohmatsu India Private Limited (U74140MH199 5PTC093339) a private company limited by shares was converted into Deloitte Touche Tohmatsu India LLP, a limited liability partnership (LLP Identification No. AAE-8458) with effect from October 1, 2015.