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Developing a Framework of Equity Crowdfunding for Small and Medium Enterprises (SMEs) in Malaysia: A Conceptual Paper

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ABSTRACT

The Covid-19 pandemic has affected the global economic turmoil leading to the global recession around the world. This will adversely affect Malaysia's small and medium enterprises (SMEs) sustainability. Companies with less than three years of operations face various challenges tapping into funding facilities as banks will prioritise existing customers with good track records. An alternative avenue for funding and financing is necessary to survive in the business. To gain holistic understanding of the ECF, this study has four objectives: (1) To uncover the roles of ECF to SMEs in the time of crisis; (2) To investigate the crucial influencing factors to success the crowdfunding campaigns; (3) To explore the roles of regulation to protect investor and issuers in equity crowdfunding; (4) To develop a framework for fundraisers to ensure their successful campaign. This study will employ a mixed-method approach to achieve the objectives. The interview will be conducted with registered ECF operators, and the questionnaire will be distributed to ECF fundraisers. Since different data sources will be used, the data preparation is divided into web scrapping and text extraction. Python programming language and scrapper library, known as Beautiful Soup, will used to obtain the company's details, while text extraction will be performed on the pdf files. Therefore, Python library known as PyPDF2 will be used to extract data from PDF files. It is hoped that the findings and proposed framework can assist the government and policymakers in enhancing successful applicant campaigns and improving the investors' protection legal framework. Along with the national agenda, namely Sustainability Development Goal (SDG) 8 and the Strategic Thrust 1 of the Shared Prosperity Vision 2030, successful SMEs are vital as they can create jobs opportunity for the local community and foster economic growth through more and large pool of investments.

INTRODUCTION

Islamic Fintech and Digital Financial Inclusion Report 2020 by Malaysia Digital Economy Corporation (MDEC) stated that the problem faced by SMEs is lack of credit history and proper credit assessment models. It prevents SMEs from accessing micro capital. Due to this problem, they may experience difficulties obtaining funds through normal lending channels as they are just starting and may not prove that they can repay a loan. They may also struggle to obtain seed funding from the usual investment channels open to SMEs, including angel investors and venture capitalists. These investors may provide certain benefits (such as expertise), but they may require significant stake in the company or maybe reluctant to provide funds to unproven start-ups.

In addition, SMEs' poor financial and digital literacy would contribute to the difficulties in raising the fund, particularly during the crisis. Digital platforms providing financing known as 'Regulated Market Operators' has been introduced by the government to expand the availability of capital for SMEs and provide the Malaysian public with opportunities for a more diverse investment portfolio. Since its inception, equity crowdfunding (ECF) has received a positive response from the public. Over half the investors are retail investors and most of the ages below 35 years old, signalling a tech-savvy and financially comfortable demographic.

Securities Commission (SC) Malaysia Annual Report 2020 stated that in 2020 alone, the capital raised grew by 457% to RM127.73 million, from RM22.92 million in 2019. A total of 78 issuers have successfully fundraised via 80 campaigns, with two issuers fundraising twice within 2020. Among the successful issuers, 44 per cent below 35 years old. It showed enormous growth in the fintech industry, particularly on ECF in Malaysia. In 2020, Malaysia is ranked in number 36 worldwide fintech ranking (Findexable, 2020). Kuala Lumpur ranked

78 while Sabah is placed in 235 ranked. It shows that enormous differences are ranking among the states in Malaysia. The outcomes from this demonstrate that the growth of ECF in Malaysia focuses on the capital city, which is Kuala Lumpur only.

Even though ECF assists SMEs to obtain external finance relatively easier than conventional financing, the success of ECF campaigns is not guaranteed. Through ECF, SMEs are expected to bear a greater risk of failure during the early development challenges. According to Kickstarter, the failure of ECF campaigns on its platform is about 61% (The Wall Street Journal, 2021). The ECF fundraisers need to manage the ECF to ensure it will succeed constructively. Even though ECF fundraisers have a relatively strong foundation during the global economic crisis, they still strive financially to sustain their business. ECF fundraisers need to respond effectively to the economic crises due to uncertainty in the duration and the impact of the economic crisis.

Other than that, among the regulatory challenges of ECF will be its vulnerability to cybersecurity threats. ECF is exposed to the risk of cyberattacks because of the online nature of ECF. It has been a dream for cybercriminals to benefit financial gain by manipulating the ECF systems. Such cyberattacks may come in the forms of overloading a platform's infrastructure, confusing accounts, illegal access to personal and financial information, identity theft of CF platform's users and fraud. Cybersecurity issues fall under the purview of Personal Data Protection Act 2010 (PDPA 2010), Computers Crime Act 1997 (CCA1997), Penal Code (PC) and other related-cyber laws. However, the drawbacks of these laws would be proving the crimes occurrence and the evidence in the court of law. This is due to the anonymity created by the online aspect of crowdfunding platforms, leaving untraceable events and perpetrators but only losses to the investors, their investment in entirety.

Thus, the existing digital financing legal measures focus on strengthening the ECF platform operators' and issuers' disclosure and transparency requirements. The ECF platform operators operate typically as intermediaries to raise shares and funds from the investors. This setup is available online susceptible to several challenges, especially issues of fraud and uncertainty. These issues have been addressed through the existing provisions of items 13.22 of Guidelines on Recognized Market (GRM) that impose the obligation to the issuers regarding the disclosure requirement. Issuers are required to submit relevant information to the ECF platform and ensure that all information is true and accurate and shall not contain any information or statement that is false or misleading or from which there is a material omission. Nevertheless, there is no guarantee of transparency and full disclosure as required, as the issuers can still falsify the actual company's vital information, such as the nature of the projects and financial performance, before launching that campaign.

Due to the challenges encountered by ECF fundraisers, a framework will be proposed to assist SMEs with being successful ECF fundraisers. Without appropriate guidance, ECF fundraisers may not be able to sustain their business as apart from funding availability, proper business strategy and support structure, including legal knowledge, are essential to ensure the success of a business. Successful SMEs are vital as they can create job opportunities for the local community and foster economic growth through more and a large pool of investments. Since SMEs represented 97.2 per cent of business establishments in 2020, their contribution to Malaysian GDP is anticipated to be increased with the higher successful ECF fundraisers rate. This is aligned with the national agenda, namely Sustainability Development Goal (SDG) 8 and Strategic Thrust 1 of the Shared Prosperity Vision 2030. Therefore, this study addresses the importance of developing a framework to assist fundraisers to ensure ECF campaign is successful.

Lastly, there are a few studies that have been conducted on equity crowdfunding (ECF) such as ECF cultural project (Foà, 2019), study on ECF based literature review analysis (Montgomery et al., 2018; Elsaid, 2021; Serwaah, 2021), ECF platform and social media (Battisti et al., 2021), roles of blockchain in ECF (Knewtson & Rosenbaum, 2020; Nguyen et al., 2021). However, there are very few studies on the factor of a successful ECF campaign in Malaysia, particularly highlighting the issuer's perspective. To overcome this research gap, this study needs to be conducted. Hence, a holistic and flexible legal, structural and regulatory framework should be in place to encourage the financial cycle of the business and economy through the initiative of ECF.

Research Objectives

1. To determine the roles of equity crowdfunding (ECF) to SMEs in Malaysia.

2. To investigate the crucial factors that influence the success of crowdfunding campaigns in Malaysia.
3. To examine the roles of regulation to protect investor and issuers in equity crowdfunding.
4. To develop a framework for fundraisers to ensure their successful campaign.

Research Questions

1. What are the roles of equity crowdfunding (ECF) to SMEs?
2. What are the crucial factors that influence the success of crowdfunding campaigns in Malaysia?
3. How do the regulations protect investors and issuers in equity crowdfunding?
4. How does a framework assist fundraisers to ensure ECF campaign is successful?

LITERATURE REVIEW

Definition of Crowdfunding

allowing individuals to finance projects through public contributions. Investors can support these projects through donations or by receiving a return on their investment (Schwienbacher & Larralde, 2010; Belleflamme et al., 2014). This approach is a specific type of crowdsourcing wherein a central entity delegates tasks to numerous individuals, each making a small contribution in exchange for corresponding rewards. Thus, crowdfunding can be seen as an extension of crowdsourcing, where individuals invest varying amounts of money and receive proportional returns (Rubinton, 2011).

Crowdfunding is classified into five categories based on the complexity of the financing process: donation-based crowdfunding, sponsorship crowdfunding, pre-sale crowdfunding, loan-based crowdfunding, and equity crowdfunding (Hemer, 2011). Within this framework, four primary crowdfunding models exist. The first allows individuals to donate to projects without expecting any promised rewards. The second involves a lending-based model, where entrepreneurs function as borrowers. The third model is equity-based, enabling contributors to earn a share of the project's profits. Lastly, the reward-based model offers contributors non-financial incentives in exchange for financial support (Massolution, 2015). Among these, equity crowdfunding is the most intricate, and despite its recognized significance by governments and related organizations, its growth could be much better.

Even though Malaysia has developed the ECF regulatory framework in 2016, the Malaysian ECF sector is still in its early stage of growth (SMEBIZ, 2018) due to limited public knowledge about crowdfunding and less willingness to contribute to crowdfunded initiatives. Even though there is a decline in ECF financing during the beginning of movement control restrictions in 2020, in line with the economic turmoil, the ECF grows steadily after the business operations are resumed. As at the end of 2020, ECF platforms generate RM199.23 million from 150 fundraisers and 159 campaigns (Capital Markets Malaysia, 2021).

Investor and the Success of ECF: Fundraiser Perspective

The motivations for launching and participating in crowdfunding projects are diverse. Beyond financial rewards, investors often experience a sense of involvement, community, and fulfilment from contributing to projects that resonate with their values (Gerber & Hui, 2013). For fundraisers, crowdfunding not only provides essential capital but also offers a means of establishing their identity. Project initiators can leverage crowdfunding platforms not just for startup funding but also to engage with investors, which serves as valuable market research (Mollick et al., 2014). This interaction allows them to promote their innovations and create a supportive environment for project development. Additionally, project owners can obtain critical insights, including pricing information, feedback on potential design improvements, and demographic data about prospective buyers (Buysere, 2012).

The success or failure of ECF depends on the quality of the fundraisers as well as the ECF platforms. Even though many studies examine the benefits of ECF platforms on the success of the ECF, the influence of fundraisers' characteristics should not be undermined. The characteristics of fundraisers that may predict the success of ECF include regulation, lower risk assessment, effective corporate governance mechanism, good performance and high reporting and disclosure transparency.

The risk assessment of ECF fundraisers is highly crucial as most ECFs are related to new start-ups (Ahlers et al., 2015) which are viewed as risky business operations. Issues on ECF such as high information asymmetry, low chances of survival, lack of investor protection and uncertainty of online transactions (Wasiuzzaman et al., 2021; Amaro & Duaete, 2015; Dorf, 2013) necessitate a proper risk assessment of the ECF fundraisers so that the high investment risk faced by ECF investors can be mitigated. Having lower risk will motivate investors to participate in the ECF platforms which will eventually contribute to the success of ECF.

Corporate governance issues in ECF are more prominent as the agency problems and information asymmetry in ECF are greater (Buttice & Vismara, 2021) as compared to traditional equity. Without effective corporate governance, ECF fundraisers have opportunity to gain advantage at the investors' expense (Cumming et al., 2021). Consequently, ECF market may not succeed, and the growth opportunities may be hindered (Cumming et al., 2019). Hence, internal, and external governance mechanisms must be in place to support the increasing importance of ECF markets.

ECF fundraisers with better performance will attract larger pools of investors (Maiti et al., 2018). The provision of additional fundings can be used to create new growth opportunities that will enhance the fundraisers' performance (Cumming et al., 2019). Literature suggests that the fundraisers' experience in previous project and funding reciprocity have significant contribution to the success of the ECF (Koch & Seiring, 2015).

The quality of information is perceived as a prerequisite for the success of ECF campaign and ECF platforms (Farajian, et al., 2015). Thus, the reporting and disclosure transparency will mitigate the moral hazards problems and information asymmetry with potential investors (Bogdani et al., 2021), even in the absence of an assurance on the ECF reports (Donovan, 2021). Empirical evidence suggests that higher quality disclosure to disseminate distinctive information about the business is a method that is available to start-up firms to improve the reliability of ECF fundraisers' financial reporting (Bogdani et al., 2021).

Covid-19 Disruption of Economy and Small and Medium Enterprises (SMEs)

The Covid-19 pandemic that has spread rapidly caused hundreds of thousands of death and many have suffered from reduction in prospects and disruption of livelihood (World Bank Group, 2020). Even though various measures have been undertaken to mitigate the impact of Covid-19 on health care system, the measures have restricted consumption and investment as well as curbed labour supply and production. Thus, the snowball effect of Covid-19 deems to impose adverse impact on global business performance that disrupts the growth of worldwide economy (Ruiz Estrada et al., 2020). As forecasted by the World Bank Group (2020), there is a reduction of 5.2 percent in global GDP in 2020. This will lead to economic disruption that causes many countries to suffer from economic crisis particularly emerging and developing countries. The impact of economic crisis is more vulnerable for SMEs. It proved by Department of Statistics Malaysia that stated, based on the time series of Malaysia's GDP and SMEs GDP, the growth of SMEs GDP is usually higher than Malaysia's GDP. However, in 2020, the growth of SMEs' GDP registered at negative 7.3 percent, which was lower than Malaysia's GDP for the first time over the past 17 years since 2003.

Small and medium enterprises (SMEs) in Malaysia forms 97.2 percent of the total business organisations in 2020 (SME Corp, 2022) indicating that they provide major contribution to the country's gross domestic product and employment growth (Wasiuzzaman et at., 2020). One of the challenges faced by SMEs is lack of access to capital market and formal sources of external finance (Beck & Demiguc-Kunt, 2006). The creditworthiness evaluation done by financial institutions might hinder the accessibility of the funds available to SMEs. Without having good financial conditions and ability to provide high quality collateral, the rejection rate of SMEs loan applications is higher (Wasiuzzaman et al, 2020). Due to emerging technology, alternative and innovative financial source from non-banking sectors such as equity crowdfunding (ECF) is developed to assist SMEs in raising funds. Facilitated by Securities Commission Malaysia (SC), unlike the conventional forms of financing, this financing platform offers SMEs an opportunity to raise funds and it allows a large pool of small investors to participate in the financial market (Smirnova et al., 2019) using a relatively less expensive, quicker, and more convenient distribution channel (SME Corp, 2020). The crowdfunding platforms has increased rapidly worldwide (Ziegler et al., 2020) and have been used as alternative investment opportunities (Block et al., 2020).

Regulation

Investing through crowdfunding brings potential high risks. However, ECF seems capable of offering financial solutions to issuers seeking additional funds to expand their company. However, in reality, it may only benefit one party. The retail investors may likely lose their investment due to the adverse selection of businesses the ECF platform had offered. Since SMEs and start-ups are the primary target of the ECF platform, the business viability and the protection provided to the investors will be the main concern.

Cicchiello (2019b) suggests that the success of ECF depends on the ability of each country to develop forward-thinking regulations that can support this new funding model while providing the right level of protection for crowdfunding investors. The lack of appropriate regulations creates an unpredictable environment and a state of uncertainty that deter investors and, consequently, strangles equity crowdfunding investments (Cicchiello, 2019a). According to Ziegler et al. (2018), the more investors and platforms perceive that the existing crowdfunding regulatory framework is adequate in their countries, the more likely these countries to exhibit higher crowdfunding volumes per capita and a larger share of business funding.

It is essential to have a well-defined regulation, incentive, and protection for crowdfunding actors (Belleflamme et al., 2014; Pesok, 2014; Hornuf and Schwienbacher, 2017; Cicchiello et al., 2019). Regulation is a natural response to internal and external adverse facts like systemic risk caused by asymmetric information (Lee, 2019; Cable, 2014) or other events that compromise the market's stability. Studies on investor protection are fragmented and should be derived from papers on ECF regulations.

Given the very nature of a crowdfunding platform, investors in a crowdfunding project may, at times, have limited visibility or transparency to the authenticity 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 initially disclosed. While each investor should perform due diligence on the idea, creator and online platform, this can sometimes be difficult to perform effectively for several reasons. Many people participating in crowdfunding are not subject matter experts, but instead, ordinary 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.

The regulatory aspect is important to attract investors; nevertheless, the protection of investors may enhance or constrain the creation and development of firms (La Porta et al., 2002; Glaeser et al., 2001). Strong protection reduces investors' freedom in choosing projects and managing the business (Moskowitz and Vissing-Jørgensen, 2002), consequently delaying the funding of start- ups or other firms (Hyytinen and Takalo, 2003). Therefore, fostering investors means avoiding stringent requirements and preferring norms and rules on transparency and disclosure. Or at very least, institutions might not apply rules that limit entrepreneurial freedom when capitals are designed for small companies.

Pecking Order Theory

Donaldson initially introduced this theory in the year 1961 after finding that the firms prefer to use internal financing instead of external financing to finance their investment regardless of the size of the firms. In the year 1984, Myers and Majluf modified to explain in detail with rationale issue (Myers and Majluf, 1984). This theory is not about optimal capital structure decisions; however, the firm should choose their financing based on cost and benefit. This theory highlighted that the hierarchy of funds should utilise the firm's financing.

Using this theory can predict profitability and leverage relationships due to the information asymmetry between insiders and outsiders. As a result, firstly, this theory proposed prioritising internal financing such as retained earnings. Due to the internal financing required lower information cost and safest mode of financing. Secondly, SMEs should use external financing, consisting of debt and equity financing. Meanwhile, it has been suggested that the SMEs should choose to use debt financing over equity financing. In addition, the SMEs attempt to maintain using internal financing; however, once the funds are lessened, the SMEs needs to rely on external financing such as debt financing. As such, as a relatively new equity financing alternative, equity crowdfunding would be selected only if internally generated funds are insufficient.

RESEARCH METHODOLOGY

Research Design

This study will adopt a qualitative approach in analysing the data. Data will be collected, such as the financial information extracted from the SMEs fundraising's annual report and financial statement as well as legal materials including legal statutes, orders, and guidelines. To achieve the objectives, the interview will be conducted among 10 ECF platforms that are registered and recognised as ECF operators such as Ethis Ventures, Crowdo, Ata Plus, Funded by Me, Pitchin, and Fundel in order to get their views on investment in ECF mainly during this crisis time. Other than that, the survey will be conducted on 150 SMEs fundraising/issuers of ECF. The approach of statutes interpretation which consists of the literal rule, golden rule, mischief rule and purposive approach, will also be adopted, in particular, the provisions relating to ECF in the CMSA 2007 and Guidelines on Recognized Markets 2019 (GRM 2019).

Data obtained from interviews, survey, financial reports and legal materials will be analysed through content analysis. Data analysis includes Thematic Content Analysis (TCA) which is a descriptive presentation of qualitative data in nature. Qualitative data may take the form of interview records and survey collected from respondents and text sources from financial reports and legal materials that reflect on the topic of study.

In thematic and content analysis, the theme of a coding category can refer to the manifest content of the data. Thus, in this research, data collected from interviews, survey and secondary source such as financial reports and legal materials will be grouped in different themes and keywords.

CONCLUSION

In this research, the qualitative data will be analysed by using the combination of descriptive, analytical and critical analysis to achieve the objectives. The descriptive analysis will be carried out for the purpose of generating information regarding the roles of ECF, factors of successful ECF campaigns as well as rules and regulation in ECF. An analytical and critical concept is used to investigate deeply and evaluate the factual data in the study.

The result will be expected to contribute to solving the problem of this study. Firstly, the SMEs have serious problems in sustaining their business due to lack of financing during this crisis times. In addition, the rejection of loan application from bank seems higher due to lack of good financial position. Therefore, ECF can show their important roles in assisting SMEs in fundraising.

In developing a framework, we need to identify the crucial factors that can influence the success of crowdfunding campaign and how the ECF can protect the investors and issuers as well. Therefore, the proposed framework is expected to enhance the successful rate of the ECF campaign.

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