

CROWDFUNDING- AN EMERGING CONCEPT IN INDIA

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ABSTRACT

The mechanism of **crowdfunding** is a new concept that is currently being discussed in India. This discussion was started with Securities and Exchange Board of India (SEBI) releasing a **Consultation Paper** in 2014 for people to give suggestions on. Crowdfunding is aimed at the helping the start-ups and Small and Medium Enterprises (SMEs) to raise capital from multiple individuals over the internet. The main objective behind this paper is to understand and comprehend crowdfunding as a concept relevant to India and analyze the proposed regulations that SEBI has put forth.

The structure of the paper would be that- first the authors will discuss as to whether **India is ready** for crowdfunding, secondly they will discuss the **jurisdiction** of SEBI to enact regulations on this topic of crowdfunding and thirdly a detailed **analysis** and suggestions would be made for the consultation paper released by SEBI in 2014.

The article would conclude by firstly analyzing the validity of SEBI releasing these guidelines and secondly finding out how successful SEBI has been in drafting such regulations for crowdfunding activities as well as propose certain amendments that could be made along with pointing out a substantial issue which has been left out of the draft released by SEBI.

Key words: **crowdfunding, Consultation Paper, 'India is ready', jurisdiction and analysis**

Introduction

Crowdfunding is an emerging method that is used alternatively for raising capital. It is a method in which small donations or investments are raised from multiple individuals over the Internet for a project or a venture. This practice is generally for people living in different geographical areas but funding a common interest. Recently, SEBI released a consultation paper on the topic of Crowdfunding in India. Though this concept was prevalent in various countries like US and UK but, it is a new concept being introduced in India. It took its roots in the financial crisis of 2008 when entrepreneurs and others faced the major problem of financing. Since the banks were refusing to provide loans, the entrepreneurs had to look for other options like Crowdfunding.

Crowdfunding according to the definition provided in the SEBI consultation paper means “a solicitation of funds (small amount) from multiple investors through a web-based platform or social networking site for a specific project, business venture or social cause”.ⁱ Long before the formulation of this term, India had witnessed its first crowdfunded project by Dhirubhai Ambani in the making of Reliance Industries. Crowdfunding can be carried out in four ways these are- Donation Crowdfunding, Reward based Crowdfunding, peer to peer Crowdfunding and Equity Crowdfunding.

Donation Crowdfunding involves investors investing money without any expectation of future returns or repayment. They do not even expect to receive the amount they contributed.ⁱⁱ This is a very popular concept and small rewards or gifts, which are not of tangible value; act as incentives for investors to participate. These are the “thank-you” gifts.ⁱⁱⁱ An example of this would be a website that is like kickstarter. In Reward based Crowdfunding investors are given rewards in return of their investments according to the mutual terms that had been agreed upon. These rewards include providing of a service, commodity etc. Peer to peer Crowdfunding involves matching up or collection by an online platform and then providing small businesses or enterprises with the required amount of investment as contributed by various individuals. These are unsecured loans on which the interest rate is fixed by the online platform which is facilitating the process. Lastly, in Equity Crowdfunding the investor receives an equity share in the business they have chosen to invest in^{iv}. This model of receiving an equity stake in the venture of the particular company an individual invests in is also prevalent in US.^v Through the consultation paper SEBI is trying to formulate a legal basis for securities crowdfunding. This would include equity, debt and fund based crowdfunding.

Is India Ready For Crowdfunding?

As mentioned above the concept of crowdfunding is not new in the Indian jurisdiction. The part which will be new to India would be the concept going online. This will thus pose as a major challenge because India has not yet been very successful in developing a crime free cyber network as of now. There is a very low trust level amongst the users in India as to the credibility of anything taking place online. Plus, the industry is also not very investor friendly. Earlier, the e-commerce concept became a trend only because of the introduction of cash on delivery system by companies. It can be safely said India is still not able to deal with fake web sites and spam mails. It cannot be said to be a country which can deal with internet security and awareness efficiently.^{vi} Further, the problem of money laundering would also scale up as ministers and other stakeholders would start getting involved in these crowdfunding projects.^{vii}

In spite of all the above mentioned problems, the concept of crowdfunding is catching fast. US has already made it legal by the enactment of Jumpstart Our Business Start-ups Act, 2012 (JOBS Act) and so are other countries, thus such an enactment should be enacted in India also so that it can compete with other countries on equal levels. The JOBS Act is one of the closest international equivalents to our crowdfunding regime.^{viii} It is very essential for a country like India to explore a variety of options to raise capital for its start up businesses. To put into effect a working model of capital raising for these start-up ventures and small and medium scale enterprises it is firstly very essential that SEBI specifies in clear words that its Regulations shall be applied on the Internet sites which will get involved in the process of crowdfunding. Secondly, these platforms should also come to the regulators so that they can work in a way which is credible and also very transparent in nature. Thirdly, India should stricken the penalties and liabilities on any cyber related fraud that happens so as to deter others from doing the same. Also all the provisions made should keep into mind the IT laws prevalent in the country. Thus, India is ready for adopting a new concept that is being used worldwide so as to promote the growth of its industries.

Assumed Jurisdiction Of SEBI?

Though crowdfunding is a rising idea in India, it is also ridden with a lot of loopholes that need to be fixed before it becomes a norm.^{ix} Lack of regulations for such activities has given rise to concerns of possible defrauding of investors^x and the Consultation paper is not entirely capable of dealing with crowdfunding activities.

The authors feel that the consultation paper is yet another instance of “assumed regulatory jurisdiction” by SEBI, which, if implemented in the country might fall short of the objectives and need of the society, especially to start-ups and Small and Medium Enterprises. As said by Satish Kataria, “It (guidelines) defies the concept crowdfunding as start-ups would have to depend again on institutional investors.”^{xi} The SEBI has assumed its authority in this matter without even considering the actual characteristics of Crowdfunding and without even consulting other laws like the Income Tax Rules^{xii}, the Companies Act, 2013, and the RBI Rules^{xiii}. While the Income tax Rules come within the purview of Ministry of Finance, Companies Act comes within the functions of Ministry of Corporate Affairs and effectively, the Parliament. There are a lot of pieces missing in this jigsaw puzzle. The SEBI needs to take into account all these statutes, in order to come up with an actual regulatory body. The problem is manifold. If we consider crowdfunding platforms as private company, then according to Section 42(2) and 42(4) of the Companies Act, 2013, a private company cannot have more than 50 investors, since it will become a deemed public company, which has a lot of restrictions. To be clear, it is a Companies Act restriction and not a requirement of the SEBI, another instance of assumed jurisdiction taken in its consultation paper.^{xiv} Only after the exploitation of these provisions, can crowdfunding be carried out in the Indian context, without any legislative amendment and mere intervention of SEBI.^{xv} Secondly, funding through debt would again be difficult, since the companies act makes it unworkable for small private companies to perform this through debt, even if that debt is convertible to equity.

The SEBI has clearly specified that a company cannot go around asking general public for money, debt or equity, unless their rules are followed.^{xvi} These rules are really complex and have entry barriers- minimum capital, minimum years of operation and so on, which will be discussed below.

The whole situation or rather uncertainty regarding the regulatory body in India can be concluded only after determining the answers of two crucial questions; whether crowdfunding has the characteristics of a public offer or a private placement; second, which authority has the regulatory jurisdiction over the crowdfunding activities in India. To answer the first question, there is a need to differentiate between public offer and private placement. Section 23 of the Companies Act, 2013 talks about both, public offer and private placement to issue securities. As per this section, public offer can be made only by a public company, which would require a prospectus and other compliances.^{xvii} The option of private placement is available to both, a public company^{xviii} and a private company^{xix}. Now, Public offer for issuing securities has been denied to the private companies via Section 2(68) (iii). Therefore it would be really difficult for the crowding platforms

or start-ups, who need money from investors in large amounts, as they cannot be a private company if they want to make a public offer, which would defeat the very purpose of the crowdfunding. Secondly, Section 42(2) of the Companies Act, 2013 requires that the number of people subscribing to the securities in a company shall not be more than 50 and if it is more than 50, it would be a public offer, involving particulars like a prospectus and associated compliances, including listing of such securities on a recognised stock exchange, which could be quite meaningless for a start-up. The route of Public offer has always been considered as a commercially unviable option by early stage entrepreneurs and start-ups. There is always an option of private placement. But, if we look at the current situation, as is presented in SEBI's consultation paper, it has limited the number of investors^{xx} and the category of investors^{xxi}. This again leaves us in a dilemma, whether to call Crowdfunding a public offer or a private placement. In a situation, where a company approaches the public for investment and at the same time, limit the number to 200, it would neither be called a public offer, nor a private placement. It would rather lie in between the two options. This dilemma has further led to the unsolved confusion of the jurisdiction, i.e. of SEBI or the Ministry of Corporate Affairs. While SEBI has been given the power to prevent undesirable actions and protect the interest of investors, the power to regulate and administer private placements is given to the Ministry of Corporate Affairs. The Supreme Court in the landmark judgment of Sahara India Real Estate Corporation Ltd.v. SEBI^{xxii}, observed that as per provisions specified under Section 55A of the Companies Act, so far matters relate to issue and transfer of securities and the failure to pay dividends, SEBI has the power to administer in the case of listed public companies and in the case of those public companies who anticipate to make their securities get listed on a recognized stock exchange in India. Though this judgment has bridged the gap and covered the grey areas which were present in regards to jurisdiction of SEBI and Ministry of Corporate Affairs, there is yet a loophole created by the consultation paper presented by SEBI. In the absence of any legislative support, the purported regulatory and administrative authority of SEBI to promulgate a whole mesh of regulations on Crowdfunding seems certainly against all canons of delegated legislation. One could have reasoned a fortiori that the appropriate authority in this case would be the MCA which has been vested with the residuary rule-making power under the Companies Act.^{xxiii} Since Crowdfunding has the characteristics of both public offer and a private placement, it can also be referred as a hybrid transaction, falling under the purview of SEBI as well as Ministry of Corporate Affairs. Therefore, both have an overlapping jurisdiction in the same. In such a situation, where both have equal jurisdictions, it would be a viable option, that the regulators redraw the contours of regulations by explicitly recognising the

intrinsic nature of crowdfunding before arriving at an appropriate regulatory framework. There is a crying need for a set regulation for crowdfunding in India. There needs to be a stringent regulation for the benefit of stakeholders and this needs to be done by SEBI in collaboration with banking regulator Reserve Bank of India, Finance Ministry, Ministry of Corporate Affairs^{xxiv} and others, before taking a call on who can be the nodal agency for such activities^{xxv}, so that there is a balance between protection of investors and promotion of entrepreneurship.^{xxvi} Our policy makers can also take inspiration from United States. In order to accord recognition to crowdfunding activities, the US Congress opted to create an exemption by adding Section 4(a)(6) under the Securities Act.^{xxvii} Although Securities Exchange Commission had an express authority in the matters of Crowdfunding, still, for the benefits of the stakeholders, it opted to take this step. A proper regulatory framework can be brought into place after considering that will regulate Crowdfunding and secondly, how will it be regulated. For the former, the legislature needs to discuss and debate over which body is perfect and equipped to regulate this kind of platforms. And for the latter, it would make a lot more sense, if the regulators conducted an assessment study of crowdfunding before crafting concrete legislations. The assessment which needs to be done should also include the risks and advantages of Crowdfunding in the Indian Scenario. The growing popularity of the "Crowdfunding" phenomenon makes it impossible to ignore its significance. While standardizing crowdfunding, it is pertinent to note that while it is really important to ensure that start-ups and small and medium enterprises are able to raise their funds without any problems, it is equally important to make certain that systematic risks are avoided. If there is any lack of regulations surrounding investments through crowdfunding, it may leave the investors in a wobble, if the companies are found to be badly governed. As said by Dam Moram, a crowdfunding expert, *“Without adequate regulation, fraud is one major concern for investors. With regulation, influence of strong investors on the organisation and its management can be levelled.”*^{xxviii}

SEBI Consultation Paper 2014 Analysis And Suggestions

The Consultation Paper that was released in 2014 was aimed at the start-ups and small scale medium enterprises. SEBI, through this paper, recognised Crowdfunding as an alternative method of financing for raising capital by the small scale enterprises and start-ups. This method of Crowdfunding will be in addition to the Institutional Trading Platform etc. The paper published by SEBI is not only a detailed analysis of the concept of Crowdfunding, its risks and advantages but also contains a description of Crowdfunding laws in various countries and the legal regime that exists in India like the Companies Act, 2013 and a variety of SEBI regulations that exist.^{xxix}

Through these guidelines SEBI seeks to regulate the issuers, the investors and the entities that raise fund through the platforms. The issuers are the individuals who invest through these Crowdfunding platforms and the issuers are those who raise funds for the businesses.^{xxx}

Regulations provided for the issuers is inclusive of the fact that the company must not have been established more than 48 months ago and further it should not be a listed company. The size of the issue, i.e, capital raised by the company should not be more than INR 100 million. The company in no way must have been sponsored, promoted or related to an industrial group which has a turnover of more than of INR 25 Crores or have a business that is established. There are also other restrictions like, the issuing company should be along with its directors, promoters or associates, 'fit and proper' as specified under the SEBI (Intermediaries) Regulations, 2008, Schedule I etc.^{xxxi} The regulations for investors that have been provided in the Consultation Paper seem like this concept of Crowdfunding is going to be limited to those who are knowledgeable in that particular area of business or to those who have the capacity to bear losses. Only “Accredited Investors” are officially recognized to invest, these include the Qualified Institutional Buyers, high net worth individuals, companies who have a minimum net profit worth of INR 25 Crores and are incorporated in India and lastly the retail investors. These retail investors are also required to follow a certain criteria provided in the paper to be eligible as investors, not all retail investors are eligible. Those who are the eligible retail investors have to necessarily ensure that they do not invest more than INR 60,000 in any crowdfunded issue and do not invest more than 10% of the net worth in these activities of crowdfunding.^{xxxii} The entities that raise investment also have to follow particular criteria on the basis of their division. They are divided into three categories- Class I Entities, Class II Entities and Class III Entities. Class I Entities are those which are recognized stock exchanges and SEBI Depositories. Apart from these SEBI has also proposed other entities. Class II includes Technology Business Incubators and Class III includes Associations and Networks of Private Equity or Angel Investors.^{xxxiii}

There are a few major problems in the above mentioned provisions that have been provided for in the Consultation Paper. The major problem regarding this is that SEBI has included only the unlisted public companies to be eligible for crowdfunding. But, the start ups or small enterprises are generally listed as a private company. This is because there are easier compliance norms to follow and they do not have much capital. Thus, SEBI should have included private companies, LLPs or other forms under the Consultation Paper so that even they can fund through crowdfunding.^{xxxiv} Also, SEBI can provide for a platform wherein the companies can display the

status of their company and profits and losses that they are in so that the investors can invest in the companies without any hindrance and along with this a fair price can be maintained.^{xxxv}

Next, it can hardly be said that any of the accredited investors would be giving “small amounts” towards the financing of the company, which was the very essential part of the concept of crowdfunding. Further, unlike what the name suggests, SEBI has restricted the investor to only accredited investors. The retail investors are also required to possess certain criteria like having knowledge of the investment or being able to get advice regarding the investment and with all this they should also possess the ability to bear the losses, with all these there is hardly any “crowd” left in the word crowdfunding.^{xxxvi} The fact that according to the SEBI Consultation paper, companies that are seeking funding through this mechanism are also prohibited to advertise in any form or promote their company in any way to attract investors add to the point. Also, there seems no reason as to why such accredited investors would invest using crowdfunding as there are other options available to them, and crowdfunding is just putting these other platforms on the internet in a way. According to the Consultation Paper the QIBs are required to invest a minimum of 5% of each company they invest in using the crowdfunding methods, if this is applied then only those start ups would succeed which have been invested in by these QIBs. Thus, in this way retail investors would also get to invest in only those which start ups in which QIBs have invested. So in the real sense crowdfunding would not be used for all start ups even by the inclusion of retail investors. Regarding this, SEBI should open up its definition of investors to include more people so that it can be considered “crowdfunding” in the more real sense. And it should be ensured that autonomy of QIBs does not exist and the retail investors also get to invest in companies they want.

In the SEBI Paper, according to the guidelines the maximum limit that has been kept on the capital that can be raised through a process of crowdfunding is kept to be INR 10 Crores in a period of overall twelve months. Whereas, this limit on capital that can raised in other countries is a lot lesser, like in US it is pegged at INR 6 crore, INR 20 crore in UK, INR 9.8 crore in New Zealand, INR 7.8 crore in France and INR 8.2 crore in Canada. Hence, the amount set up by SEBI is considered to be unrealistic keeping in mind the average quantity of investments that come to Indian start-ups.^{xxxvii} So it should reduce the amount to come on a more realistic one that has significance in the actual Indian scenario.

Next, SEBI has also provided with certain regulations that the companies which are raising fund by method of crowdfunding have to follow. They have to disclose all the information truthfully and provide all facts clearly so that they can raise funds. Also, this information provided will help

the investors who are funding their companies to take well informed decisions. To disclose the companies have to provide a Private Placement Offer Letter with proper and complete details of the company, its management, financial condition, past history, issue size, rights and liabilities attached to securities, etc.^{xxxviii} Though it has not been clearly specified but it might be needed out of the issuers to employ a financial analyst and ask him to provide with a “compulsory rating” regarding the practicability and feasibility of the venture that the company is in to. This is to ensure that the investors can make an informed decision regarding their investment. These regulations seems to be with burdensome on the face of it because the companies opting for this method of fund raising are all small and new issuers, and such obligations that are generally put on private and public companies should not be put on them.^{xxxix} Moreover, these companies would not even have sufficient resources to provide such a detailed disclosure of their companies which would effectively help the interested investors to make a decision. Instead, these companies could wind up giving extra information about themselves and thus causing harm to themselves. On the hand if we would see, then investor protection is sole responsibility of these regulations. In a way policymakers keep on struggling between extreme investor protections and ensuring benefits for the start up ventures.^{xl} Thus, the ideal situation would be if the portals would help these companies to arrange for the appropriate disclosure and later charge fee that they might have incurred in the process of helping them.^{xli} The cost effective way out for the companies in this regard could be to come up with certain guidelines upon which all of the companies agree on unanimously. These guidelines would ascertain a set criterion for companies to rate themselves on. In this way a standard could be maintained for all investors to look into and it would become easier for the companies too.

Another issue with the Consultation paper is that there is no secondary market provided for the investors. Securities cannot be transferred to anyone else except to the issuer provided that it has been made in accordance with the sections of Companies Act 2013 and the rules made under it which are in relation to the buyback of securities by unlisted public companies, another accredited investor who has been registered and a family member or a relative or a friend of the accredited investor or any such person who is an equivalent to these.^{xlii} Now, since there is no secondary market provided, the investors do not have any exit option available to them. This exit option is necessary because at times the company may not be able to give expected returns or have some internal mismanagement and in that case investors always prefer to have a safe option of exiting the whole chaos with them. The unavailability of this option could create a detriment amongst the

investors to engage in such crowdfunding activities, they would rather prefer to go along with another option in which they can safely back out if the venture does not work out according to their needs. Though, on the other hand if we see, an argument in favour of this could be that the concept crowdfunding is to fund companies by raising capital and not providing the investors exit options that may help them resale their securities.^{xliii} In other countries like the US, the securities are locked in for a period of one year after which they can be resold. In this one year also, securities can be sold to an accredited investor or to a family member of the investor. In UK, investors can transfer their securities in case of happening of certain events like the sale of the company or floatation happens or management buy-out takes place.^{xliv} SEBI should amend such a strict provision and provide for a more open provision. Some extent of reselling should be allowed, like reselling on the platform with the supervision of the forum to ensure no manipulation is practiced, should be permitted so that this issue does not become a detriment for investors.

The SEBI Consultation Paper had discussed various issues but the one issue which is missing from been taken into account is that of cross-border crowdfunding. Cross-border crowdfunding could take into shape in two possible ways. First would be the aspect of some foreign investor investing in an Indian company through crowdfunding and the second would be some foreign company raising funds through crowdfunding from Indian investors. The issues that might be raised are firstly, the extent of jurisdiction of SEBI to regulate these transactions. Will a non-resident investor be governed by the provisions or will the regulations still apply if an Indian investor invests in a foreign company raising capital through crowdfunding? Secondly, what will happen in case of insolvency of a cross border platform? Thirdly, there might be cases in which Indian investors do not completely appreciate the legal results or the legal operations of the investment they made and fourthly, there may be cases where funds are raised by a foreign parent company in a jurisdiction with feasible crowdfunding provisions and later these funds are transferred to its subsidiary in India. This way Indian provision of crowdfunding could be by passed and issuer can chose a favourable set up for him. How will SEBI regulate this?

In all such cases and many more, there have been no proper guidelines provided by SEBI, to satisfactorily provide an answer. If SEBI tries to incorporate this in its regulations then the contract law of various jurisdictions would be required to be kept in mind. It is precisely this ambiguity which makes various platforms deter from entering into cross-border investments. This ambiguity in the various contract laws could be resolved by interference of an international platform. If an international platform is provided for such kind of cross-border investment there will be a much

lower level of risk in this particular issue.^{xlv} Another option could be all that of all countries taking a stand together to stop such menace of by passing laws, but the major issue in this would be that countries with flexible crowdfunding provisions would not like to co-operate and would rather attract investors and issuers.^{xlvi}

Thus, the above was a short analysis of the important features that are present in the crowdfunding consultation paper issued by SEBI followed by a detailed criticisms and suggestions regarding those important features. By the incorporation of the suggestions the prospects of crowdfunding would increase and the provisions related to them would be more practical and thus their implementation would not be a problem once they are finalised and published.

Conclusion

To summarize everything it can be said that this concept of crowdfunding which is going to be introduced in the Indian laws is a complicated concept having both its advantages and risks. Mostly all the risks associated with crowdfunding are related to the internet. If the internet becomes a safer place carry out activities of trade and commerce at, then crowdfunding as a concept would be able to reach its potential to full and would function as a channel in realizing dreams of various people. Also, to build trust in people, some provisions should be such that would make this process of crowdfunding offline too. This could be a starter so that people start being more comfortable with the whole idea and eventually it can be shifted online. Awareness programs could be initiated by SEBI to teach investors, issuers and platforms intrinsic details about the procedure. Also, some training sessions could be made mandatory so that a basic uniform standard could be adopted in the whole process. The aim should be to gain confidence in people so that they can start trusting and move ahead with fulfilling their dream projects. Meanwhile the determination and fixing of flaws in the present online system should be worked upon.

Before going on to concluding the consultation paper, the authors would like to reiterate that according to them the introduction of such a paper by SEBI is an erroneous move and instead it should have been brought out by both SEBI and MCA so that no questions on its legality would have occurred. The question of the jurisdiction over the Crowdfunding matters is still not determined due to the undetermined nature of crowdfunding activities. On one hand SEBI is trying to bring into picture such a latest and new trend, but on the other hand but not looking into the details, SEBI has created a negative image for itself as such an important regulatory body.

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- ^{xiii} The Reserve Bank of India Act, 1934.
- ^{xiv} Supra 1, para 7.3.2
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- ^{xvi} Supra 1, Para 7.2.
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^{xxxix} Supra 1, para 9.9.4.

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