

## EQUITY CROWDFUNDING IN INDIA: TOWARDS A REGULATORY FRAMEWORK

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### 1. INTRODUCTION

Crowdfunding has emerged in recent times as an alternative means of raising capital for entrepreneurial ventures and small businesses trying to carve out a space in the market. Crowdfunding is increasingly gaining popularity in India and has been used for projects and campaigns such as Teach for India<sup>1</sup> and the Goa Project<sup>2</sup>. Several filmmakers have also relied on raising funds through crowdfunding.<sup>3</sup> The Securities and Exchange Board of India (SEBI) released a Consultation Paper on Crowd Funding in July, 2014 (hereinafter “**Consultation Paper**”), where it defined crowdfunding as a ‘*solicitation of funds from multiple Accredited Investors through a web-based platform or social networking site for a project, business venture or social cause*’.<sup>4</sup>

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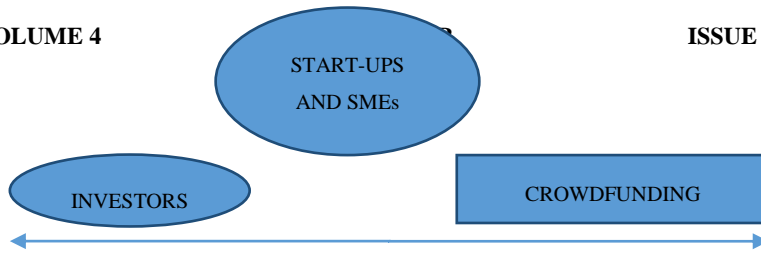
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<sup>1</sup> TEACH FOR INDIA PROJECT, <http://www.teachforindia.org/>.

<sup>2</sup> THE GOA PROJECT, <http://www.thegoaproject.com/>.

<sup>3</sup> See, for e.g., Pawan Kunar, LUCIA; Abhay Kumar, PLACEBO.

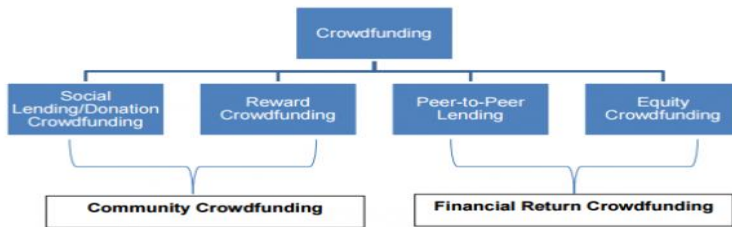
<sup>4</sup> *Supra* note 2, p. 1.



Crowdfunding as an avenue of raising capital has three entities: the investors allowed to invest (hereinafter “**Accredited Investors**”), the small and medium enterprises (inclusive of start-up companies) allowed to raise funds through crowdfunding platforms (hereinafter “**SMEs**”), and the intermediaries (hereinafter “**Crowdfunding Platforms**”) that facilitate the meeting of the Accredited Investors with the SMEs.

What do the Crowdfunding Platforms get in return for facilitating the meeting of the Accredited Investors and the SMEs? Crowdfunding Platforms charge a fee from both the Accredited Investor as well as the SME. The more credible the Crowdfunding Platform is, the higher is the rate of fee charged. Thus Crowdfunding Platforms are incentivized to have highly active screening committees to ensure that a large number of Accredited Investors choose their platform to invest, and this would in turn attract a large number of credible SMEs on such platforms.

The International Organisation of Securities Commission (hereinafter “**IOSCO**”) has identified four types of crowdfunding:



Source: IOSCO Staff Working Paper - Crowd-funding: An Infant Industry Growing Fast , 2014

Donation crowdfunding is the solicitation of funds for social purposes, while reward crowdfunding is a category of crowdfunding where Accredited Investors receive existing or future tangible rewards for their investments.<sup>5</sup> Peer-to-peer lending allows for a debt based means of raising capital, where entrepreneurs are lent a certain sum of money which they have to pay back after a certain period of time (more often than not, with interest). Under equity based crowdfunding, equity shares of the company seeking funds are issued to the Accredited Investors as consideration for their investment.<sup>6</sup> The researcher will primarily be focusing on the niche area of equity based crowdfunding in the length of her paper.

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<sup>5</sup> *Supra*, note 2, p. 2.

<sup>6</sup> *Ibid*, p. 3

## 2. LOOK AT SEBI'S CONSULTATION PAPER

### 3. BACKGROUND

SEBI's framework in the Consultation Paper provides for crowdfunding as a means of raising capital, through a comparative study of the concept in several jurisdictions, and an assessment of benefits and risks associated with it. The Consultation Paper aims at reaching a regulatory framework for crowdfunding in India by identifying creative projects, benevolent causes, and start-up ventures as being ideal avenues for the same.<sup>7</sup>

Typically, SMEs are funded through loans from financial organisations, angel investors, or through private equity.<sup>8</sup> However, equity based crowdfunding has been gaining popularity as an alternative means of raising capital for start-up ventures and companies. Equity Crowdfunding Platforms in India include Ketto, Wishberry, catapult, etc.

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<sup>7</sup> *Ibid.*

<sup>8</sup> *Ibid.*, p. 4

Table 1: Table Illustrating The Different Equity Crowdfunding Platforms In India And Depicting Facts About Them

<b>CROWDFUNDING SITES IN INDIA- OPPORTUNITIES AND FACTS</b>					
	<b>CATE GORY</b>	<b>FUNDRA ISED SO FAR</b>	<b>UPFRON T LISTING</b>	<b>SITE FEE</b>	<b>PAYMEN T PRCOES SING FEE</b>
MILAAP	Social Causes	4.18 Million USD	Free	Their website claims that they disburse 100% to borrowers	Informatio n Unavailabl e
KETTO.O RG	All	INR 4 Crores	Free	5%	5%
START51	All	INR 16,95,062	Free	5%	Informatio n Unavailabl e
FUNDDR EAMSIN DIA	All	Informatio n Unavailab le	Free	5%	3.95%
WISHBE RRY.IN	All	INR 4.5 crore	INR 2,500 plus taxes	10% (Includes Payment Processing Fee)	N/A

CATAPU LT	All	INR 75 lacs	Rs 1,499	Standard- 10%; Premium- 15%, Advanced- 15% plus	Information Unavailable
BITGIVIN G	Social Causes	INR 35 Lacs	Free	Information Unavailable	Information Unavailable

**Source:** Table compiled on 12<sup>th</sup> May, 2015 by Binnews

### 3.1.1. *Towards Regulation*

Through the Consultation Paper, SEBI seeks to propose a regulatory mechanism and invites comments and suggestions in this regard. If the costs that are associated with regulation are excessive, then crowdfunding may not be a viable method at all. The optimum level of regulation should be such that it puts crowdfunding at an equal or higher advantage than private placements and initial public offers (hereinafter “**IPO**”).

In its Consultation Paper, SEBI identifies equity based crowdfunding as being based on the private placement model under Section 42 of the Companies Act, 2013 (hereinafter “**Companies Act**”). The three parties who will be the subject

of regulations are: Accredited Investors, SMEs, and Crowdfunding Platforms.<sup>9</sup>

### 3.1.2. *Accredited Investors*

Potential investors must understand the inherent risks involved, the illiquid nature of the securities issued, and be capable of bearing any loss that may arise. In this context, SEBI proposes that only Accredited Investors be allowed to participate in crowdfunding. These include:

- a) Qualified Institutional Buyers (hereinafter “**QIB**”)
- b) Companies incorporated under the Companies Act, having a net worth of at least INR 20 Crores
- c) High Net Worth Individuals (hereinafter “**HNIs**”), where the minimum net worth should be INR 2 Crores
- d) Eligible Retail Accredited Investors (hereinafter “**ERIs**”), who receive investment advice or have passed an appropriateness test.<sup>10</sup>

Apart from this, retail investors are eligible to invest only if they earn a minimum gross income of INR 10 Lakhs, and have properly filed tax returns for 3 years. Furthermore, to protect them from risks, SEBI wishes to impose an investment cap of

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<sup>9</sup> *Ibid*, p. 30.

<sup>10</sup> *Ibid*, p. 31.

INR 60,000 on them, and prohibit them from investing more than 10% of their net worth through crowdfunding.<sup>11</sup>

### 3.1.3. *SMEs*:

SMEs must satisfy the following conditions if they wish to be eligible to register themselves on a Crowdfunding Platform:

- a) The SME allowed herein must be an early stage SME or a start-up that intends to raise a capital of not more than INR 10 Crores in a one year period;<sup>12</sup>
- b) The SME must not be promoted, sponsored or related to any other group with a turnover of more than INR 25 Crores;
- c) The SME cannot be more than 48 months old, and cannot be listed on any exchange;
- d) The SME, its directors, promoters or associates must be 'fit and proper' persons as specified under Schedule II of Securities and Exchange Board of India (Intermediaries) Regulations, 2008;<sup>13</sup>

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<sup>11</sup> *Ibid*, p. 32.

<sup>12</sup> *Ibid*, p. 37.

<sup>13</sup> *Ibid*, p. 37.



- e) The SME cannot use multiple Crowdfunding Platforms within a 1 year period and cannot directly or indirectly advertise their offer to the public in general;
- f) Disclosures are required to be made at the time of registration with a Crowdfunding Platform, as well as at regular and ongoing intervals. This is so as to enable Accredited Investors to make an informed decision and keep a track of the appreciation of their investments. Though future projections are not ordinarily allowed, SEBI proposes that these be allowed owing to the lack of any business history. However, the projections made must be realistic.<sup>14</sup>
- g) SEBI proposes that a private placement offer letter be submitted to the crowdfunding portal by the SME. This would contain the SME's name and registered address, issue size, description of the venture, past history of funding, history of prior refusal from a Crowdfunding Platform, financial statements, price of securities, rights and liabilities attached, details of the venture's management, major risks involved, and a dispute resolution

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<sup>14</sup> *Ibid*, p. 40.

mechanism.<sup>15</sup>This would be circulated to Accredited Investors.

#### 3.1.4. *Crowdfunding Platforms*

The main objective of crowdfunding is to keep fraudulent SMEs at bay. Therefore, the Consultation Paper suggests that:

- a) All Crowdfunding Platforms must be registered with SEBI; these include recognized stock exchanges, SEBI registered depositories, and other SMEs with specific domain knowledge and experience. Technology business incubators, angel investors or private equity associations are also proposed to be allowed if they satisfy certain conditions.<sup>16</sup>
- b) These entities must take reasonable measures to reduce the occurrence of fraud, and must conduct necessary due diligence. The directors, promoters and shareholders are also to be scrutinized. Any information presented by the SMEs must be verified, and information must be transmitted to SEBI as and when called for.<sup>17</sup>

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<sup>15</sup> *Ibid*, p. 39.

<sup>16</sup> *Ibid*, pp. 47-48.

<sup>17</sup> *Ibid*, p. 49.

- c) The Crowdfunding Platform must also have a fair process, its own domain ID/ website recognized and certified by SEBI, and a procedure to address possible conflicts.
- d) SEBI has also provided measures against the possibility of cyber crimes being committed.<sup>18</sup>

#### 4. NECESSITY OF CROWDFUNDING

SEBI's Consultation Paper notes the gravity of the financial crisis of 2008, which caused the failure of several banks, making them reluctant to lend to small businesses as this might involve high risks and low returns.<sup>19</sup> SEBI, in the context of the financial crises and an stagnating IPO market, recognised the need to encourage innovative and sustainable ways of fund raising, and aims to provide an impetus to genuine SMEs.<sup>20</sup>

More recently, the Non- Performing Assets (hereinafter "NPAs") of banks have increased to such an extent, that the government has drafted a bill<sup>21</sup> to amend the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 to deal with these NPAs. Banks

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<sup>18</sup> *Ibid*, p. 50.

<sup>19</sup> *Supra* note 1.

<sup>20</sup> *Ibid*, p. 27.

<sup>21</sup> Surabhi Aditi Nigam, *FM introduces Bill to fast track recovery of bad debt*, (June 30, 2016), <http://www.thehindubusinessline.com/economy/jaitley-introduces-amendments-to-fast-track-loan-recovery/article8585023.ece> .

have become extremely cautious while lending to enterprises and there is additional pressure from the government too, to be highly selective while doing so.<sup>22</sup> Hence SMEs do not have a chance of borrowing money from banks as they have no previous experience to prove their credence, nor do they have any collateral to give. In such a situation, the avenue of crowdfunding as a means of raising capital has captured the imagination of the public.

SEBI's concerns lie in balancing out the impetus to be provided for SMEs vis-a-vis the systemic risks involved in crowdfunding as such.<sup>23</sup> The IOSCO working paper on crowdfunding (hereinafter "IOSCO Working Paper") referred to by SEBI,<sup>24</sup> notes that regulating a previously exempt sector might give credibility to transactions that are mired by risks, and it could attract less experienced investors who could stand to lose.<sup>25</sup>

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<sup>22</sup> Dinesh Unnikrishnan, *Bank NPAs: The Rot Runs Deeper and the only Solution is more Radical Reforms*, (June 30, 2016), <http://www.firstpost.com/business/bank-npas-the-rot-runs-deeper-and-the-only-solution-is-more-radical-reforms-2518888.html>.

<sup>23</sup> *Supra* note 24, p. 28.

<sup>24</sup> Eleanor Kirby, Shane Worner, *Staff Working Paper of the IOSCO Research Department*, (June 27, 2016), <http://www.iosco.org/research/pdf/swp/Crowd-funding-An-Infant-Industry-Growing-Fast.pdf>.

<sup>25</sup> *Supra* note 27, p. 14.

## 5. GOVERNING LEGISLATIONS IN INDIA

The existing legal framework which governs the raising of capital for a business venture comprises:

- a) the Companies Act,
- b) the Securities and Exchange Board of India Act, 1992 (hereinafter “SEBI Act”),
- c) the Securities Contracts Regulation Act, 1956, and
- d) the Depositories Act, 1996.

The two means by which capital can be raised are through a private issue of securities, and through a public offer.<sup>26</sup>Section 2(68)(iii) of the Companies Act, prohibits a private company from making invitations to the public to subscribe to the securities of the company. Therefore, to seek funds from the public, the company must be listed, and cannot be a private limited company. This presents the first hurdle to crowdfunding.

Section 24 of the Companies Act, provides that the issue and transfer of public securities are to be governed by the rules of SEBI. Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009 (hereinafter

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<sup>26</sup> CHAPTER III, RULE 23, COMPANIES (PROSPECTUS AND ALLOTMENT OF SECURITIES) RULES, 2014.

“ICDR”), require public issuers to adhere to very specific requirements such as the appointment of a merchant banker and registrar to the issue, filing of a draft offer document with SEBI, eligibility conditions, as well as detailed disclosures and risk highlights to be made.<sup>27</sup> Not only are such conditions a financial impossibility for SMEs who barely have any capital, but these disclosures pose great difficulty to the new entrants to the market who have very little know-how with regards to such disclosures and legal compliances.

Hence, the avenue of crowdfunding in India is governed by the following:

- a) The idea of equity crowdfunding falls within this private placement model espoused by Indian corporate law. With respect to private placements, Section 42 of the Companies Act, along with Chapter III of the Companies (Prospectus and Allotment of Securities) Rules, 2014 (hereinafter “Companies Rules”), provides that private placements cannot be made to more than 200 persons in one financial year (excluding QIBs and employees of the company being offered securities under an employee stock option scheme

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<sup>27</sup> SECURITIES AND EXCHANGE BOARD OF INDIA (ISSUE OF CAPITAL AND DISCLOSURE REQUIREMENTS) REGULATIONS, 2009.

(hereinafter “ESOPs”).<sup>28</sup> Each of such persons are to receive the offer by name, and there are also specific rules with respect to the mode of subscription by such persons.<sup>29</sup>

- b) Further, Section 12(1) of SEBI Act requires intermediaries dealing in securities to be registered, and a certificate of registration obtained from SEBI. A Crowdfunding Platform would necessarily be such an intermediary, and would have to obtain a certificate in accordance with the rules of SEBI.
- c) With regard to SMEs, SEBI has laid down several regulatory mechanisms in the recent past. SMEs can list their securities on an ‘SME Segment’ on recognised stock exchanges.<sup>30</sup> Various relaxations for such SMEs are provided under the ICDR: the draft offer document may be filed directly with the exchange, and requirement of filing it with SEBI first is done away with.<sup>31</sup> The eligibility criteria provided under Regulation 26 therein are not applicable to SMEs.<sup>32</sup> Half yearly returns may be filed instead of

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<sup>28</sup> RULE 14(2), COMPANIES (PROSPECTUS AND ALLOTMENT OF SECURITIES) RULES, 2014.

<sup>29</sup> RULE 14, *Ibid.*

<sup>30</sup> SEBI, LISTING OF SMALL AND MEDIUM ENTERPRISES (SMEs) AND START-UP COMPANIES ON SME PLATFORM WITHOUT MAKING AN INITIAL PUBLIC OFFER, (July 3, 2016), [http://www.sebi.gov.in/cms/sebi\\_data/boardmeeting/1373435315913-a.pdf](http://www.sebi.gov.in/cms/sebi_data/boardmeeting/1373435315913-a.pdf).

<sup>31</sup> *Ibid.*

<sup>32</sup> *Ibid.*

quarterly, and financial results need not be published in the newspaper.<sup>33</sup>

- d) Another platform provided by SEBI for SMEs, is called the Institutional Trading Platform (hereinafter “ITP”). Only those SMEs which have not listed any securities on any recognised stock exchange are permitted to list their securities exclusively on the ITP.<sup>34</sup> It does not involve a private placement or public offer; the objective of the ITP is to provide an initial impetus for SMEs.<sup>35</sup> SEBI has made listing on the ITP attractive by making it cost effective, easy, and tax beneficial. By availing this option, SMEs can reduce their debt burden by attracting private equity players.

## 6. RISKS ASSOCIATED AND BENEFITS ACCRUED

### 6.1. Risks:

The central idea that backs crowdfunding is to solicit small investments from a large number of investors. The Consultation Paper attributes such cautions to investors whose risk tolerance is very low. Since investments in SMEs involve

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<sup>33</sup> *Ibid.*

<sup>34</sup> *Supra* note 2, p. 22.

<sup>35</sup> CHAPTER XC, SECURITIES AND EXCHANGE BOARD OF INDIA (LISTING OF SPECIFIED SECURITIES ON INSTITUTIONAL TRADING PLATFORM) REGULATIONS, 2013



low liquidity and high risks, this could be dangerous to uninformed Accredited Investors.<sup>36</sup> The risks posed by raising capital through crowdfunding are several:

- a) Since the solicitation of funds occurs through an online portal, in cases of default, fraud, or if the web portal shuts down, the Accredited Investors would have no recourse. The public funding here is sought for future possibilities, as

Bubble and Balm, a soap manufacturing company in the UK, raised funds through the equity crowdfunding platform Crowdcube in 2011. It closed overnight in, having raised money from 82 Accredited Investors, who lost 100% of their investments and had no way of contacting the company.

against concrete business plans assessed for viability under existing regulations.

- b) The internet plays a central role in crowdfunding, and its essentially wide reach could expose a larger number of people to risk by bypassing local laws as compared to traditional means of fundraising.<sup>37</sup>
- c) SEBI also identifies systemic risks: illiquidity due to lack of a secondary market to sell the securities, potential of

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<sup>36</sup> *Ibid*, p. 5.

<sup>37</sup> *Ibid*, p. 7.

money laundering, cross border jurisdictional disparities, lack of monitoring and transparency, and the inherent information asymmetry that arises as there is no mandated offer document.<sup>38</sup> In a regular issue of securities by a company, such securities can be freely traded in the market.<sup>39</sup>

- d) Securities obtained through making investments by crowdfunding cannot be traded on Crowdfunding Platforms, as these companies will not be treated as listed companies. Accredited Investors do not have the option of selling their securities at a desired time. While a regular secondary market may not be permissible given the regulatory framework for stock exchanges, crowdfunding web portals can create a platform for information exchange.<sup>40</sup>

## 6.2. **Advantages:**

Nonetheless, equity crowdfunding has several advantages. The most significant one that appeals to SMEs is the lack of stringent regulation and requirement of several compliances. Companies that raise funds from 50 or more investors are

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<sup>38</sup> *Ibid*, p. 8.

<sup>39</sup> SECTION 56, COMPANIES ACT, 2013.

<sup>40</sup> *Supra*, n. 28, p. 25.

required to release a public offer, regulated under the Companies Act, as well as the ICDR.<sup>41</sup> Using a web portal for crowdfunding, an entrepreneur can get across an idea and the project proposed can be financed by several hundreds of potential Accredited Investors. Other advantages include the spreading of risk and an overall boost to the economy.<sup>42</sup>

## 7. JURISDICTIONAL COMPARISON OF CROWDFUNDING REGULATIONS

In this chapter, the researcher has conducted a comparative study of the legal status of crowdfunding in other countries and the repercussions of such regulations on their respective economies.

### 7.1. The United States of America

The US has over-regulated crowdfunding through the Jumpstart Our Business Startups Act, 2012 (hereinafter “JOBS Act”).<sup>43</sup> Though JOBS Act allows advertising and marketing a company’s investment opportunities through social media, web based platforms etc. and a crowd sourced equity funding

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<sup>41</sup> SECTION 42, COMPANIES ACT, 2013.

<sup>42</sup> Ibrahim, Darian M., *Equity Crowdfunding: A Market for Lemons?*, Minnesota Law Review, Forthcoming; William & Mary Law School (June 30, 2016), <http://ssrn.com/abstract=2539786>.

<sup>43</sup> *Supra* note 2, p. 11.

option allows SMEs to obtain moderate amounts of capital, the act also imposes caps as to the amount of money that can be raised per year through crowdfunding, disclosure documents and annual reports are to be filed with the regulating agency. Funding platforms are prohibited from offering investment advice or making recommendations.

## 7.2. **The United Kingdom:**

Similar to the US, the UK has several stringent regulations on crowdfunding in place which define investors as an exclusionary specific group and impose an upper cap on investment. A highly successful crowdfunding scene,<sup>44</sup> regulations in the UK further provide that adequate and fair information must be provided which is not misleading and risks should be highlighted.

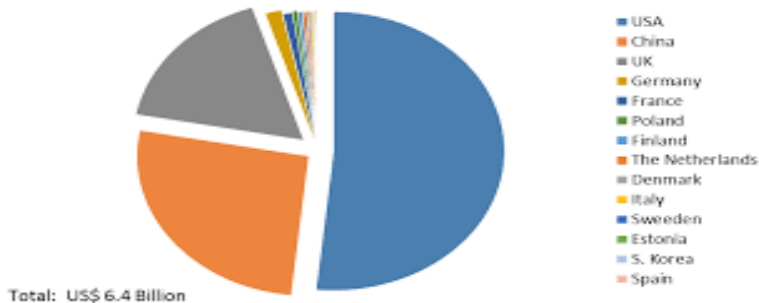
A measure taken by the UK Government to make the avenue of crowdfunding risk averse is to make it mandatory for investors to pass an online appropriateness test to prove that they are aware of the risks.

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<sup>44</sup> Samantha Hurst, *Half a Decade of Success, Crowncube Releases a New Video*, *Crowdfund Insider*, (June 28, 2016), <https://www.crowdfundinsider.com/2016/07/87449-crowdcube-releases-new-introduction-video/>.

### 7.3. New Zealand:

New Zealand is the most crowdfund-friendly jurisdiction in the world. The Financial Markets Conduct Act 2013, regulates equity based crowdfunding and peer to peer lending in New Zealand. A license must be obtained for portals as well as investment seekers to raise funds through crowdfunding. Though the statute imposes a cap on the amount that can be raised, it does not impose any base minimum or upper cap on the amount that is to be invested or imposes any distinction between retail and sophisticated investors.<sup>45</sup> This makes New Zealand conducive to this alternate means of raising capital.



**Source:** IOSCO Working Paper- Equity Crowdfunding country wise in September 2014.

<sup>45</sup> FINANCIAL MARKETS AUTHORITY, NEW ZEALAND GOVERNMENT, (June 29, 2016), <https://fma.govt.nz/compliance/role/crowdfunding-platforms/>.

## 8. CRITICAL ANALYSIS

The proposal made by SEBI in its Consultation Paper seeks to amalgamate a new law on crowdfunding with the existing laws regulating the raising of capital for a business venture. For the concept of crowdfunding to work well as an alternative mode of seeking investments, the amount of regulation needs to be optimum, and must balance out impetus creation as well as investor protection, and cover all the expected areas of risk. There are several issues arising from the proposed regulatory mechanism.

### 8.1. Clarification with regards to transfer of shares in secondary markets:

#### 8.1.1. *Provision:*

The Consultation Paper provides for the transfer of securities in the following ways:<sup>46</sup>

- a) Through a buyback of securities under the Companies Act;
- b) To another accredited investor on the same portal where the securities were bought through crowdfunding; and
- c) To a family member or relative or friend of the existing investor.

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<sup>46</sup> *Supra* note 46, p. 25.

### 8.1.2. *Analysis*

Not only is this list highly restrictive, but there is also a lack of a clear definition as to who constitutes a valid transferee for securities to be transferred to ‘family members’, ‘relative’ or ‘friends’. This lacuna could give rise to informal, unregulated secondary markets, confusion and litigation. SEBI should provide us with a clarification on the definition of ‘family member’, ‘relative’ and ‘friends’, and possibly expand the ambit of its secondary market.

## 8.2. **Stance on Cross-border funding should be clarified:**

### 8.2.1. *Provision:*

No provision on Indian investors involved in crowdfunding opportunities in other jurisdictions.

### 8.2.2. *Analysis:*

Since crowdfunding essentially occurs on a web platform, it would be accessible to Accredited Investors outside the country as well. A foreign company may raise funds in India and foreign investors may participate in crowdfunding activities in India. It is also possible that Indian Accredited Investors may seek to be involved in crowdfunding opportunities in other jurisdictions. The corresponding

question to be answered is whether SEBI has a duty to protect Indian investors investing beyond Indian borders. This issue has not been addressed by the Consultation Paper.<sup>47</sup>

### 8.3. **Restricted coverage of the Consultation Paper:**

#### 8.3.1. *Provision:*

The Consultation Paper states that crowdfunding shall be available only to unlisted public companies.

#### 8.3.2. *Analysis:*

This provides a highly restricted coverage of the consultation paper. Considering that this model is meant to facilitate start-ups and fledgling businesses, and ensuring compliance with the stringent regulations that apply to public companies would be burdensome and costly for such SMEs, it is essential that entities such as private limited companies, one person companies, limited liability partnerships and sole proprietorships, which are all common business models used by SMEs should also be included.<sup>48</sup>

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<sup>47</sup> *Supra* note 1, p. 26.

<sup>48</sup> *See generally, supra* note 49.



**8.4. List of Accredited Investors mentioned in paragraph 9.1.4 of the Consultation Paper should be expanded:**

**8.4.1. *Provision:***

Definition of Accredited Investors has been explained on page 3 of the Introductory Chapter of this paper.

**8.4.2. *Analysis:***

Accredited Investors as defined by SEBI would in practicality be very few in number. Furthermore, most of the Accredited Investors look to invest in risk-averse companies that have proven track records. Such Accredited Investors hardly finance entrepreneurs trying to convert their ideas into viable businesses. The exclusion of small investors is directly in conflict with the very notion of crowdfunding, which seeks to attract small sums from a very broad base of investors.

Restricting investments to only accredited Accredited Investors is simply a way to make existing venture capital and private equity investments more efficient using the internet.<sup>49</sup> Crowdfunding is meant to engage Accredited Investors who would otherwise not be able to invest in the capital market, as the investment amounts required from each individual investor

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<sup>49</sup> *supra*, note 1, p. 24.

is small. The stringent eligibility criteria prescribed alienates ‘crowds’ from crowdfunding and makes it accessible to only a few elites, and isolates a large section of potential Accredited Investors.<sup>50</sup>

Though such an investment is inherently risky, the crowdfunding process can be structured in a manner that any loss to SMEs is small and bearable.<sup>51</sup> Jurisdictions such as US, France, and Canada allow small investors to participate in crowdfunding, and supplement this with appropriate safeguards for their protection.

**8.5. Permissible investment limit mentioned in paragraph 9.1.5 of the Consultation Paper should be modified:**

**8.5.1. Provisions:**

(a) Rule 14(2)(c) of the Companies Rules, to which crowdfunding is subject, mandates that the minimum size of each investment must be at least INR 20,000. (b) QIBs are required to collectively hold a minimum of 5% of the securities issued through crowdfunding.

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<sup>50</sup> *Ibid.*

<sup>51</sup> Bradford, Steven C., *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. (June 30, 2016), <http://digitalcommons.unl.edu/cgi/viewcontent.cgi?article=1118&context=lawfacpub>.

### 8.5.2. *Analysis:*

As previously mentioned, QIBs are unlikely to invest in SMEs with no track record and slow and minimal returns. India should adopt New Zealand's provision in this regard and not have any base minimum with regards to investment limit. This will help deal with the following issues:

- a) It is advisable that the language in the rules be changed to facilitate smaller investments by retail Accredited Investors in crowdfunding rounds (which would also potentially reduce their downside risk);
- b) Furthermore, ventures which deal with ideas that do not have profitable returns (such as ventures for social causes or art work) significantly face the blow. No person would want to invest INR 20,000 when they know that the return that they will be receiving for the same is minimal.<sup>52</sup> A reduction in base limit would benefit such ventures and significantly further their cause;
- c) Requiring QIBs to collectively hold a minimum of 5% of the securities issued through crowdfunding may impose an unrealistic burden on the issuer companies and defeat their fundraising attempts. This requirement might lead to a

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<sup>52</sup> *Supra* note 49.

situation where the company succeeds in raising the requisite amount from HNIs and ERIs but cannot complete the transaction due to a shortfall in QIB investment. Hence, this requirement too should be done away with.

**8.6. Limit on number of investors up to 200 (excluding QIBs and employees of the company under ESOPs) should be amended:**

**8.6.1. Provision:**

A limit of 200 investors (excluding QIBs and employees of the company under ESOPs) is specified in Chapter III of the Companies Rules.

**8.6.2. Analysis:**

The objective of crowdfunding is to allow the public at large to participate in funding and earning returns from ventures that interest them.<sup>53</sup> This limit of 200 Accredited Investors specified in Chapter III of the Companies Rules, is inadequate and an amendment in such rules to allow up to 1,000 Accredited Investors, excluding QIBs or employees of the

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<sup>53</sup> Belleflamme, Paul, Lambert, Thomas, Schwienbacher, Armin, *Crowdfunding: Tapping the Right Crowd*, 29 J. Bus. Venturing, p. 585 (July 1, 2016), [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1578175](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1578175).

company under a scheme of ESOPs should be allowed.<sup>54</sup> This suggestion could possibly supplement the precious suggestion on removing the base limit of investment for investment through crowdfunding. While the large number of shareholders may increase the transaction costs and cause administrative difficulties for the management, the issue can be dealt with by issuing shares with differential voting rights given to shareholders by issuing securities with differential voting rights.

Given that shares issued through crowdfunding would be regulated at various levels by both the Crowdfunding Platform as well as being under the purview of SEBI, the traditional arguments of not allowing newly established companies to issue such shares with varied rights may not be justifiable. Shares with differential voting rights are also viable from the perspective of crowdfunding Accredited Investors who would typically invest small amounts and would be primarily interested in getting a return, without expecting any substantial involvement in the day-to-day affairs of the company.

If this suggestion of increasing the maximum number of

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<sup>54</sup> Debanshu Mukherjee, ShubhangiBhadada, and Ors, *Response to SEBI Consultation Paper on Crowdfunding in India*, VIDHI CENTRE FOR LEGAL POLICY, (June 28, 2016), <https://static1.squarespace.com/static/551ea026e4b0adba21a8f9df/t/55702567e4b02d3071c80513/1433412967379/Vidhi+Crowdfunding+Paper.pdf>.

permissible Accredited Investors to 1000 or more is accepted, then a requirement arises to modify the thresholds for initiating cases for oppression, mismanagement and class actions in the Companies Act (Sections 244 and 245). Given that most retail Accredited Investors will face coordination problems, it is recommended that a trustee be pointed to represent their interests and enforce their rights effectively.<sup>55</sup>

## 8.7. **Modification in requisite of disclosing future projectiles:**

### 8.7.1. *Provision:*

Due to the lack of history and track record, the Consultation Paper has made it necessary that issuers provide future projections of their business to facilitate Accredited Investors in decision making.

### 8.7.2. *Analysis:*

However, there is uncertainty about what should be the criteria to ensure that the projections are realistic and achievable and not misleading in nature.

It is widely recognised that inclusion of forward-looking information in an offer document carries the risk of the promoters presenting an over-optimistic picture of the future potential of the business. Therefore, instead of requiring

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<sup>55</sup> *Ibid.*

companies to provide future projectiles, issuers should be required to obtain a compulsory rating about the viability of the business from an independent analyst or business specialist.

## 8.8. **Seeming ineptness of Crowdfunding Platforms:**

### 8.8.1. *Provision:*

Provision on eligibility of Crowdfunding Platforms has been explained on pages 4 and 5 of this paper.

### 8.8.2. *Analysis:*

The following proposals for change in the functioning of Crowdfunding Platforms can be recommended to SEBI:

- a) Crowdfunding Platforms, their managers/directors and other employees should not be permitted to invest in offerings on their platforms and not have any financial interest in the issuers;<sup>56</sup>
- b) Crowdfunding Platforms in India, much like those in UK should supply the Accredited Investors with risk assessment forms which provide disclosures related to risks and other investor education materials, to ensure that investors understand the risks involved. The Accredited Investors should not be allowed to invest till they have fully

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<sup>56</sup> *Ibid.*

read and signed such forms;

- c) Maintain escrow accounts for transfer of funds and release them to the only after the investment threshold has been met. The Crowdfunding Platforms should guarantee the Accredited Investors of a suitable exit mechanism in case the issuer fails to reach the threshold;
- d) The Crowdfunding Platform along with providing the function of an intermediary for the meeting of the investor and the enterprise, should also provide a platform for open communication in order for prospective investors to discuss the offering and its various aspects and to facilitate information exchanges between potential buyers and sellers (from within the community of registered Accredited Investors);
- e) The Crowdfunding Platforms should also assist the issuer to produce the information required for making the necessary disclosures, as it is not easy for new business ventures to do this by themselves.



8.9. **Mandatory security features and IT Policies to be put in place to make the crowdfunding platform secure from cybercrimes:**

8.9.1. *Provision:*

There is no provision on ways to make the Crowdfunding Platform immune to cybercrimes.

8.9.2. *Analysis:*

The Information Technology (Reasonable Security Practices and Procedures and Sensitive Personal Data or Information) Rules, 2011 (hereinafter “**IT Rules**”) make it mandatory for the company in concern to comply with reasonable security practices and procedures.<sup>57</sup> The IT Rules provide for a legislative framework for the protection of sensitive information which will also apply to Crowdfunding Platforms. Under these rules, the company will be deemed to have complied with ‘reasonable security practices’ if the conditions stated in the IT Rules are fulfilled.

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<sup>57</sup> RULE 8(1), THE INFORMATION TECHNOLOGY (REASONABLE SECURITY PRACTICES AND PROCEDURES AND SENSITIVE PERSONAL DATA OR INFORMATION) RULES, 2011.

## 9. CONCLUSION

The process of crowdfunding has several associated risks that need to be necessarily addressed. SEBI's proposed regulations take into account the laws in several different jurisdictions and lay down many effective guidelines largely drawn from the UK model. Despite the presence of risks, equity based crowdfunding is also a new and helpful alternative in corporate finance. Research has shown that crowdfunding based on a profit-sharing model (especially through issuance of equity shares) can be conducive for early-stage SMEs as it creates a more sustainable and self-sufficient model of capital generation. The regulations espoused by SEBI in its Consultation Paper certainly provide a much better avenue of raising capital for SMEs than the existing avenues available to them.

It is important to have this avenue of crowdfunding regulated since start-ups have no previous track records, but it is also important not to over-regulate them or have an overkill on the budding entrepreneurs and their creative ideas. SEBI in its Consultation Paper has taken an overtly cautious approach and in doing so has taken the 'crowd' out of crowdfunding. Though regulations are necessary, the ones suggested by SEBI with regards to the number of Accredited Investors, the bracket of

Accredited Investors, and the cap on investment, may have to be relaxed or altered so as to ensure that the process is viable and beneficial, and does not get subsumed within the costs of regulation itself.

Any technological advancement brings with it new challenges for regulators and lawmakers. With regard to crowdfunding, SEBI has taken a very cautious approach, and has laid down guidelines that do not compromise investor protection. It has assessed the advantages as well as risks, and taken note of the shortcomings associated with crowdfunding. However, there are still several aspects that need to be clarified, and areas that need to be covered under regulation such as cross border crowdfunding transactions and secondary markets, which form important aspects of the very concept of crowdfunding.

Though SEBI made a substantial move in October 2013 by approving ITP, the initiative seemed to be a failure since not one of the 4,200 start-ups in India as at the end of the year 2015 had taken the initiative of getting listed on the ITP.<sup>58</sup> However, SEBI in the month of May this year, based on the suggestions of a panel headed by Narayan Murthy, is planning

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<sup>58</sup> Anirudh Laskar, *Easier SEBI Rules Fail to Lure Start-ups to Launch*, LIVE MINT, (July 3, 2016), <http://www.livemint.com/Companies/VL379geKEu4phiz6ALNWzK/Easier-Sebi-rules-fail-to-lure-startups-to-launch-IPOs.html>.

to revamp its ITP regulations of 2013. If SEBI actualizes these suggestions and consequently regulates the avenue of crowdfunding, SEBI would manage to take the Indian economy by storm by giving SMEs a severe boost and make India a hub for investment and innovation.

It has been two years since SEBI released its Consultation Paper, but no guidelines or rules have been formulated in accordance with the responses received by SEBI. SEBI should regulate this avenue of raising capital soon since crowdfunding is the need of the hour, especially with the surge of Non-Performing Assets in the Indian economy which have made banks highly reluctant to lend money to enterprises, especially those with no prior experience. This could possibly stagnate several ideas and innovative enterprises thus severely harming the economy in the long run. Why is SEBI not issuing rules or regulations with regards to crowdfunding? Is SEBI waiting for another Sahara like episode to take place in the avenue of crowdfunding before it regulates this avenue?