

## Crowdfunding in India – a trend gone wrong?

### Introduction

In the wake of 2008 financial crisis and the increasing skepticism of financial institutions to fund nascent business ventures, crowdfunding emerged as a feasible method of raising funds for emerging & growth stage companies in different jurisdictions. The Indian start-up ecosystem has been no exception to this alternative funding wave; rather, the trend has witnessed a massive impetus with approximately 200 early-stage companies raising about INR 3.5 billion (about USD 52 million)<sup>1</sup> to INR 4 billion (USD 59 million) on crowdfunding platforms over the span of past 18 months.<sup>2</sup>

Crowdfunding is the solicitation of small amount of funds from various investors through web-based platform or social networking site for a specific project, business or social cause.<sup>3</sup> It is typically categorized into 4 kinds, donation, reward, peer-to-peer lending<sup>4</sup>, and equity-based. Equity-based crowdfunding is the solicitation of funds from investors by early-stage companies in lieu of equity stake through an online platform. The close semblance that equity-based crowdfunding bears with public offer of securities has caused the Indian securities market regulator, Securities & Exchange Board of India (“SEBI”) to exercise heightened caution while analyzing the dynamics involved. Despite attempts since 2014 to establish a regulatory framework, SEBI has failed to gauge the Indian crowdfunding trend and promulgate decisive regulations, leaving the legal regime unsettling and fettered with ambiguities.

This newsletter critically analyzes SEBI’s approach towards equity-based crowdfunding regulation and the likely impact that it forecasts on the Indian start-ups and small & medium sized enterprises.

### 1. Need for regulating crowdfunding in India

Crowdfunding enables start-ups and small & medium sized enterprises to avail funds in small amounts from retail investors by advertising business proposals through an online platform on the basis of future projections. As opposed to public funding, the issuing entity does not circulate a prospectus, nor does it comply with the rigors of valuation and dealings with SEBI regulated market intermediaries like merchant bankers, transfer agents, registrar to issue, etc. This substantially reduces the cost of capital, despite the higher risk element which is classically associated with innovative business propositions. It also provides new investment avenue to small retail investors facilitating portfolio diversification.

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<sup>1</sup> 1 USD = about INR 67

<sup>2</sup> See “Crowd control: SEBI warning turns off crowdfunding tap for start-ups”, The Economic Times (Sep 9, 2016) available at <http://economictimes.indiatimes.com/small-biz/money/crowd-control-sebi-warning-turns-off-crowdfunding-tap-for-startups/articleshow/54202702.cms> (last accessed on Oct 24, 2016)

<sup>3</sup> Paragraph 2.1 of the SEBI Consultation Paper on Crowdfunding in India, 2014

<sup>4</sup> Donation crowdfunding involves funding for social, artistic, philanthropic purpose without any reward or return on funds. Reward crowdfunding involves the investors receiving some existing or future tangible rewards such as consumer product, membership benefits, etc. as consideration. Peer-to-peer lending is a form where the online platform matches the lenders with borrowers to provide unsecured loans at such interest rates as determined by the platform

On the flip side, crowdfunding poses systemic risks for the in-experienced retail investor. Since the investment is not based on system of disclosures, the scope for conducting due diligence is negated and the investor fails to ascertain the viability of the advertised business model. This results in information asymmetry, lack of transparency, illiquidity in secondary market, and higher risk for fraudulent conduct. Given the divergent interests of promoting new companies and investor protection, the need for establishing a regulatory regime that factors in the pros and cons of crowdfunding as well as strikes a balance between the conflicting interests cannot be over emphasized.

## 2. SEBI's approach

SEBI's stance on crowdfunding from 2014 till date can be best ascertained as puzzling and devoid of clarity.

**2.1 2014 Consultation Paper:** In 2014, SEBI published a consultation paper on crowdfunding in India ("**Consultation Paper**")<sup>5</sup> proposing a framework. The proposal focused on ushering crowdfunding as a viable capital raising method and providing adequate investor safeguards without involving higher compliance costs and regulatory burdens. It clarified that raising funds on an online platform was not equivalent of listing securities on stock exchange, and accordingly similar level of regulation need not be applied to crowdfunders, companies and platforms. As per the Consultation Paper:

- Crowdfunding investment can be through equity, debt or indirectly through funds<sup>6</sup>, by sophisticated "accredited investors", provided that the entity is an unlisted public company not more than 48 months old and intends to raise capital up to INR 100 million (USD 1,498,690) within a period of 12 months.
- "Accredited investor" includes (i) qualified institutional buyers, (ii) companies having a minimum net worth of INR 100 million (about USD 1.5 million), (iii) high net worth individuals with minimum net worth of INR 20 million (about USD 300,000), and (iv) retail investors who satisfied the prescribed eligibility criteria. An investor whose minimum annual gross income was INR 1 million (USD 15,000) and who had paid taxes for the last 3 years, upon certification that he shall not invest beyond INR 60,000 (USD 900) and 10% of his net worth in a given issue could become an eligible retail investor, provided he received investment advice from an investment adviser or services from a portfolio manager.
- The investee can raise funds by private placement offer made through a SEBI registered crowdfunding platform. The procedure for private placement will be as prescribed under Companies Act, 2013 (as discussed below in para 2.4).
- The offer can be made to any number of qualified institutional buyers and a maximum of 200 high net worth individuals and retail investors and the minimum offer size should be INR 20,000.

<sup>5</sup> The full text of the Consultation Paper can be accessed at [http://www.sebi.gov.in/cms/sebi\\_data/attachdocs/1403005615257.pdf](http://www.sebi.gov.in/cms/sebi_data/attachdocs/1403005615257.pdf) (last accessed on Oct 24, 2016)

<sup>6</sup> The Consultation paper provides 3 routes of crowdfunding, subject to conditions prescribed for each route: (i) equity where the issuer can raise INR 100 million (about US 1.5 million) against equity shares, (ii) debt where issuer can raise INR 100 million against debentures or debt securities, and (iii) fund where funds from accredited investors will be pooled and invested by SEBI registered alternative investment fund such as venture capital funds, SME funds, etc.

- The private placement offer letter must be detailed containing information *inter alia* about the anticipated business plan, issue size, intended usage, past funding history, valuation, financial situation, grievance redressal and dispute resolution mechanism in place, etc.
- The company must make periodic disclosures regarding its overall financial position.

**2.2 Adequacy of the Consultation Paper:** The Consultation Paper was opened for public comments and several issues were highlighted which continue to remain as is. *Firstly*, the rationale of limiting the option only for unlisted public companies to the complete exclusion of private companies is unclear, specifically when most of the start-ups and small & medium enterprises are incorporated as private companies. *Secondly*, the high threshold for qualifying as an eligible retail investor is opposed to the crowdfunding model's basics which aim at pooling of small amounts from the "crowd" i.e. non-sophisticated individuals who otherwise refrain from investing in securities market. It is doubtful that accredited investors with experience and adequate knowledge about the securities market would be willing to invest small amounts in start-ups and small & medium entities through a crowdfunding platform as opposed to established alternative investment platforms. *Thirdly*, the Consultation Paper fails to detail a proposed fee structure for crowdfunding platforms which is crucial for targeted entities to analyze the capital raising cost. *Fourthly*, it is also silent on whether registered crowdfunding platforms will be regarded as intermediaries and hence, mandated to comply with SEBI (Intermediaries) Regulations.<sup>7</sup> *Lastly*, it does not delve into how the securities in crowdfunding model will be traded and transferred, leaving the grappling issue of illiquidity unaddressed. Nonetheless, the Consultation Paper reflected SEBI's willingness to recognize crowdfunding. It was a progressive attempt to facilitate alternative funding means for early-stage companies while ensuring investor protection through a system of cost effective disclosures. As of date, the status quo of non-regulation continues and the proposals are yet to be crystallized into binding regulations.

**2.3 2016 Investor Caution Notice:** In a diametrically opposite move, SEBI issued a public notice cautioning investors against online platforms facilitating fund raising for start-ups on August 30, 2016 ("**2016 Notice**").<sup>8</sup> As per the 2016 Notice, electronic platforms engaged in fund raising activities through social media, websites and other such digital platforms are performing activities similar to the stock exchanges. It provides that investment through digital platforms by private placement where the offer is open to all investors who are registered with the said platform is unauthorized, illegal and in contravention of the Securities Contract (Regulation) Act, 1956 ("**SCRA**") and the Companies Act. The rationale is premised on the fact that only recognized stock exchanges can provide a platform where equity and other securities can be issued and traded by the public and such dealing must be in accordance with the listing conditions and SCRA.

The 2016 Notice has caused a chilling effect on the crowdfunding market, raising questions regarding the legality of prominent digital equity crowdfunding platforms like Grex,

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<sup>7</sup> Market intermediaries are registered entities who facilitate the trading activities in the securities market; they must be registered with SEBI and comply with conditions relating to net worth, eligibility, disclosures, filings as contained in the SEBI (Intermediaries) Regulations, 2008

<sup>8</sup> The full text can be accessed at [http://www.sebi.gov.in/cms/sebi\\_data/pdffiles/34568\\_t.pdf](http://www.sebi.gov.in/cms/sebi_data/pdffiles/34568_t.pdf) (last accessed on Oct 24, 2016)

LetsVenture, Termsheet, Equity Crest.<sup>9</sup> Most of these digital platforms issued private placement offers for equity investment deals ranging between INR 30 million (USD 450,000) to INR 40 million (USD 600,000) spread over 5 to 20 investors per deal and involving 0.5 to 1% of a start-up's equity capital as consideration.<sup>10</sup> Thus, the crowdfunders in absence of any regulation resorted to private placement procedure under the Companies Act for raising funds. The moot question is whether crowdfunding platform's activities should be assessed as per the private placement norms under Companies Act or do these platforms have to ensure that investee's online offer is in sync with SEBI's prescription for public offer and listing.

**2.4 Analysis:** Private and unlisted public companies cannot offer shares to the public and can issue shares to investors through methods provided under Companies Act and private placement under S. 42 is one such method.<sup>11</sup> Private placement is defined as offer of securities or invitation to subscribe to a select group of persons by a company (other than by way of public offer) through issue of private placement offer letter. Accordingly, a private placement is valid if the following essentials exist:

- The offer is through a private placement letter in the prescribed format providing the details such as valuation, price base, offer size, terms and conditions, details about the issuer entity, etc.
- The minimum investment size cannot be less than INR 20,000 (USD 300) and the offer can be made to a maximum of 50 persons, subject to overall limit of 200 persons per financial year excluding qualified institutional buyers.
- All offers must be made to such persons whose names are recorded in a separate register maintained by the company prior to the invitation to subscribe.
- The subscription amount must be received through banking channels into a separate bank account and not in cash.
- The allotment must be completed within 60 days of receipt of subscription amount.
- The issuing company shall file a return of allotment with the Registrar of Companies once the process is completed.

Further, S. 42 provides that breach of the above essentials will qualify the offer as a public offer. Public offer of securities is an offer for sale to the public through issue of prospectus. This route is only available to listed companies in compliance with S. 23 to 41 of Companies Act, listing agreement executed with stock exchange, and SEBI (Issue of Capital & Disclosure Requirement) Regulations. However, there is no clarity as to how will SEBI require private and unlisted public companies who availed the crowdfunding platforms to comply with requirements of public offer. In this backdrop, SEBI's initial view in the Consultation Paper that crowdfunding on online platforms is not equivalent to listing on stock exchange has legal merit. In the absence of specific crowdfunding regulations, this interpretation can be used by

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<sup>9</sup> See "Crowdfunding firms jittery after SEBI notice, seek clarity", The Economic Times (Sep 21, 2016) available at <http://economictimes.indiatimes.com/small-biz/policy-trends/crowd-funding-firms-jittery-after-sebi-notice-seek-clarity/articleshow/54436951.cms> (last accessed on Oct 24, 2016). It is confirmed by Economic Times sources that SEBI has specifically instructed Grex which is a 2 year old crowdfunding platform to stop on-boarding new investors or taking up fund raising mandates from start-ups

<sup>10</sup> *Supra* note 2

<sup>11</sup> The Companies Act allows a private company or an unlisted public company to issue shares through other methods such as preferential allotment, rights issue to existing shareholders, issue of shares in lieu of employee stock options, issue of bonus shares, etc. For the purpose of the analysis, focus is on private placement process

crowdfunders to privately place equity shares on digital medium without listing or public offer. The Companies Act does not prohibit circulation of private placement offer letter through electronic means. In an era of e-governance, the Companies Act specifically recognizes maintenance of statutory registers in electronic format<sup>12</sup> which necessarily implies that all documents relating to the private placement process can be maintained as e-records. As long as the companies and crowdfunding platforms under SEBI's scanner have adhered with the requirements of S. 42, the offer cannot be considered a public offer and if that be the case, SEBI is outreaching its jurisdiction in an overcautious and regressive manner.

## Conclusion

The 2016 Notice is in juxtaposition of the legitimate expectation that the start-up community beholds in light of the Consultation Paper. The dampening impact can be felt on aspiring entrepreneurs who will be left at the mercy of conventional funders, with no recourse of approaching a crowd of interested investors for pooling of small amounts. The shift in SEBI's perspective is excessively reserved as it is not backed by any evidence of fraudulent conduct on part of the crowdfunding platforms or the start-ups availing their services. While investor protection is critical, the need for facilitating crowdfunding as an alternative and cost effective funding means for start-ups and small entities cannot be sidelined. It is imperative that SEBI clarifies its stance on the future prospects of crowdfunding and promulgates the contours of when an offer will exceed the thresholds of private placement and colour itself as public issue.

## Author

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<sup>12</sup> S. 120 of the Companies Act