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Crowdfunding in India and Its Regulation: A Critical Analysis of SEBI's Consultation Paper on Crowdfunding

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ABSTRACT

India has traditionally adopted the practice of raising funds from crowd through donations and other forms for various purposes. Crowdfunding is a similar model but with the use of web based platforms. Crowdfunding has gained popularity all over the world due to its benefits to the growth of small businesses. This paper aims to comprehensively understand what crowdfunding is and how it is regulated in India. The paper focusses on the nature of securities based crowdfunding to answer if it can be regulated within the existing regulatory regime i.e. under Companies law, securities laws and other regulations for angel investors. It also discusses SEBI's apprehension and doubts regarding allowing securities crowdfunding without proper regulation. The paper further analyses the proposals of SEBI on regulating crowdfunding in India through its consultation paper. It provides a critical review of SEBI's proposal to regulate crowdfunding and deals with the question of SEBI's jurisdiction in dealing with crowdfunding regulation. It also analyses cross-border crowdfunding that is absent in the SEBI's consultation paper on crowdfunding. The author concludes with the remark that SEBI's proposal on regulation of securities based crowdfunding suffers from major loopholes which shall be addressed for its effective implementation and that crowdfunding should be regulated by a separate legislation which takes into account the very different nature of crowdfunding.

Keywords: Crowdfunding, SEBI, MCA, Crowdfunding Regulation, Securities based crowdfunding, Equity crowdfunding, public offer, private placement, Venture Capital Funds, Alternative Investment Funds, Angel Investors.

I. INTRODUCTION

Customarily, the start-up companies which are at the beginner's stage and carry risks of failure find difficulty in raising funds for their business. This is primarily due to their inability in accessing the angel investors, venture capitals or other private equity firms.³ Thus, Crowdfunding comes as a rescue option for such start-ups. It is a novel method, through which

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³ Arjya Majumdar & Umakanth Varottil, *Regulating Equity Crowdfunding in India: Walking a Tightrope*, OXFORD LAW FACULTY BLOG, (July. 31, 2016), <https://www.law.ox.ac.uk/business-law-blog/blog/2016/07/regulating-equity-crowdfunding-india>, (last accessed on 10 August 2020).

smaller ventures can raise funds for their project by requesting small contributions from large number of investors through internet in return of equity or future benefits.⁴

Securities Exchange Board of India (hereinafter referred to as “SEBI”) had adopted the following definition of Crowdfunding:

*“Crowd sourced funding is a means of raising money for a creative project (for instance, music, film, book publication), a benevolent or public-interest cause (for instance, a community based social or co-operative initiative) or a business venture, through small financial contributions from persons who may number in the hundreds or thousands. Those contributions are sought through an online crowd-funding platform, while the offer may also be promoted through social media.”*⁵

IOSCO Staff Working Paper has categorized crowdfunding under four types⁶ which has been widely accepted by many jurisdictions including India. These are as follows:

- a. *Donation Based Crowdfunding*: is when funds are solicited for philanthropic, social or artistic purposes without any return or exchange.⁷
- b. *Reward Based Crowdfunding*: is when funds are solicited wherein investors receive tangible award.⁸
- c. *Peer to Peer Lending/Loan based crowdfunding*: is when a platform provides funding to the borrowers by lenders/investors in nature of unsecured loans with small interest rate. Usually, banks are the platforms in such cases.⁹
- d. *Equity based Crowdfunding*: funds are solicited from investors in consideration of issue of equity shares of the company to investors.¹⁰

In India, donation and reward crowdfunding are legal and quite popular for raising funds for

⁴ Ethan Mollick, *The Dynamics of Crowdfunding: An Exploratory Study*, 29 Journal OF BUSINESS VENTURING, (2014), <https://www.sciencedirect.com/science/article/pii/S088390261300058X>, (last accessed on 10 August 2020).

⁵ Corporations and Markets Advisory Committee, Australia, 2013. *Crowd Sourced Equity Funding- Discussion Paper*, Corporations and Markets Advisory Committee, p.5, <http://ict-industry-reports.com.au/wp-content/uploads/sites/4/2013/09/2013-Crowd-Sourced-Equity-Funding-Discussion-Paper-Australia-CAMAC-Sept-2013.pdf>, (last accessed 10 August 2020).

⁶ Eleanor Kirby & Shane Worner, *Crowd-Funding: An Infant Industry Growing Fast*, IOSCO SWP3, (2014), <https://www.iosco.org/research/pdf/swp/Crowd-funding-An-Infant-Industry-Growing-Fast.pdf>, (last accessed on 10 August 2020).

⁷ *Id.*

⁸ *Id.*

⁹ *Id.*

¹⁰ *Id.*

social causes.¹¹ Peer to peer lending i.e loan based crowdfunding is also legal and regulated by Reserve Bank of India. The issue of legality arises with respect to equity or debt based crowdfunding. It can also be called securities based crowdfunding. In 2016, SEBI through a press release stated that digital equity based crowdfundings and platform involved therein are illegal, unauthorized and contravenes SEBI Securities Contract (Regulation) Act, 1956 (SCRA).¹² This is due to the fact that securities based crowdfunding are of such a nature that they would attract Company law as well as securities law provisions.

While, other jurisdictions like United States have enacted specific crowdfunding regulations i.e. Jumpstart Our Business Startups Act (hereinafter referred to as “**JOBS Act**”), India doesn’t have any legal basis for securities crowdfunding.¹³ Recognizing the importance of crowdfunding for start-ups and Small & Medium Enterprises (hereinafter referred to as “**SMEs**”), the SEBI had taken its first step in 2014 by releasing a “*Consultation Paper on Crowdfunding in India*” which provided a detailed understanding of crowdfunding and its regulation in other jurisdictions. It also proposed legal framework for securities crowdfunding in India and discussed challenges faced thereby.¹⁴

Due to the various risks and regulatory challenges associated with Securities based crowdfunding, the authors would focus on the regulation of the same in India. In the second part of the paper, the authors would discuss the risks associated with securities based crowdfunding which have led to making it illegal by SEBI. In the third part, the authors would first study the existing regulatory regime governing crowdfunding in India and then study the regulatory proposals of SEBI’s Consultation Paper on Crowdfunding. In the fourth part, analysis of SEBI’s consultation paper would be done where the authors would first analyse if SEBI has jurisdiction to regulate crowdfunding, then SEBI’s proposals to regulate crowdfunding and problems associated with them and lastly the cross-border crowdfunding which is missing in the SEBI’s consultation paper. In the last part, the authors would conclude with the observation regarding structure of securities crowdfunding and appropriate measures of its regulation.

¹¹Girija Gadre, “et al”, *How crowdfunding works*, THE ECONOMICS TIMES WEALTH (Dec. 3, 2018), https://economictimes.indiatimes.com/wealth/earn/how-crowdfunding-works/articleshow/66891983.cms?utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst, (last accessed on 10 August 2020).

¹² Securities and Exchange Board of India, 2016. *SEBI Cautions Investors*, SEBI, https://www.sebi.gov.in/media/press-releases/aug-2016/sebi-cautions-investors_33094.html, (last accessed on 10 August 2020).

¹³ Umakanth Varottil, *SEBI Consultation Paper on Crowdfunding*, INDIACORPLAW, (Jun. 19, 2014), <https://india.corplaw.in/2014/06/sebi-consultation-paper-on-crowdfunding.html>, (last accessed on 10 August 2020).

¹⁴ Securities and Exchange Board of India, 2014. *Consultation Paper On Crowdfunding In India*, SEBI (hereinafter referred to as “**SEBI Consultation Paper**”), https://www.sebi.gov.in/sebi_data/attachdocs/1403005615257.pdf, (last accessed on 10 August 2020).

II. SEBI'S APPREHENSION REGARDING SECURITIES BASED CROWDFUNDING

Securities crowdfunding mechanism has many advantages. Most important is that it spreads the risk to large number of investors and thus reduces the risk on an individual investor. But at the same time, it has many risks associated with it, which creates apprehension in the mind of SEBI and leads to making it illegal.

One of its greatest apprehension is due to the chances of frauds and scams possible with raising fund from large crowd over internet. General public is not in a position to carry proper due diligence to verify the background of the fundraising companies, which may lead to companies vanishing after raising funds.¹⁵ It also creates the risk of cybercrimes due to the absence of adoption of strict security measures by the crowdfunding platform. Indian crowd has always been doubtful of activities carried on online platforms. Even the e-commerce platform gained popularity only when the option of “cash-on-delivery” where people could pay only on receiving the product, was made available.¹⁶ India has not been able to make online platforms safer and is still plagued with cybercrimes. It also comes with the risk of people getting involved in money laundering activities.¹⁷

Another apprehension due to which SEBI has made the equity based crowdfunding illegal is the risk associated with failure of early stage companies. As per the statistics, more than 50% of start-ups are prone to failure in their initial five years.¹⁸ Therefore, SEBI which has been entrusted with protection of investors does not want to put investors in a position where they have no way to recover their investment when a company defaults.

Crowdfunding also comes with the disadvantage of information asymmetry between the crowd and the fundraising company. Traditional models of fundraising involves investors who have knowledge and expertise in issuing company's business investing in such ventures. In a crowdfunding mechanism, the public forming part of the crowd may not have such knowledge and expertise and therefore they cannot determine if a venture is capable of generating revenue. The issuing company may also not provide complete disclosures to be verified by the investors,

¹⁵ Dr. Manoj Kumar Joshi, *Crowdfunding For Startups in India*, 24 AWESHKAR REVIEWED R. J. 37, 40 (2018), http://welingkar.stageisobar.com/sites/default/files/pdf/we-research-aweshkar-research-journal/aWEshkar_March_2018.pdf#page=39, (last accessed on 10 August 2020).

¹⁶ R. Pawha et al, *Crowdfunding: Is India Ready?*, 1 COMP. L. J. 50, 54 (2015), http://papers.ssrn.com/sol3/paper.s.cfm?abstract_id=2605329, (last accessed on 10 August 2020).

¹⁷ G. P. Krishna, *An Empirical Overview of Crowd Funding – An Emerging Trend in India*, 2 INT. J. OF RES. 893, 895 (2015).

¹⁸ Erkki K. Laitinen, *Prediction of Failure of a Newly Founded Firm*, 7 JOURNAL OF BUSINESS VENTURING 7 323, 340 (1992).

creating information symmetry which may harm the investors.¹⁹

In addition, the absence of secondary market in case of crowdfunding, makes the securities offered through it, illiquid. Such investors do not have option of recouping their investment by selling their securities on the crowdfunding platform²⁰ unlike in the public issue of securities which are freely tradable on stock exchanges.²¹ This also takes away the option of immediate exit to the investors in case the issuing company defaults or commits fraud putting them in a disadvantageous position.

India, has faced two major scandals involving illegal issue of shares that proves that SEBI cannot allow such unregulated securities crowdfunding. *First*, was Sahara Scandal where two companies of the Sahara Group had raised around 3 billion from 30 million investors without complying with the public issue requirements of prospectus and listing on stock exchange.²² This was done through the defined network of the employees, associated companies and related individuals.²³ On investigation, SEBI struck down the whole arrangement and directed Sahara to refund the amount raised. This later went to the Supreme Court which observed that Sahara was in violation of securities regulations and must refund the amount to investors.²⁴ The Supreme Court also instructed imprisonment of Chief of Sahara Group so as to ensure the refund.²⁵ The whole arrangement could be seen as crowdfunding due to involvement of number of investors. But such was not allowed in the current regime due to failure in observance of the securities regulations.

Second scandal involved Saradha Group of companies. It had raised 20 to 30 billion from 1.7 million people. It was found to be a Ponzi scheme and led to arrest of people from the group.²⁶ This can also be characterized as crowdfunding which wasn't permitted by the Indian judiciary. On analysing above risks associated with unregulated securities based crowdfunding, it seems fair for SEBI to make the platforms involved in securities crowdfunding illegal. The two

¹⁹ Arjya B. Majumdar, *Regulating Equity Crowdfunding in India-A Response to SEBI's Consultation Paper*, INTERNATIONAL SYMPOSIUM ON CORPORATE GOVERNANCE AND CAPITAL MARKETS, 11 (June 26, 2015), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2621488#:~:text=The%20Securities%20and%20Exchange%20Board,channel%20of%20early%20stage%20funding., (last accessed on 10 August 2020).

²⁰ Kirby & Worner, *supra* note 4.

²¹ Companies Act, 2013; §. 58.

²² Shwetha Chandrashekar, *Equity-Based Crowdfunding as an Early Stage Financing Alternative: Critique of the Regulatory Proposals in India*, INDIA CORPLAW BLOG, (March, 27 2016), <https://indiacorplaw.in/2016/03/equity-based-crowdfunding-as-early.html>, (last accessed on 10 August 2020).

²³ *Id.*

²⁴ *Sahara India Real Estate Ltd. v. Securities Exchange Board of India*, (2013) 1 SCC 1 (India).

²⁵ *Id.*

²⁶ ET Bureau, *Saradha Chit Fund Scam at a Glance*, THE ECONOMIC TIMES, (Dec. 13, 2014), <https://economictimes.indiatimes.com/news/politics-and-nation/saradha-chit-fund-scam-at-a-glance/articleshow/45499321.cms?from=mdr>, (last accessed on 10 August 2020).

scandals along with many others had led to creation of stricter regulations by the regulators. Consequently, it resulted into portrayal of genuine fundraising by start-ups as fraudulent acts committed by Saradha and Sahara which further restricted crowdfunding in India.²⁷

III. REGULATORY REGIME IN INDIA

The donation based, reward based or peer to peer lending types of crowdfunding have seen the light of the day and are prevalent in India with portals like Bitgiving, Wishberry, Milaap, Fuel-A-Dream and Range De. But securities crowdfunding hasn't seen that light because of stricter regulations in India on offers of shares to public.²⁸ Therefore, the author would first look at the existing regulatory regime which governs crowdfunding and impose limitations on the same. Thenceforward, the author would discuss the recommendations for promoting crowdfunding in India in SEBI's Consultation paper.

(A) Existing Crowdfunding Regulations in India

Securities based crowdfunding involves fund raising by offering equity interests on the business to the investors through a web based platform. Traditionally, if a company want to raise finance by issuing securities, certain provision of company's law or provisions of regulations governing angel investors are attracted.

- *Public Offer*

The public offer method is where the securities can be issued to unlimited number of investors publicly.²⁹ It may seem that the crowdfunding model is similar to the public offer under the Company's Act. The method of raising finance through public offers like Initial Public Offering (IPO) comes with high eligibility conditions which may be difficult to attain for the early stage startups.³⁰ It allows public issue of shares only via prospectus with further obligation to list it on a recognised stock exchange.³¹ The whole process takes several months and becomes an expensive affair for the companies.³² Thus, proving impossible for the small companies who aim to get crowdfunding from public at large.

- *Private Placement*

²⁷ Majumdar & Varottil, *supra* note 1, at 13.

²⁸ *Id.*, at 12.

²⁹ Jitendra Soni & Kanad Bagchi, *Crowdfunding in India: A Tale of Misplaced Regulations*, 49, ECONOMIC AND POLITICAL WEEKLY, 14 (2014).

³⁰ Depanshu Mukherjee, et al, *Response to the SEBI Consultation Paper on Crowdfunding in India*, VIDHI CENTRE FOR LEGAL POLICY, (Jul. 16, 2014), <http://vidhilegalpolicy.in/wp-content/uploads/2019/05/VidhiCrowdfundingPaper.pdf>, (last accessed 10 August 2020).

³¹ Companies Act, 2013; §. 2 (70).

³² Jay R. Ritter, *The Costs of Going Public*, 19 JOURNAL OF FINANCIAL ECONOMICS, 269 (1987).

Private placement is a method where securities are issued to specific number of investors privately. This method doesn't have stricter regulatory compliances or obligation but it has limitation on number of investors i.e. upto 50 in a financial year as well as on category of investors.³³ Due to the mere fact that private placement has a cap on number of investors, the crowdfunding loses its nature and purpose if routed through private placement. Moreover, if the number of offerees exceeds 50 then such takes character of public issue and had to meet the onerous requirements of the same.³⁴ Rule 14 of the Companies Rules, 2014³⁵ had amplified the number of offers to 200 persons but excluded offers to the Qualified Institutional Buyers, other institutional investors and employees falling under employee stock options scheme.

- *Venture Capital Funds (VCFs) and Alternative Investment Funds (AIFs)*

SEBI (Venture Capital Funds) Regulations, 1996 regulated the VCFs in India. It is required to be registered and have to meet certain eligibility criteria and adhere to investment guidelines.³⁶ There are various restrictions on VCFs like it has to maintain a corpus of minimum INR 50 million³⁷, can only invest maximum of 25% of corpus in a single venture, should invest minimum 66.67% of its corpus in unlisted equity instruments.³⁸ It further requires minimum of INR 500,000 from an individual investor and can only invite investors through private placement.³⁹ It cannot invite investment from public.⁴⁰

Additionally, SEBI (Alternative Investment Funds) Regulations, 2012 regulated AIFs that are "angel funds" which raises funds for Indian as well as foreign investors and further invests pooled funds in seed stage companies. They also have the obligation to disclose their investment strategies and register themselves with SEBI.⁴¹ They also have the obligation to maintain minimum corpus of INR 200 million⁴² and have to receive minimum of INR 10 million from each investor.⁴³ It also cannot invite public subscription and has to route their issue of units through private placement.⁴⁴ Thus, the crowdfunding which aims to gather funding from large public with lowest cost wasn't imaginable in the regime.

³³ Companies Act, 2013; § 42 (2).

³⁴ *Id.*

³⁵ Companies (Prospectus and Allotment of Securities) Rules, 2014; Rule 14 (2) (b).

³⁶ SEBI (Venture Capital Funds) Regulations, 1996; Regulation 3 (1)

³⁷ SEBI (Venture Capital Funds) Regulations, 1996; Regulation 11 (3).

³⁸ SEBI (Venture Capital Funds) Regulations, 1996; Regulation 12(i),

³⁹ SEBI (Venture Capital Funds) Regulations, 1996; Regulation 11 (2).

⁴⁰ SEBI (Venture Capital Funds) Regulations, 1996; Regulation 15.

⁴¹ SEBI (Alternative Investment Fund) Regulations, 2012; Regulation 3 (1).

⁴² SEBI (Alternative Investment Fund) Regulations, 2012; Regulation 10 (b).

⁴³ SEBI (Alternative Investment Fund) Regulations, 2012; Regulation 10 (d).

⁴⁴ SEBI (Alternative Investment Fund) Regulations, 2012; Regulation 10 (g).

- *Analysis of Existing Regulations*

The crowdfunding involves smaller investments from large number of investors but such kind of fundraising had been stifled by the securities regulations. Under the new Companies Act, even though the smaller companies have been allowed to raise funding from up to 200 investors in exchange of securities in a financial year but it restricts their ability to disseminate their offer in public because of restriction on advertisements accompanied with private placements.⁴⁵

Moreover, the definition of crowdfunding provides for “small financial contributions” whereas the minimum contribution requirements for VCFs and AIFs i.e. INR 500,000 and INR 10 million respectively, are too high for raising funds through crowdfunding. They also have diversified investment portfolio not restricted to early stage businesses and cannot offer their units to public. SEBI through such regulations have recognized the inability of early stage businesses in raising funds but failed to address the funding requirements of such businesses.⁴⁶ Thus, it is difficult to place crowdfunding in either VCF or AIF.

It can be concluded by looking at the existing regulatory regime that securities based crowdfunding has been strictly regulated in India by placing onerous obligations on public issue of securities. The design of the regulatory regime is in a manner that it aims to protect investors by overshadowing the need of crowdfunding platforms in India.⁴⁷ Equity crowdfunding had been made impossible.

The authors observe that it is difficult to place crowdfunding under either “public offer” or “private placement” route or as VCF or AIF. If we imagine a scenario where a start-up or SME approaches large number of investors who are a part of general public on a crowdfunding platform but restricts the number of investors to 50, then such an offer cannot be categorised into either public offer or private placement.⁴⁸ Thus, the authors opine that crowdfunding is a novel concept which lies in the middle of the extremities of public offer and private placement. Therefore, a completely different legal framework is required for this unconventional method of fundraising.

(B)SEBI Consultation paper

Indian government had been focussing on start-ups and small business and had been promoting their growth. Therefore, it realized the importance of crowdfunding platforms in India as a fundraising platform to meet the needs of start-ups and other smaller companies. Therefore,

⁴⁵ Companies Act, 2013; § 42 (8).

⁴⁶ Mukherjee, *supra note 28*.

⁴⁷ Majumdar, *supra note 17*, at 14.

⁴⁸ Soni & Bagchi, *supra note 27*, at 15.

SEBI brought up the consultation paper discussing the prospects of crowdfunding and its implementation in India. Its major concern was balancing the growth of small businesses and the protection of investors. It proposed reforms that could be brought to promote crowdfunding in India by learning from its regulation in other jurisdictions.⁴⁹

The Donation based, reward based and peer to peer lending did not fall within the jurisdiction of SEBI. Therefore SEBI focussed on three kinds of crowdfunding⁵⁰ i.e.:

- a. Equity based Crowdfunding.
- b. Debt Based Crowdfunding.
- c. Fund Based Crowdfunding

The consultation paper aimed to protect retail investors as well as provide access to capital market to start-ups and small businesses by restricting the reach of regulatory provisions protecting investors to the extent that they affect crowdfunding in India.

- *Eligible Investors*

SEBI has proposed a stricter regulation regarding investors who can form the crowd for funding small companies and start-ups. It proposed that only “**Accredited Investors**”⁵¹ could invest through crowdfunding platforms. These accredited investors include:

- a. “Qualified Institutional Buyers (“**QIBs**”) as defined in SEBI (Issue of Capital and Disclosure Requirements) regulations, 2009 like insurance companies and banks.
- b. Companies under Companies Act with net worth of Rs. 20 crore or more.
- c. High Net-worth Individuals (“**HNI**”) with net worth of 2 crore or more.
- d. Eligible Retail Investors (“**ERI**”) who have annual gross income of Rs. 10 lacs or more.

The ERIs are those retail investors who have filed the income tax return for minimum 3 financial years. Additionally, the ERIs cannot invest more than 10% of their net worth i.e. minimum INR 20,000 and cannot invest more than INR 60,000 in an issue through a crowdfunding platform.”⁵²

The first three accredited Investors which are QIBs, companies under the companies Act and HNIs are the investors who have enough financial backing to take the risks associated in crowdfunding. However, ERIs are the residual retail investors. Only those individual investors

⁴⁹ SEBI Consultation Paper.

⁵⁰ SEBI Consultation Paper, Para 9.0.7.

⁵¹ SEBI Consultation Paper, Para 9.1.4.

⁵² *Id.*

who receive the investment advice from an investment advisor, who avail the services of a portfolio manager and, who have passed an “Appropriateness Test” conducted by either crowdfunding platform or NISM accredited institution are called Eligible Retail Investors to participate in crowdfunding activities.⁵³ This ensures that only those retail investors who have experience, knowledge, backing from an investment advisor and those who can survive the losses incurred on investing through crowdfunding can invest in start-ups and small businesses.⁵⁴ Hence, SEBI had aimed to minimize losses to investors and provided adequate safeguard.

- *Eligibility for Companies and Conditions*

The SEBI Consultation paper aimed to protect the small businesses and start-ups that are at beginner’s stage with limited capital or who does not have any avenue left for raising capital.⁵⁵ Hence, it excluded the companies at better stage with evolved business and access to capital from the benefit of the crowdfunding option. Thus SEBI provided that company benefitting from crowdfunding should⁵⁶:

- a. not be more than 2 years old,
- b. be unlisted,
- c. not be a branch or associate of any larger conglomerate or group of company,
- d. not engage in financing ventures like further lending,
- e. not engages in real estate activities, and
- f. not offer more than INR 100 million in a year.⁵⁷

In addition to the abovementioned conditions, it provided for disqualification of any company which breaches the securities regulation and the companies act. It also proposed that these issuer companies shall not engage in multiple platforms but route all their offers through one crowdfunding platform which is recognized by SEBI. They should not engage in advertising their offers to public or in incentivizing others to promote their offers. They should also have provision dealing with oversubscription.⁵⁸

In this way, SEBI Consultation paper tried to create balance between access to crowdfunding

⁵³ SEBI Consultation Paper, Para 9.1.4.1.

⁵⁴ Majumdar, *supra* note 17, at 25.

⁵⁵ SEBI Consultation Paper, 2014, Para 9.2.4.

⁵⁶ *Id.*

⁵⁷ *Id.*

⁵⁸ SEBI Consultation Paper, Para 9.2.6.

and protection of investors.

- *Investment Limits*

In accordance with the Companies Rules, 2014 which provides that the offer shall not be made to more than 200 investors in a financial year in case of private placement of securities⁵⁹, SEBI proposed that the offer through crowdfunding platform shall not be made to more than 200 ERIs and HNIs.⁶⁰ This excluded QIBs and employees under Employees stock option scheme. Thus, the offer could be made to unlimited number of QIBs.⁶¹

SEBI had further proposed that all QIBs should hold more than 5% of the securities issued collectively. Further, a company should purchase minimum of 4 times the offer value per person, HNI should buy at least 3 times the minimum offer value per person and an ERI should purchase the minimum offer value per person⁶² which is INR 20,000 in private placement of securities. Additionally, the cap on investment by ERI is INR. 60,000.⁶³

- *Disclosure Requirements*

An informed decision of an investor is a must for protecting investors in crowdfunding platforms. They should be able to track the advancement in their investment frequently.⁶⁴ The procedure begins with application of small company or start-up to the crowdfunding platform which then conducts proper due diligence. On approval, company's information and requirements is posted on the platform. Accredited Investors can thereby assess the company and its requirements. If the investor shows interest, the issuing company can circulate the offer by private placement⁶⁵ to the accredited investors who are registered on the crowdfunding platform.⁶⁶

Furthermore, SEBI proposed that the private placement should be in accordance with requirements under Section 42 of Companies Act, 2013. It contains details regarding the offer size and price, the financial condition of the company, details of the management and governance and the risks associated with the business.⁶⁷ Though offer documents generally do not contain future plans but due to lack of history of the company, it should also provide future

⁵⁹ Companies (Prospectus and Allotment of Securities) Rules, 2014; Rule 14 (2) (b).

⁶⁰ SEBI Consultation Paper, Para 9.1.5.1.

⁶¹ SEBI Consultation Paper, Para 9.1.5.1.

⁶² SEBI Consultation Paper, Para 9.1.5.3.

⁶³ *Id.*

⁶⁴ SEBI Consultation Paper, Para 9.3.2.

⁶⁵ SEBI Consultation Paper, Para 9.3.3.

⁶⁶ SEBI Consultation Paper, Para 9.3.4.

⁶⁷ SEBI Consultation Paper, Para 9.3.3.

growth plan to the investors.⁶⁸ Additionally, the issuing company is required to make biannual disclosures to the crowdfunding platform regarding financial statements, usage of funds, state of business, other fundings and pending litigations or penalty.⁶⁹

Authors opine that the SEBI had tried to bring crowdfunding within the purview of Company Law by introducing abovementioned limitations on investments that are in compliance with requirement of Section 42 of Companies Act and Companies rules.⁷⁰

- *Eligibility of Crowdfunding Platforms*

The Crowdfunding platforms are the most important in the whole process. Thus, if any fraudulent entity plays the role of the crowdfunding platform, it can be harmful to the whole system. Therefore SEBI has classified entities in several classes to setup a crowdfunding platform.⁷¹ Class I includes the Recognized Stock Exchanges and the SEBI registered Depositories.⁷² Class II includes Technology Business Incubators which is promoted by state or central government and have experience of 5 years with net worth of INR 10 crore or more and is registered as Society under Societies Act, 1860 or under Section 8 of Companies Act.⁷³ Class III includes the Associations of Private Equities and Angel Investors which has 3 years track record, 100 or more members, is registered under Section 8 of Companies Act, 2013 and, has a paid up share capital of INR 2 crores.⁷⁴

At the same time, SEBI proposed separate entities with experience and knowledge in the field to form the platforms.⁷⁵ It also proposed separate new class of *Crowd fund AIFs* for the Fund based crowdfunding.⁷⁶

In addition to the eligibility conditions, crowdfunding platform have also been entrusted with the duty of a gatekeeper to conduct screening and adequate due diligence along with regulatory and background check of the companies so as to minimize any risk of fraud.⁷⁷

IV. ANALYSIS

The most important question that needs to be answered with analysis of SEBI's Consultation

⁶⁸ SEBI Consultation Paper, Para 9.3.5.

⁶⁹ SEBI Consultation Paper, Para 9.3.6.

⁷⁰ Anantha Krishnan Iyer, *A Crowdfunding Critique*, INDIACORLAW BLOG, (Feb., 2016), <http://indiacorplaw.blogspot.sg/2016/02/penny-wise-crowdfundingcritique.html>, (last accessed on 10 August 2020).

⁷¹ SEBI Consultation Paper, Para 9.4.4.

⁷² SEBI Consultation Paper, Para 9.4.4.2.

⁷³ SEBI Consultation Paper, Para 9.4.4.4.

⁷⁴ SEBI Consultation Paper, Para 9.4.4.7.

⁷⁵ SEBI Consultation Paper, Para 9.4.4.3.

⁷⁶ SEBI Consultation Paper, Para 9.4.4.6.

⁷⁷ SEBI Consultation Paper, Para 9.4.5.

Paper is whether the regulatory approach proposed by SEBI would enable crowdfunding and its growth or hinder its functioning in Indian market. Such would be analysed by looking into whether the cost incurred in investor protection by these regulatory proposals is exorbitant. If the cost is found to be too much, it becomes a commercially unviable option of fundraising for small businesses, putting them back in the earlier position. Thus, to analyse the Consultation Paper, we have to first determine if SEBI has appropriate jurisdiction to regulate crowdfunding. Then we would discuss various problems associated with the proposals of SEBI. Lastly, we would discuss cross-border crowdfunding, that is absent in the Consultation paper.

SEBI's Jurisdiction

The public offer method of raising funds has consequences which are in interest of public and therefore, SEBI has the jurisdiction under securities law to protect the interests of investors. Whereas, for the regulation of private placement route, Ministry of Corporate Affairs (hereinafter referred to as "MCA") has been granted jurisdiction.⁷⁸ We have observed that a crowdfunding mechanism falls in the middle of public offer and private placement mechanism. It is a hybrid structure which has properties of both public offer and private placement. Therefore, the question regarding overlapping jurisdiction of SEBI or MCA comes into the picture in absence of any regulation of the crowdfunding mechanism. SEBI by releasing the Consultation Paper on Crowdfunding seems to have assumed jurisdiction over its regulation. This assumption of jurisdiction is against the principles of delegated legislation.⁷⁹

Section 24 of the Companies Act confers residuary power to MCA for matters provided in the Act.⁸⁰ Hence, it can be argued that MCA shall have jurisdiction over securities crowdfunding regulation. Such an argument is easily countered by recognizing the fact that MCA's jurisdiction is restricted to matters provided in the Act which does not encompass crowdfunding.⁸¹ Therefore, such an argument doesn't have any legal backing. Additionally, in the landmark case of *Sahara India Real Estate Corporation Ltd. v. SEBI*⁸², the supreme court observed that according to section 55 A of companies Act, regulations regarding matters related to the transfer of securities and failure to pay dividends by listed public companies or public companies that are likely to be listed on recognized Stock Exchange in India falls under the jurisdiction of SEBI.⁸³ This judgment has tried to clarify the ambit of SEBI's jurisdiction but

⁷⁸ Soni & Bagchi, *supra* note 27, at 15.

⁷⁹ *Id.*

⁸⁰ Companies Act, 2013; § 24.

⁸¹ Soni & Bagchi, *supra* note 27, at 15.

⁸² *Sahara India Real Estate Ltd. v. Securities Exchange Board of India*, (2013) 1 SCC 1 (India).

⁸³ *Id.*

doesn't help the case of crowdfunding due to its hybrid nature. Furthermore, Securities Laws (Amendment) Act, 1995 has tried to create clear demarcation between the regulatory powers of SEBI and MCA by abrogating the power of central government to exempt any securities market transaction from SEBI's purview.⁸⁴

The authors are of the opinion that SEBI's consultation paper is based on an assumed jurisdiction which doesn't have any legal backing. Authors propose that the legislators shall work out the intricacies of crowdfunding and come up with a separate legislation empowering a particular body. It can learn from the example of US, which has amended several provisions of Securities Act, 1933 and empowered the Securities Exchange Commission (SEC) to regulate crowdfunding.⁸⁵ In the opinion of authors, SEBI has more expertise in regulating a platform like crowdfunding which demands investment from public. Thus, SEBI's assumed jurisdiction may be right with respect to regulation of crowdfunding but it cannot be appropriate without a proper legislation acknowledging the nature of crowdfunding and empowering SEBI.

SEBI's Proposals

First, the author observes that the "accredited investors" form a very small portion of investors. The threshold levied on retail investors investing through crowdfunding platform is very high.⁸⁶ It is restricted to only wealthy investors and those who have experience or knowledge or advice from an investment advisor. Such condition add to the reduction of "crowd" from crowdfunding by reducing large number of potential retail investors which forms crowd.⁸⁷ Such restrictions do not ease the restrictions already imposed on traditional venture capital funds or private equity investors but only provides them a provision to operate through internet.

Second, accredited investors having greater expertise and experience in investing in start-ups would be able to identify start-ups which are likely to succeed. They would thus only invest in such start-ups, thereby excluding large number of businesses that are vulnerable and seek funds through crowdfunding platforms. Similarly, due to the requirement that QIBs shall collectively hold at least 5% of securities, the chances of crowdfunding failure has increased. In view of the fact that QIBs are in a position to ascertain start-ups with chances of success, it would result in investment into only those start-ups which are success-worthy.⁸⁸

⁸⁴ Securities Law (Amendment) Act, 1995.

⁸⁵ Soni & Bagchi, *supra* note 27, at 15.

⁸⁶ P.M. Vasudev & Susan Watson, *Global Capital Markets: A Survey of Legal and Regulatory Trends*, EDWARD LEGAL PUBLISHING, (2017).

⁸⁷ Darian M. Ibrahim, *Equity Crowdfunding: A Market for Lemons?*, 100 MINNESOTA LAW REVIEW, 561, (2015), https://www.minnesotalawreview.org/wp-content/uploads/2016/01/Ibrahim_4fmt.pdf, (last accessed on August 10, 2020).

⁸⁸ Majumdar & Varottil, *supra* note 1, at 17.

The limitation of investors to accredited investors creates the possibility where an accredited investor with established connection may not invest through crowdfunding at all, when it has access to other existing mechanisms that creates contact between start-ups and angel investors.⁸⁹

Third, on reading the consultation paper, it seems that only the unlisted public companies can have access to crowdfunding platforms. We have already established that being public comes with its disadvantage of extra compliances and obligations. It is a burdensome process where public companies have to undergo a lot of disclosure requirements. Thus, it is highly improbable that such early stage start-ups would be structured as public company.⁹⁰ Therefore, authors opine that it is more practical to allow the start-ups which are structured a private companies, Limited Liability Partnerships, or One Person Companies to be able to access crowdfunding platform.

Fourth, the disclosures that are required by the issuing company to provide via private placement are burdensome for the early stage businesses. The requirements to disclose their financial condition, management, history, future plans, rights and liabilities attached to securities are excessively detailed requirements for such new issuers. Such companies might not have the resources available for such detailed information.⁹¹ It may create a scenario where such companies end up giving excess information which in turn harms them. Thus, such onerous obligations which are otherwise put on public and private companies shall not be similarly applied to early stage businesses.⁹²

Fifth, SEBI's Consultation paper does not provide a secondary market for the investors investing through crowdfunding platforms. It limits the selling of shares to the issuer, or to the accredited investor registered on same platform, or to the family member or relative.⁹³ Such restriction would be against the investor's interest and may act as a deterrent. Investors would not have an exit option, in case they want to recoup their investments or if they want immediate exit when the company suffers loss.⁹⁴ The authors believe that a forum should be created where the company's accounts could be displayed and the option of selling the shares is made

⁸⁹ Majumdar, *supra note 17*, at 25.

⁹⁰ Mukul Agarwal, et al, *Crowd- Get Ready to Fund!!! SEBI Proposes A New Framework*, NISHITH DESAI ASSOCIATES HOTLINE, (Jul., 3, 2014), http://www.nishithdesai.com/information/research-and-articles/nda-hotline/nda-hotline-single-view/article/crowd-get-ready-to-fund-sebi-proposes-a-new-framework.html?no_cache=1&cHash=ba6faea21bee5d30450465b332c6fb10, (last accessed on 10 August 2020).

⁹¹ Soni & Bagchi, *supra note 27*, at 15.

⁹² Thomas Lee Hazen, *Crowdfunding or Fraudfunding? Social Networks and the Securities Laws – Why the Specially Tailored Exemption Must be Conditioned on Meaningful Disclosure*, 90 NORTH LAW REVIEW, 1736, (2012).

⁹³ Para 9.9.4

⁹⁴ Majumdar, *supra note 17*, at 12.

available.⁹⁵

Sixth, the whole process which requires due diligence and screening of companies by the crowdfunding platforms would increase the transaction costs.⁹⁶ It is obvious that the investors would anyway conduct adequate due diligence, regulatory and background check on the company.⁹⁷ Therefore, the additional due diligence by screening committee would be burdensome and costly for issuing companies as well as the platforms.

Seventh, the small companies and start-ups which seek funds through crowdfunding platforms are prohibited from advertising and soliciting their offers in public due to the restriction on private placements as per Companies Act and Rules.⁹⁸ This goes against the essence of crowdfunding. Due to its nature of private placement, it also faces the cap on number of investors to 200.⁹⁹ This again goes against the very nature of crowdfunding which involves “crowd”.

Eighth, the crowdfunding path is the middle of public offer and private placement.¹⁰⁰ SEBI’s proposal suggest structuring of crowdfunding as private placement while it should be in a less regulated form of public offer. This structure goes against the very tenet of crowdfunding. SEBI’s proposal has not effectively changed anything as the restrictions placed in earlier regulatory regime remains the same except it is more stringent and online which makes securities crowdfunding difficult.¹⁰¹

Ninth, SEBI needs to understand that the market does not function effectively under fear and suspicion. It needs to provide way for entities to avail various opportunities along with the risks associated with it and manage it themselves. In such a scenario, the classification of entities to be eligible to operate as crowdfunding platform was totally uncalled for. It hampers and deters the existing crowdfunding platforms like Wishberry, Bitgiving, etc. that primarily functions under donation and reward based crowdfunding from entering into the field of equity based crowdfunding.¹⁰²

Cross-Border Crowdfunding

⁹⁵ Pratyush Pandey, *Analysis of the consultation paper on Crowdfunding in India by SEBI*, IPLEADERS, (Aug. 4, 2014), <https://blog.ipleaders.in/analysis-of-the-draft-crowdfunding-rules-by-sebi/>, (last accessed on 10 August 2020).

⁹⁶ Majumdar & Varottil, *supra* note 1, at 18.

⁹⁷ *Id.*

⁹⁸ Companies Act, 2013; § 42 (8).

⁹⁹ Companies Rules, 2014; Rule 12 (2) (b).

¹⁰⁰ Soni & Bagchi, *supra* note 27, at 15.

¹⁰¹ Vasudev & Watson, *supra* note 84.

¹⁰² Soni & Bagchi, *supra* note 27, at 16.

SEBI's Consultation Paper has completely skipped the issue of cross-border crowdfunding. Due to wide reach of internet and the nature of crowdfunding which is to access large crowd, it may be possible that Indian investors participate in foreign crowdfunding activities where a foreign company may raise funds through crowdfunding. Another possibility is of Indian companies raising funds from foreign investors through crowdfunding platform.¹⁰³ These two scenarios raises plethora of questions. It questions SEBI's jurisdiction in governing foreign investors and its role in protection of investors beyond Indian borders. It needs to be clarified whether SEBI has the duty to protect foreign investors participating in Indian crowdfunding activities and Indian investors participating in foreign crowdfunding activities. Also, whether SEBI has jurisdiction over all the activities of Indian crowdfunding platform or only over the ones within India. Additionally, how will SEBI protect investors in case of cross-border platform's insolvency?¹⁰⁴

IOSCO Staff Paper suggests international harmonisation of crowdfunding regulations so as to enable effective cross-border crowdfunding. The uncertainties regarding contract law applications in different jurisdictions needs to clear for successful crowdfunding. One of the example of international platform of crowdfunding is TrustBuddy. It has different businesses and client accounts in each jurisdiction under its franchise so as to individually comply with the laws of each jurisdiction. But it hasn't experimented with the contract law part of crowdfunding across borders.¹⁰⁵

V. CONCLUSION

The authors are of the opinion that SEBI's proposals have failed to address the challenges which were present in existing regulatory regime in India. In fact, it has adopted earlier regime with stricter regulations on scope of investors and obligations of the platform. It is one question that whether SEBI has jurisdiction in crowdfunding but most important question is how it should be regulated. SEBI's proposals do not take into account the very definition of crowdfunding i.e. "*small financial contribution from large number of investors*". SEBI, by putting a cap on category and number of investors has taken away the essential "crowd" from crowdfunding. Further, instead of focussing on reducing the obligations on early stage businesses which do not have enough resources to fulfil them, SEBI has imposed strict disclosure requirements and other obligations that a public company has to undergo. It also has

¹⁰³ Majumdar, *supra note 17*, at 26.

¹⁰⁴ Aditi Bhargava, "et al", *Crowdfunding- an Emerging Concept in India*, 32 INTERNATIONAL JOURNAL OF LEGAL DEVELOPMENTS AND ALLIED ISSUES 57, 66 (2017).

¹⁰⁵ Kirby & Worner, *supra note 4*, at 42.

failed to understand the unconventional nature of crowdfunding which cannot be categorized into public offer or private placement under Companies Act. Its structuring as Private placement is contrary to its basic principle. An in-depth analysis of crowdfunding would reveal that equity or securities crowdfunding is a hybrid of public offer and private placement and cannot be defined as private placement. It is beyond the traditional mechanism of capital market.¹⁰⁶

The author opines that SEBI shall in consultation with the government bring adequate changes in the Companies Act and Rules to make it conducive for crowdfunding, by at least removing the cap on offers, easing the burdensome requirements and expanding the crowd. It should also provide a secondary market to incentivise the investors and clarify its stance on cross-border crowdfunding.

Authors accept that SEBI has to balance the small business interests with investors' interests and prevent fraudulent entities from taking advantage of investors. But SEBI had entirely focussed on investor protection without paying any heed to the growth of small businesses. The SEBI Consultation paper has theoretically studied the regulation of crowdfunding across various jurisdictions but has failed in studying empirical evidences of the implementation of such regulations. It has failed to learn how the regressive regulatory approaches have had negative effect on crowdfunding in countries like US.¹⁰⁷

The regulatory bodies should study the contours of crowdfunding, its significance and its regulation in various jurisdictions. It should carry out an Impact Assessment Study of the regulatory approaches in different jurisdictions¹⁰⁸ and accordingly frame a separate Regulation for securities based crowdfunding in India. Hence, a separate legislation is imperative in order to regulate securities based crowdfunding in India. It should take into consideration SEBI's proposals and address the loopholes in the same, which affects adequate progress of crowdfunding mechanism.

¹⁰⁶ Sheldon Ryan Hoffman & Joan Mcleod Heminway, *Proceed At your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN. L. R., 879, 941, (2011).

¹⁰⁷ Soni & Bagchi, *supra note 27*, at 16.

¹⁰⁸ *Id.*