Regulating Equity Crowdfunding in India - A Response to SEBI's Consultation Paper[*]

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Abstract

In the aftermath of the 2008 financial crisis, small businesses found it increasingly difficult to raise funds. As a response, equity crowdfunding has emerged as a viable alternative for sourcing capital to support innovative, entrepreneurial ideas and ventures. Equity crowdfunding merges the complexity of public funding, with the systemic risks of venture capital funding.

The Securities and Exchange Board of India (SEBI) has recently released a consultation paper which, inter alia, proposes a framework for ushering in crowdfunding by giving start-ups and SMEs access to capital markets and to provide an additional channel of early stage funding. This paper seeks to address some of the issues concerning the regulation of crowdfunding in India. The first issue that is raised is why must crowdfunding be subject to regulation, when pre-existing securities laws may be interpreted to include crowdfunding activities. A discussion on the nature of crowdfunding and its inherent differences from venture capital and public funding sets up the foundation for which a separate exemption may be carved out of existing securities laws. Similar to the JOBS Act and other legislations around the world, SEBI's consultation paper also seeks to create exemptions for crowdfunding activities. This raises the second issue involving a comparison of SEBI's proposed regulations, particularly in terms of eligibility criteria for fundraisers and contributors, mechanisms, levels of disclosure and independent accreditation, etc, with that of other jurisdictions.

A review of SEBI's consultation paper would ascertain whether the principles followed by SEBI in regulating this sector would culminate in the development of crowdfunding activity, or stifle it. At the same time, SEBI's consultation paper does not take into account two key aspects of crowdfunding. The first is that of peer to peer lending – when the proceeds of crowdfunds are issued to an individual and not a company. The second is that of cross-border crowdfunded companies. Given that crowdfunding is typically facilitated by web-based portals and promoted through social media and other internet-enabled networks, it is likely that crowdfunding activities will transcend national boundaries.

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I. Introduction

In the aftermath of the 2008 financial crisis, small businesses found it increasingly difficult to raise funds. As a response, crowdfunding has emerged as a viable alternative for sourcing capital to support innovative, entrepreneurial ideas and ventures[1]. According to a World Bank commissioned report in 2013, Kickstarter, the market leader in pledge or donation-based crowdfunding, has channeled over USD 815 million from 4.9 million backers to nearly 50,000 projects throughout the world, between 2009 and 2013[2]. By March 2014, Kickstarter had surpassed USD 1 billion[3].

The 2013 World Bank report also brings out the significance of crowdfunding in developing countries. It is estimated that households in developing countries would have the ability to make crowdfunded investments of upto USD 96 billion a year[4]. While much of this funding capacity is expected to come from China, Brazil is not far behind[5].

With the swift growth of the crowdfunding industry, a number of associated risks also arise, which in turn have attracted the attention of securities regulators. In order to mitigate such risks in India, the Securities and Exchange Board of India has recently released a consultation paper which, inter alia, proposes a framework for ushering in crowdfunding by giving access to capital market to provide an additional channel of early stage funding to start-ups and SMEs and seeks to balance the same with investor protection. This consultation paper comes in the wake of a number of regulatory changes around the world which seek to bring crowdfunding under the jurisdiction of securities regulators.

A key responsibility of any securities regulator is that of investor protection. Securities laws, involving stringent eligibility criteria for fundraising companies and detailed disclosure requirements have been most instrumental in mitigating risks for public retail investors to some extent. However, while more traditional forms of capital markets fundraising are highly regulated by virtue of securities laws[6], the same level of regulation might stifle crowdfunding efforts[7]. Policymakers continually face the challenge of effectively balancing the benefits of encouraging small business formation against the investor protection goals of the securities laws[8]. This challenge becomes even more pronounced in the case of crowdfunded companies which typically are small and medium enterprises[9].

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[1] Paul Belleflamme, Thomas Lambert, Armin Schwienbacher, "Crowdfunding: Tapping the Right Crowd", Journal of Business Venturing (forthcoming)

[2] Crowdfunding's Potential for the Developing World. 2013. infoDev, Finance and Private Sector Development Department. Washington D.C: World Bank

[3] Katherine Noyes, "Why investors are pouring millions into crowdfunding", Fortune, April 16, 2014 available at http://fortune.com/2014/04/17/why-investors-are-pouring-millions-into-crowdfunding/ (last accessed on 3rd January 2015)

[4] *Op.cit.* Crowdfunding's Potential for the Developing World

[5] Daniel Broderick, Crowdfunding's Untapped Potential In Emerging Markets, Forbes BrandVoice, August 5, 2014 available at http://www.forbes.com/sites/hsbc/2014/08/05/crowdfundings-untapped-potential-in-emerging-markets/ (last accessed on 3rd January 2015)

[6] 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 Carolina Law Review 1735

[7] Crowdfunding's Potential for the Developing World *op cit.*

[8] Crowdfunding or Fraudfunding, *op cit*

[9] Crowd-funding: An Infant Industry Growing Fast *op cit*

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In 2014, SEBI embarked upon this challenge. The primary question arises as to whether the proposed regulations on crowdfunding will promote or stifle the growth of the industry in India and consequently attempt to derive acceptable limits of regulation. If the costs associated with regulatory provisions for investor protection are excessive, crowdfunding may not remain a viable capital raising method. Crafting a crowdfunding exemption requires a careful balancing of investor protection and capital formation[10].

In order to ascertain suitable limits of regulation of the crowdfunding industry, three aspects may be considered. The first is an examination of pre-existing securities laws applicable to venture capital and public funding, the interpretation of which, may be expanded to include crowdfunding activities. However, the nature of crowdfunding is inherently different from venture capital and public funding. Crowdfunding involves a large number of possibly non-sophisticated investors, in an early-stage company which has a high chance of failure. Crowdfunding merges the complexity of public funding, with the systemic risks of venture capital funding. In other words, crowdfunding merges the complexity of public funding, with the systemic risks of venture capital funding. This distinction sets up the foundation for which a separate exemption may be carved out of existing securities laws.

Legislations exempting crowdfunding activities from traditional securities laws have been passed in a number of other jurisdictions, beginning with the United States[11]. Other countries, including Italy, New Zealand, the United Kingdom and Australia have followed suit[12]. Presently, the Indian Companies Act, 2013 prohibits the circulation of a fund raising offer for equity to more than 200 potential investors. It also prohibits companies from issuing shares to more than 50 shareholders without undertaking a public offering[13]. Similar to the JOBS Act and other legislations around the world, SEBI's consultation paper also seeks to create exemptions for crowdfunding activities. This raises the second issue involving a comparison of SEBI's proposed regulations, particularly in terms of eligibility criteria for fundraisers and contributors, mechanisms, levels of disclosure and independent accreditation, etc, with that of other jurisdictions.

As mentioned earlier, the challenge faced by policymakers in effectively balancing the benefits of business formation against the investor protection goals becomes far more acute in the case of crowdfunded companies[14]. In terms of the existing law on raising capital, a proposition may be made that the present-day law in India makes it impossible for crowdfunding activities to occur. Any exemptions offered to crowdfunding activities must still address certain basic issues concerning information asymmetry, agency costs and investor protection at the very least. A review of SEBI's consultation paper would ascertain whether the principles followed by SEBI in regulating this sector would culminate in the development of crowdfunding activity, or stifle it.

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[10] C. Steven Bradford, "Crowdfunding And The Federal Securities Laws", 2012 Columbia Business Law Review 1

[11] Jumpstart our Business Startups Act, 2012 (United States)

[12] Decreto Crescita Bis of December 2012 (Italy); Financial Markets Conduct Bill of September 2013 (New Zealand); Financial Conduct Authority Regulation on equity crowdfunding of March 2014 (UK); Guidance Note on Crowdfunding, Australian Securities and Investments Commission, 12-196MR ASIC guidance on crowd funding, http://asic.gov.au/about-asic/media-centre/find-a-media-release/2012-releases/12-196mr-asic-guidance-on-crowd-funding/

[13] Section 42, Companies Act, 2013

[14] Eleanor Kirby and Shane Worner, "Crowd-funding: An Infant Industry Growing Fast", Staff Working Paper No. [SWP3/2014], IOSCO Research Department

At the same time, SEBI's consultation paper does not take into account two key aspects of crowdfunding. The first is that of peer to peer lending – when the proceeds of crowdfunds are issued to an individual and not a company. The second is that of cross-border crowdfunded companies. Given that crowdfunding is typically facilitated by web-based portals and promoted through social media and other internet-enabled networks, it is likely that crowdfunding activities will transcend national boundaries.

This paper examines the form and mechanism of SEBI's proposed regulations on crowdfunding to ascertain whether such regulations will promote or stifle the industry. We begin with an examination of the mechanism of crowdfunding and the extant law on fundraising in India.

II. Overview of Existing Fundraising Laws in India

a. The Sahara Case

Before we delve into and analyze the present law on fundraising, the case of *Sahara India Real Estate Corporation Ltd. & Ors. v. Securities Exchange Board of India & Anr*[15] places into perspective, the provisions relating to fundraising under Indian company law.

Two unlisted companies belonging to the Sahara Group of Companies - Sahara India Real Estate Corporation Limited (hereinafter referred as SIRECL) and Sahara Housing Investment Corporation Limited (hereinafter referred as SHICL), sought to raise funds by issuing optional fully convertible debentures on a private placement basis. The Red Herring prospectus filed by Sahara companies provided that the Sahara companies did not intend to list these securities on any recognized stock exchange. Further, the RHP provided that only those persons to whom the information memorandum was distributed[16] and/or friends, associated group companies, workers/employees and other individuals associated with Sahara Group were eligible to apply for the issue of these OFCDs. The extant law at the time provided that a prospectus inviting investments against the issue of securities by a company must be filed with the Registrar of Companies, Ministry of Corporate Affairs and the Securities and Exchange Board of India[17]. Since the OFCDs were not intended to be listed, it was the opinion of the Sahara companies that the prospectus would only be required to be filed before the Registrar of Companies and not the Securities and Exchange Board of India[18].

The information memorandum, as a pre-cursor to the prospectus, was issued through approximately a million agents and three thousand branch offices to more than thirty million persons, inviting them to subscribe to the OFCD. The Securities and Exchange Board of India was of the opinion that this amounted to a public offer and took cognizance of the distribution of the information memorandum while processing the draft RHP (DRHP) submitted by Sahara Prime City Limited, another Sahara group company, for its initial public offering.

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[15] (2013) 1 SCC 1

[16] Under Section 60B of the Companies Act, 1956 (now repealed)

[17] Section 60 of the Companies Act, 1956 (now repealed)

[18] Section 55A of the Companies Act, 1956 (now repealed) provided that the issue and transfer of securities and non-payment of dividend shall be administered by the Securities and Exchange Board of India in cases of listed public companies and those public companies which intend to get their securities listed on any recognized stock exchange in India

At the time, Sahara Prime City Limited had sought to raise up to INR 30 billion through the IPO in order to raise funds for its various housing projects across the country. As part of its draft red herring prospectus, it was required to disclose fundraising details of its group companies, including the Sahara companies mentioned above[19]. Upon the issue and notification of the draft red herring prospectus, SEBI invited comments and objections from the general public[20]. A number of complaints were received in respect of the disclosures made regarding the group companies of Sahara Prime City Limited including SIRECL and SHICL. These complaints alleged that SIRECL and SHICL were issuing convertible bonds to the public throughout the country for many months and the same was not disclosed in the Sahara Prime City Limited DRHP[21].

In spite of SEBI seeking clarifications on the issue of the OFCDs from the Sahara companies on a number of occasions, the Sahara companies did not furnish the details sought by SEBI. There evidently seemed to be reluctance on the part of the companies in providing the relevant details as sought by SEBI, which would enable SEBI to decide whether the OFCD issuances made by them are in compliance with the relevant provisions of the Act and applicable laws administered by SEBI[22]. Eventually, SEBI initiated an investigation and passed a final order on June 23, 2011. SEBI concluded that neither SIRECL nor SHICL had issued OFCDs by way of "private placement" and that the issue of the OFCDs did in fact, amount to a public issue, over which SEBI would have jurisdiction. The Sahara companies appealed first before the Securities Appellate Tribunal, and when the appeal was dismissed, to the Supreme Court of India.

One of the issues that arose *inter alia* before the Supreme Court of India was whether the OFCDs issued by SIRECL and SHICL were by way of "private placement"- as claimed by the Sahara Companies on appeal, or by way of an invitation "to the public" - as counter claimed by the SEBI?

Sahara contended that they were not bound by the Companies Act or the ICDR since theirs was not a public issue. The RHP explicitly stated that the OFCD was open to only those to whom the information memorandum was circulated or to those who were affiliated with the Sahara Group or were affiliated to people affiliated with the Sahara Group. Further their securities were unlisted in the stock exchange and would continue to remain so subsequent to their placement.

Firstly, the Supreme Court considered Section 67 of the Act which deals with the issue of shares and debentures to the Public. Section 67 (1) deals with the offering of shares and debentures to the public.[23]

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[19] Draft Red Herring Prospectus dated September 29, 2009 issued by Sahara Prime City Limited, available at http://www.sebi.gov.in/dp/saharaprime.pdf (last accessed on January 12, 2015)

[20] Under Regulation 9 of the SEBI (ICDR) Regulations, 2009

[21] Order bearing no WTM/KMA/CFD/316/11/2010 of the Securities and Exchange Board of India available at http://www.sebi.gov.in/cmorder/SaharaOrder.pdf (last accessed on January 12, 2015)

[22] Ibid

[23] Section 67 (1) Any reference in this Act or in the articles of a company to offering shares or debentures to the public shall, subject to any provision to the contrary contained in this Act and subject also to the provisions of sub-sections (3) and (4), be construed as including a reference to offering them to any section of the public, whether selected as members or debenture holders of the company concerned or as clients of the person issuing the prospectus or in any other manner.

Section 67(2) deals with what constitutes an invitation to the public to subscribe for shares and debentures.[24] Section 67 (3) deals with the circumstances when the offer or invitation would not be deemed to be made to the public.[25] However, the court held that proviso to section 67 (3) clearly elucidated that any offer made to 50 persons or more would be deemed to be a public offer and outside the purview of section 67 (3). Further, the Court pointed out that private placement is any offer or invitation to subscribe to securities to less than fifty persons or as per the provisions of section 67 (3) of the Companies Act[26].

The court then considered the persons to whom the OFCD's were offered. It observed that people who were not affiliated to the Sahara group were permitted to subscribe to the shares provided they were introduced by people affiliated with the Sahara Group. The court held that

> 'private placement connotes the issue of securities to close and associated people without issuing any advertisements with such conditions in which circumstances; the offering may not be construed as "offering securities to the public or invitation to public to subscribe for those securities. In this instance introduction would be required only by those not affiliated with the Appellant's Companies; in other words the general public'.

Secondly, the court also held that the since the issue had been made to the public through the use of the information memorandum, provisions of Section 60B(9) requiring the filing of prospectus of the SEBI were attracted[27]. The Sahara companies' conduct of issuing the information memorandum through approximately a million agents and three thousand branch offices to more than thirty million persons was indeed a public issue and therefore sufficient in order to attract the provisions of Section 73. The Court accepted SEBI's contention that the OFCDs issued by SIRECL and SHICL was by way of an invitation "to the public"[28].

Lastly, after establishing that the securities were offered to the public, the Court took into account, the provisions of Section 73 of the Companies Act which provided for the mandatory listing of the securities in a recognised stock exchange when offered to the public[29].

b. Aftermath of Sahara and Consequent Changes in the Company Law

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[24] Section 67 (2) Any reference in this Act or in the articles of a company to invitations to the public to subscribe for shares or debentures shall, subject as aforesaid, be construed as including a reference to invitations to subscribe for them extended to any section of the public, whether selected as members or debenture holders of the company concerned or as clients of the person issuing the prospectus or in any other manner.

[25] Section 67 (3) No offer or invitation shall be treated as made to the public by virtue of sub-section (1) or sub section (2), as the case may be, if the offer or invitation can properly be regarded, in all the circumstances -
(a) as not being calculated to result, directly or indirectly, in the shares or debentures becoming available for subscription or purchase by persons other than those receiving the offer or invitation ; or
(b) otherwise as being a domestic concern of the persons making and receiving the offer or invitation:

[26] Section 2 (h), SEBI (Issue and Listing of Debt Securities) Regulations, 2008.

[27] Section 60B (9) Upon the closing of the offer of securities, a final prospectus stating therein the total capital raised, whether by way of debt or share capital and the closing price of the securities and any other details as were not complete in the redherring prospectus shall be filed in a case of a listed public company with the Securities and Exchange Board and Registrar, and in any other case with the Registrar only.]

[28] *Sahara India Real Estate Corporation Ltd. & Ors. v. Securities Exchange Board of India & Anr* (2013) 1 SCC 1

[29] Section 73(1) Every company intending to offer shares or debentures to the public for subscription by the issue of a prospectus shall, before such issue, make an application to one or more recognised stock exchanges for permission for the shares or debentures intending to be so offered to be dealt with in the stock exchange or each such stock exchange. '

As a direct result of the Sahara case, the Ministry of Corporate Affairs introduced a new provision in the then Companies Bill 2011 (enacted in 2013). The Companies Bill 2011 was scheduled to replace the earlier Companies Act of 1956. Given the slightly ambiguous demarcation of jurisdiction between the Registrar of Companies and the Securities and Exchange Board of India, it was felt necessary to clearly set out what constituted a public offer and what did not.

Section 42 of the Companies Act, 2013 enables companies to make private placement through issue of a private placement offer letter[30]. Through these private placements, the company may issue shares to upto fifty persons (not including qualified institutional buyers[31] and employees). This restriction is further reinforced in the Companies (Prospectus and Allotment of Shares) Rules, 2014. A company may only make an offer for the issue and allotment of shares to upto two hundred persons in a financial year[32] (again, not including qualified institutional buyers and employees).

In the event that a company, listed or unlisted, makes an offer to allot or invites subscription, or allots, or enters into an agreement to allot, securities to more than the prescribed number of persons, whether the payment for the securities has been received or not or whether the company intends to list its securities or not on any recognized stock exchange in or outside India, the same shall be deemed to be an offer to the public and shall accordingly be governed by the provisions relating to public offers[33].

The explanation to Section 42(2) suggests a prohibition to the exact situation as that of the Sahara companies. Irrespective of the fact that the company may not list its securities on any stock exchange or that payment for the securities may not have been received, if the company makes an offer to allot or issue securities to more than two hundred persons in a financial year, or if the company allots or issues securities to more than fifty persons, it would be deemed to be an offer to the public. Public offerings in India are governed under Part I of Chapter III of the Companies Act, 2013 and the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations 2009. The public offer process

[30] Section 42 (1) Companies Act, 2013. See also Rule 14 and Form PAS-4 of the Companies (Prospectus and Allotment of Securities) Rules, 2014

[31] Regulation 2(zc) of the SEBI ICDR Regulations, 2009 defines 'qualified institutional buyer' as

(i) a mutual fund, venture capital fund, Alternative Investment Fund and foreign venture capital investor registered with the Board;
(ii) a foreign institutional investor and sub-account (other than a sub-account which is a foreign corporate or foreign individual), registered with the Board;
(iii) a public financial institution as defined in section 4A of the Companies Act, 1956;
(iv) a scheduled commercial bank;
(v) a multilateral and bilateral development financial institution;
(vi) a state industrial development corporation;
(vii) an insurance company registered with the Insurance Regulatory and Development Authority;
(viii) a provident fund with minimum corpus of twenty five crore rupees;
(ix) a pension fund with minimum corpus of twenty five crore rupees;
(x) National Investment Fund set up by resolution no. F. No. 2/3/2005-DDII dated November 23, 2005 of the Government of India published in the Gazette of India
(xi) insurance funds set up and managed by army, navy or air force of the Union of India;
(xii) insurance funds set up and managed by the Department of Posts, India;

[32] Rule 14(2)(b) of the Companies (Prospectus and Allotment of Securities) Rules, 2014

[33] Explanation I to Section 42(2), Companies Act, 2013

includes a far longer and more onerous set of requirements and eligibility criteria than the private placement route. The cost of capital in public offers is also typically higher than that of a private placement[34].

c. Other Methods of Fundraising

There is a separate fundraising mechanism available for Small and Medium Enterprises (SME). Companies having a post-issue paid up share capital of less than INR 250 million have an option to list on the SME exchange[35] as opposed to the main board. Companies having a post-issue paid up share capital of less than INR 100 million must necessarily list on the SME exchange and not the main board. A number of relaxations have been allowed in case of SME listings, including filing the draft offer document directly to the stock exchange, relaxed eligibility criteria and lesser continuous disclosures amongst others[36].

Venture capital funds are also regulated in India[37]. VCFs may be in the form of a body corporate, a trust or a company, which are required to register themselves in order to carry out activities as a VCF. VCFs must meet eligibility criteria and must comply with the provided investment guidelines. The investment strategy of the VCF must be disclosed to SEBI at the time of registration. The minimum contribution from each investor is INR 500,000 and the VCF must have a corpus of a minimum of INR 50 million. There are further restrictions as to the types of investments a VCF may make. No more than 25% of the VCF's corpus may be invested in a single venture and a minimum of 66.67% of the corpus must be invested in unlisted equity instruments. VCFs cannot invite subscription from the public and must receive funds and issue units only via the private placement route.

Privately owned investment vehicles in India raising funds from Indian or foreign investors are also regulated - under the SEBI (Alternative Investment Funds) Regulations, 2012. Alternative investment funds may be trusts, companies, LLPs or body corporates which invest pooled funds for the benefit of the investors and must be registered with SEBI. There are three categories of AIFs, of which the investments of Category I AIFs are restricted to start-ups, early stage ventures, social ventures, SMEs, in the infrastructure or other sectors or areas which the government or regulators consider as socially or economically desirable, venture capital funds, SME Funds, social venture funds and infrastructure funds. Category III investment funds employ diverse or complex trading strategies and may employ leverage including through investment in listed or unlisted derivatives. Category II investment funds are those which do not fall under Categories I or III. Similar to VCFs, the investment strategy, purpose and methodology must be disclosed. The minimum investment required from each contributor is INR 10 million and the minimum investment corpus is required to be INR 200 million. Again, similar to VCFs, AIFs cannot invite subscription from the public and must receive funds and issue units only via the private placement route.

[34] Jay R. Ritter, The costs of going public, Journal of Financial Economics, Volume 19, Issue 2, December 1987, Pages 269-281. See also

[35] A trading platform of a recognised stock exchange having nationwide trading terminals meant for small and medium enterprises

[36] Chapter XB, SEBI (ICDR) Regulations, 2009

[37] SEBI (Venture Capital Funds) Regulations, 1996

In the next section we shall describe the mechanism of crowdfunding and how, given the extant provisions of law relevant to fund raising for companies in India, the same would be outright illegal, unless an exemption for crowdfunded companies is made.

III. Why the Crowdfunding Industry needs an Exemption in India

a. How Does Crowdfunding Work?

Crowdfunding is an umbrella term used to describe a method of mass communication, typically the Internet, to solicit funds from the community at large, with the project creator receiving small individual amounts of funding from a large number of donors or investors[38]. It essentially represents the natural convergence of microfinance and crowdsourcing[39]. Crowdfunding may be carried out in four ways[40] -

1. Donation crowd-funding – where funds are transferred from contributors without any expectation or liability for returns on such funds transferred. Typically donation crowdfunding is undertaken for charitable causes
2. Reward crowd-funding – funds are transferred from contributors with an agreement, tacit or otherwise, that fund-raisers would reward contributors in myriad of ways including pre-payment of a future product, free merchandise. Donation and rewards based crowdfunding do not typically offer any yields or returns on investment. As a variation of the rewards crowdfunding model, fundraisers may also engage a pre-purchase model[41]. In the pre-purchase model, contributors receive the product that the entrepreneur is making. For example, if the entrepreneur is seeking to raise funds to produce and sell a watch which can interact with Android and iOS devices, contributors would receive a watch for every USD 120 they contributed[42].
3. Peer-to-peer lending – individual lenders and borrowers are matched using an online platform. Bulk loan requirements are covered by individual lenders who may choose to provide funds for part of the requirement. These smaller portions are aggregated by the platform and the loan is originated and released to the borrower.
4. Equity crowdfunding –an equity stake in the company raising funds is offered, proportionate to the quantum invested. Contributors assume the risks and liabilities of shareholders in the company.

Governments and securities regulators are typically concerned (as is this paper) with peer-to-peer lending and equity crowdfunding (collectively referred to as financial return crowdfunding) primarily since they fall within the jurisdiction of debt and equity regulation. As a result, most of the doctrinal or socio-economic commentary on crowdfunding, including this paper, is centered on these two models.

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[38] Thaya Brook Knight, Huiwen Leo and Adrian A. Ohmer, "A Very Quiet Revolution: A Primer On Securities Crowdfunding And Title III Of The Jobs Act", 2 Michigan Journal of Private Equity and Venture Capital Law 135

[39] Andrew C. Fink, "Protecting the Crowd and Raising Capital Through the CROWDFUND Act" 90 University of Detroit Mercy Law Review 1 (2013)

[40] C. Steven Bradford, "Crowdfunding And The Federal Securities Laws", 2012 Columbia Business Law Review 1

[41] Schwienbacher, Armin, Entrepreneurial Risk-Taking in Crowdfunding Campaigns (August 29, 2014). Available at SSRN: http://ssrn.com/abstract=2506355 or http://dx.doi.org/10.2139/ssrn.2506355

[42] Agrawal, Ajay K., Christian Catalini, and Avi Goldfarb. Some simple economics of crowdfunding. No. w19133. National Bureau of Economic Research, 2013. Interestingly, Pebble, the watch company that offered such products, raised the required capital in two hours. They eventually raised USD 10 million over 37 days (see also, Best, Jason, et al. "How Big Will the Debt and Equity Crowdfunding Investment Market Be? Comparisons, Assumptions, and Estimates." University of California, Berkeley, College of Engineering (2013))

Equity crowdfunding typically involves a company requiring funds for a defined purpose (the fundraiser) which then describes its requirement for funds and the purpose for which the funds will be used, on a crowdfunding website (the portal). The fundraiser also sets out the rewards, financial or otherwise at the portal. Visitors to the portal (contributors) may choose to enter into an electronic transaction, based upon the representations offered by the fundraiser. Funds are electronically transferred from the contributors' accounts to the portal. Once the quantum of required funds is met, the portal releases the funds to the fundraiser. Simultaneously, the fundraiser issues securities, in the form of equity, to the contributors. Contributors look to receive a return in the form of a dividend stream or capital gain- similar to buying shares of a startup company or an MSME[43]. The portal is paid a fee for its services.

b. Advantages and Risks of Crowdfunding

This mechanism offers a number of advantages, primarily to the fundraiser, but also to the contributor and the portal. One of the biggest advantages that fundraisers have as on date is curiously enough, the lack of regulation. Companies that raise funds from fifty or more investors are required to undertake a public offer, regulated under the Companies Act, 2013 as well as the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009. Using the Internet, an entrepreneur can sell an idea that is viable and can be monetized- to literally millions of potential investors[44]. No intermediary such as a merchant bank or an underwriter is needed[45]. Other advantages include the spreading of risk and the boost to the economy through encouragement in the growth of SMEs[46].

However these benefits must necessarily be balanced against a number of risks. The first of these include the risk of investing in an early-stage company. Because of the low cost of capital and the relative ease with which entrepreneurs may access and engage with crowdfunding portals, crowdfunding has been used by many startup companies to raise smaller amounts of money for their initial stage[47]. Startup companies have an inherent risk of failure. Failure statistics universally show that over 50% of newly founded firms will fail during their first five years[48]. In the event that such newly founded business ventures are also crowdfunded, contributors' expectations of dividends or capital appreciation may well be blighted. Consider the case of Bubble and Balm - a fair trade soap company. In 2011 it raised GBP 75,000 through an equity crowd-funding platform Crowdcube, based in the UK. In return, it issued 15 per cent of the company's equity. In July 2013 the business closed abruptly, leaving contributors in the lurch. The

[43] Eleanor Kirby and Shane Worner, "Crowd-funding: An Infant Industry Growing Fast", Staff Working Paper No. [SWP3/2014], IOSCO Research Department

[44] Stuart R. Cohn and Gregory C. Yadley, "Capital Offense: The SEC's Continuing Failure to Address Small Business Financing Concerns", 4 N.Y.U. Journal of Law and Business 1, 6 (2007).

[45] Verstein, Andrew, The Misregulation of Person-to-Person Lending, 45 UC Davis Law Review 2 (2011)

[46] Eleanor Kirby and Shane Worner, "Crowd-funding: An Infant Industry Growing Fast", Staff Working Paper No. [SWP3/2014], IOSCO Research Department and The World Bank, Crowdfunding's Potential for The Developing World

[47] Armin Schwienbacher & Benjamin Larralde, Crowdfunding Of Small Entrepreneurial Ventures in Douglas Cumming (ed.) OXFORD HANDBOOK OF ENTREPRENEURIAL FINANCE (Oxford University Press), 2012

[48] Laitinen, Erkki K. "Prediction of failure of a newly founded firm." Journal of Business Venturing 7.4 (1992): 323-340.

contributors, having no way to recoup their losses or even contact the company, lost their entire investment[49].

Crowdfunding portals and their operations create causes for concern as well – primarily due to the lack of a secondary market. Typically in a company which has issued securities to the public, such securities are freely tradable on stock markets. The Companies Act, 2013 also prohibits restrictions on transferability of public, listed company shares[50]. Conversely, crowdfunded securities cannot be traded on crowdfunding portals as on date- leading to illiquidity. As a result, contributors cannot sell their securities to recoup their investments[51]. This risk is exacerbated in cases of default or fraud, where an immediate exit option from the company does not exist. As intermediaries, portals face a significant risk of liability arising out of false disclosures by fundraisers[52]. However, crowdfunding portals in unregulated jurisdictions, having no requirements to register themselves with the securities regulator, have little to lose from closing operations overnight[53]. Finally, the lack of standardized security measures across platforms give rise to issues relating to cybercrimes.

The third risk posed to contributors is the lack of transparency and information asymmetry[54], coupled with the lack of experience of many investors. A large number of startups are engaged in deriving revenue from technological advancements. The question of whether a technological advance is viable, or convertible into revenue, requires some level of expertise. While it is possible that a number of contributors to a tech startup may well be educated in aspects and viability of the technology concerned, it is not always the case. Similarly, music or visual art related projects involve a high degree of subjectivity as to its revenue generation capability[55]. This too, requires specialized knowledge of the music or visual art industries, which contributors may not possess. Further, when investing in a crowdfunded project, contributors are reliant solely upon the representations of fundraisers and do not undertake a due diligence on the company that they are investing into[56]. Portals typically do not offer any certification as to the veracity of the claims of fundraising companies. The lack of a detailed review on the fundraising company opens up the possibility of fundraising companies to conceal information relevant to the future of the company, whether actively or

[49] Lucy Warwick-Ching, Tanya Powley and Elaine Moore, "Alarm bells for crowdfunding as bubble pops for soap start-up, Financial Times", July 31, 2013, available at http://www.ft.com/intl/cms/s/0/8d680fd4-f9d9-11e2-b8ef-00144feabdc0.html#axzz3OgruYYXa (last accessed on January 13, 2015)

[50] Section 58, Companies Act, 2013 (the board of directors may however, restrict or refuse to acknowledge the transfer of shares in a private company)

[51] Eleanor Kirby and Shane Worner, "Crowd-funding: An Infant Industry Growing Fast", Staff Working Paper No. [SWP3/2014], IOSCO Research Department

[52] Bradford, C. Steven, Shooting the Messenger: The Liability of Crowdfunding Intermediaries for the Fraud of Others (June 27, 2014). University of Cincinnati Law Review, 2014.

[53] Eleanor Kirby and Shane Worner, "Crowd-funding: An Infant Industry Growing Fast", Staff Working Paper No. [SWP3/2014], IOSCO Research Department

[54] John Wasik, Crowdfunding, the JOBS Act, and Scams in Your Inbox, Forbes (Mar. 23, 2012, 12:23 PM), http://www.forbes.com/sites/johnwasik/2012/03/23/potentialand-obvious-scams/

[55] Galuszka, Patryk and Bystrov, Victor, Crowdfunding: A Case Study of a New Model of Financing Music Production (August 20, 2014). Galuszka, P., & Bystrov, V. (2014). Crowdfunding: A Case Study of a New Model of Financing Music Production. Journal of Internet Commerce, 13(3-4), 233–252

[56] Agrawal, Ajay K., Christian Catalini, and Avi Goldfarb. Some simple economics of crowdfunding. No. w19133. National Bureau of Economic Research, 2013

passively[57]. Some studies show that instead of detailed disclosures as to the crowdfunded project, stronger and more verifiable social networks of the fundraiser are associated with a higher chance of success[58]. Further, there is no independent perspective offered by an industry specialist as typically seen in securities acquisition transactions.

c. Application of Existing Indian Fundraising Laws to Crowdfunding

As mentioned earlier, Indian law prohibits companies from offering to issue shares to more than two hundred potential investors in a financial year or from allotting shares to fifty or more shareholders, without undertaking a public offer. A public offering of shares or convertible debt securities involves the appointment of one or more merchant bankers, a registrar to the issue, filing of a draft offer document with SEBI, eligibility requirements such as previous track record, minimum promoter's contribution, lock-in requirements, requirement to have a monitoring agency, etc., apart from detailed disclosure requirements[59]. For a public issue of debt securities, a similar, albeit simpler regime is applicable in terms of the SEBI (Issue and Listing of Debt Securities) Regulations, 2008. Further, once listed on a stock exchange, companies are required to comply with the various continuous disclosure requirements of the listing agreement.

The case of Sahara, wherein the two companies raised approximately INR 176.5 billion from 30 million investors, is not unlike the mechanism used by crowdfunded companies. While Sahara relied on its network of offices and agents, fundraisers place considerable dependence on their social networks. One key difference, of course, is the usage of the internet and online social networks in cases of crowdfunding.

When placed in perspective of the large numbers of contributors typically associated with crowdfunding, it is apparent that such fundraising mechanisms will run afoul of Section 42 of the Companies Act, 2013. Such instances are not unheard of. In February 2011, one of the leading equity crowdfunding portals at the time was asked to register itself as a broker-dealer under California law or cease its operations of selling securities[60]. While there have not been equity crowdfunding portals in India as yet, the Securities and Exchange Board of India has considered giving startups and SMEs access to capital markets to provide an additional channel of early stage funding while balancing the same with investor protection[61].

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[57] Andrew C. Fink, "Protecting the Crowd and Raising Capital Through the CROWDFUND Act" 90 University of Detroit Mercy Law Review 1 (2013)

[58] Mingfeng Lin, N.R. Prabhala and Siva Viswanathan, "Judging Borrowers by the Company they Keep: Friendship networks and information Asymmetry in Online Peer-to-Peer Lending", Management Science, Vol. 59(1), pp17-35

[59] SEBI (ICDR) Regulations 2009

[60] Leena Rao, Fundraising Platform For Startups ProFounder Shuts Its Doors, TechCrunch, February 17, 2012 available at http://techcrunch.com/2012/02/17/startup-fundraising-platform-profounder-shuts-its-doors/ (las accessed on January 14, 2015.

[61] Consultation Paper on Crowdfunding in India, Securities and Exchange Board of India available at http://www.sebi.gov.in/cms/sebi_data/attachdocs/1403005615257.pdf

Contributors to crowdfunded companies typically make small investments[62] and in most cases, would not meet the minimum investment requirements of the VCF or the AIF regulations[63]. VCFs and AIFs would also require registration and would be restricted in their investments. VCFs and AIFs are also required to have a diversified portfolio of investments.

This sets up a necessity for an exemption from the existing laws on fundraising. Specifically, it requires an amendment in the extant fundraising provisions to allow startups and SMEs to enter into crowdfunding activities without having to undertake a public offering. In doing so, India joins a number of other jurisdictions which have also considered or are in the process of considering such exemptions. In the next section, we will delve into the regulatory mechanisms of crowdfunding in other countries.

IV. Crowdfunding Regulatory Mechanisms Around the World

Three regulatory regimes can be identified in equity crowdfunding[64]. In the first case, regulation prohibits equity crowdfunding in its entirety while reiterating the existing law on fundraising by companies. In the second case, countries have begun to consider that this new way of raising capital and that it falls under the regulation of public offers of securities. In the third case, several countries have adopted tailored regulations which seek to encourage this financing without apparently compromising investor protection.

a. Australia

Raising capital in Australia is governed under the Corporations Act. While most capital raising issues require detailed disclosures in the form of a prospectus there are two main situations where a disclosure document is not required in an Australian securities offering- offers made to sophisticated investors and small-scale offerings[65]. Offers may be made without a disclosure document to investors who can show least AU $2.5 million in net assets or AU $250,000 in annual income[66]. Other investors are debarred from participating in such offers. Small scale offerings are restricted to AUD 2 million and the number of investors is restricted to 20[67]. The Australian Small Scale Offerings Board, as the name suggests, facilitates small-scale funding and provides for a secondary market[68]. Since 2005, the Australian Small Scale Offerings Board has raised $140 million in funding for more than 300 startups and small to medium enterprises through equity crowdfunding[69].

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[62] Gordon Burtch, Anindya Ghose and Sunil Wattal, An Empirical Examination of the Antecedents and Consequences of Contribution Patterns in Crowd-Funded Markets, Information Systems Research, 24(3), 499-519

[63] Recall that the minimum investment requirement to participate in a VCF or an AIF is INR 500,000 and INR 10 million respectively.

[64] Eleanor Kirby and Shane Worner, "Crowd-funding: An Infant Industry Growing Fast", Staff Working Paper No. [SWP3/2014], IOSCO Research Department

[65] Matt Vitins, "Crowdfunding and Securities Laws: What the Americans Are Doing and the Case for an Australian Crowdfunding Exemption", 22 Journal of Law, Information and Science, 92 (2013)

[66] Section 728 of the Australian Corporations Act

[67] Section 208 of the Australian Corporations Act

[68] http://www.assob.com.au/

[69] Kye White, "The solution to equity crowdfunding lies with ASIC", Startup Smart, 22 September 2014, available at http://www.startupsmart.com.au/growth/the-solution-to-equity-crowdfunding-lies-with-asic/2014092213259.html

It has been argued that neither of these exemptions serve the purposes of crowdfunding, which typically involves investors with varying net assets and annual income and certainly involves more than 20 investors[70].

In August 2012, the Australian Securities and Investments Commission issued guidelines concerning crowdfunding[71]. These guidelines reiterated the existing law on fund raising in Australia specifically pointing out certain requirements. Owner of Australian-based websites that facilitate crowdfunding may be legally considered as the person making an offer to arrange for the issue that financial product and must necessarily apply for an Australian Financial Services License and must provide a Product Disclosure Statement to investors to whom financial products are being offered. Advertising and publicity restrictions also apply to offers of financial products or securities which require a PDS or a prospectus. As on date, there is no specific exemption setting up a regulatory environment conducive to crowdfunding in Australia. However, there have been strong arguments for exempting investment crowdfunding out of those parts of the Corporations Act that were designed to regulate traditional securities offerings[72].

b. Hong Kong

The Securities and Futures Ordinance, 2002 provides for the regulation of activities and other matters connected with financial products, the securities and futures market and the securities and futures industry, the protection of investors in Hong Kong. An advertisement, invitation or document which contains an invitation to the public to offer securities is prohibited, unless authorized by the Hong Kong's Securities and Futures Commission[73]. However, offers of securities made to professional investors[74] is exempt from this rule[75]. While equity crowdfunding aimed at professional or sophisticated investors only is arguably possible, there are no specific rules on equity crowdfunding in Hong Kong.

The Securities and Futures Commission has further issued a notification advising on the potential risks involved in participating in crowd-funding activities as an investor- including risk of default, risk of illiquidity of the investment, risk of platform failure and insolvency, risk of fraud, risks associated with platforms operating outside Hong Kong, information asymmetry and lack of transparency, cyber security issues and possible illegal activities[76].

c. Italy

Italy was one of the first jurisdictions to pass a comprehensive regulation on equity crowdfunding. Law 221/2012 specifically allows crowdfunding to support the development of "innovative start-up companies".

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[70] Matt Vitins, "Crowdfunding and Securities Laws: What the Americans Are Doing and the Case for an Australian Crowdfunding Exemption", 22 Journal of Law, Information and Science, 92 (2013)

[71] 12-196MR ASIC guidance on crowd funding, 13 August 2012, available at http://asic.gov.au/about-asic/media-centre/find-a-media-release/2012-releases/12-196mr-asic-guidance-on-crowd-funding/

[72] Matt Vitins, "Crowdfunding and Securities Laws: What the Americans Are Doing and the Case for an Australian Crowdfunding Exemption", 22 Journal of Law, Information and Science, 92 (2013)

[73] Section 103 (1) of the Hong Kong Securities and Futures Ordinance, 2002

[74] See Schedule I, Part I of the Hong Kong Securities and Futures Ordinance, 2002

[75] Section 103(3)(k) of the Hong Kong Securities and Futures Ordinance, 2002

[76] Notice on Potential Regulations Applicable to, and Risks of, Crowd-funding Activities, Securities and Futures Commission, Hong Kong SAR, 7 May 2014, available at http://www.sfc.hk/web/EN/files/ER/PDF/Notice%20on%20Crowdfunding.pdf

The law refers specifically and explicitly to innovative start-ups to underscore that its target is not any and all new enterprises, but those whose business is closely and strongly linked to innovation and technology[77]. This was further crystallized into the CONSOB[78] Regulation No. 18592 of 2013 which provides for "the collection of risk capital on the part of innovative start-ups via on-line portals". Much of the onus on shareholder protection has been placed on the portal. Portals must register themselves with the CONSOB[79] and must integrity and professional requirements on a continuous basis[80].

The portal is made primarily responsible for information circulated to potential investors and must adequately warn non-professional investors as to the risks of crowdfunding activities[81]. The portal is also responsible for publishing information on the offer, including information on the issuer and on the financial instruments offered, information on risks and information on any services offered by the portal manager in relation to the offer. While the portal is responsible for the publication of the offer information, the issuer is solely responsible for the completeness and truth of the data and information[82].

Crowdfunding shareholders have a right to withdraw from the company or to sell the participation instruments, in the event that the controlling shareholders, after the offer, transfer the company's control to third parties within three years from the conclusion of the offer[83]. Further atleast 5% of the financial instruments offered must be underwritten by professional investors or by banking foundations or by innovative start-up incubators[84].

d. Japan

Soliciting investment in listed securities requires registration as a Financial Instruments Business Operator in Japan. Soliciting investment in unlisted securities is prohibited. However, with the 2014 amendment of the Japanese Financial Instruments and Exchange Act, certain relaxations have been allowed. The requirement for registration would not be imposed on crowdfunding-platform operators that handle only small issues provided that the total offering amounts to less than 100 million yen and the amount of investment per person is 500,000 yen or less. Further, the minimum capital required for registration is reduced from 50 million yen to 10 million yen for Type I Financial Instruments Business[85] Operators and from 10 million yen to 5 million yen for Type II Financial Instruments Business[86] Operators

[77] Guidelines, The Italian Government's policy for attracting innovative foreign entrepreneurs, available at http://www.esteri.it/mae/visti/linee%20guida%20italia%20startup%20visa%20en.pdf
[78] Commissione Nazionale per le Società e la Borsa, also referred to as the Italian Securities and Exchange Commission
[79] Articles 4-7, CONSOB Regulation No. 18592 of 2013
[80] Articles 8-11, CONSOB Regulation No. 18592 of 2013
[81] Articles 13, 15 and 16, CONSOB Regulation No. 18592 of 2013
[82] Annex 3, CONSOB Regulation No. 18592 of 2013
[83] Article 24 (1), CONSOB Regulation No. 18592 of 2013. These rights of withdrawal and sale must be included in the issuer's articles of association or deed of incorporation
[84] Article 24 (2), CONSOB Regulation No. 18592 of 2013
[85] Market transactions of derivatives and foreign market derivatives transactions pertaining to highly liquid securities and over-the-counter transaction of derivatives having strict market entry requirements; See Section 28(1) of the Japan Financial Instruments and Exchange Act
[86] Market transactions of derivatives and foreign market derivatives transactions pertaining to less liquid securities and financial instruments other than securities having relatively simplified market entry requirements; See Section 28(2) of the Japan Financial Instruments and Exchange Act

e. Malaysia

The Malaysian Securities Commission issued a consultation paper in August 2014[87] consequent to which a public response paper was also issued in September 2014[88] setting out, *inter alia*, the proposed regulations on crowdfunding and the views of the Securities Commission. The proposed regulations set out eligibility, disclosure and other requirements on equity crowdfunding operators (platforms), contributors and crowdfunded firms. Platforms must seek registration to apply as an equity crowdfunding operator and will act as a stock market, albeit with lesser levels of regulation. One of the key requirements of an equity crowdfunding operator is to carry out a due diligence on the company seeking crowdfunding. Companies may raise upto MYR 3 million through crowdfunding with differing levels of disclosure. For offerings below MYR 300,000, there is no requirement to file financial information, but the platform may request for certified financial statements for verification purposes. For offerings between MYR 300,000 and MYR 500,000, audited financial statements for 12 months prior to the offering must be disclosed. In the event that such audited financial statements are not available, certified financial statements by the issuer's management may instead be disclosed. This exemption from filing audited financial statements will not be available for offerings above MYR 500,000.

Investors are also categorized into sophisticated (comprising of accredited investors, high-net worth entities and high-net worth individuals) and retail (other) investors. While there is no limit to the investment amount for a sophisticated investor, retail investors may contribute upto MYR 3000 per issue, subject to an overall cap of MYR 30,000 in a 12 month period.

f. New Zealand

The Financial Markets Conduct Act of 2013 governs how financial products are created, promoted and sold, and the ongoing responsibilities of those who offer, deal and trade them in New Zealand. It specifically allows intermediary service providers such as portals, to be licensed under the Act[89]. This licensing regime is intended to facilitate suitably regulated 'peer-to-peer lending' and 'crowd-funding' services to operate in New Zealand[90]. Offers made through licensed intermediaries do not require disclosures under Part 3 of the Financial Markets Conduct Act, 2013. Further, regulations under the Financial Markets Conduct Act, 2013 were issued in 2014. These regulations provide for definitions of crowdfunding and peer-to-peer lending services[91] and set out eligibility criteria for portals to seek a license to carry out such services[92]. The regulations also set up detailed disclosure and procedural requirements, mandatory warning statements and other obligations for such service providers. With regard to the issuer, the upper limit for raising funds is capped at NZD 2 million[93]. It is interesting to note that the crowdfunding provisions in New Zealand do not

[87] Public Consultation Paper No 2/2014, Proposed Regulatory Framework For Equity Crowdfunding, available at http://www.sc.com.my/wp-content/uploads/eng/html/consultation/140821_PublicConsultation_2.pdf
[88] Public Response Paper No 2/2014, Proposed Regulatory Framework For Equity Crowdfunding, available at http://www.sc.com.my/wp-content/uploads/eng/html/consultation/140925_PublicResponse_2.pdf
[89] Section 390, Financial Markets Conduct Act 2013
[90] http://www.fma.govt.nz/assets/a-guide-to-the-financial-markets-conduct-act-reforms-november-2013.pdf
[91] Regulation 185, Financial Markets Conduct Regulations, 2014
[92] Regulation 186 and 187, Financial Markets Conduct Regulations, 2014
[93] Clause 7, Schedule I, Financial Markets Conduct Regulations, 2014

provide for upper limits on investment, nor does it create a distinction between sophisticated and retail investors making it one of the most crowdfunding friendly jurisdictions.

g. Singapore

Like other jurisdictions, securities offered by way of equity crowdfunding in Singapore could be deemed as a "public offering" and would then be required to comply with the regulations set forth by the Singapore Securities and Futures Act. However, the Monetary Authority of Singapore floated a consultation paper on facilitating securities based crowdfunding in February 2015[94]. It suggests that participation in crowdfunding activities be restricted to accredited investors and institutional investors only. Further, the consultation paper suggests a reduction in the entry barriers for dealing licensees in order to promote the growth of crowdfunding platforms, provided that Dealing Licensee that does not handle, hold or accept customer monies, assets or positions.

Companies that make an offer of securities to investors in Singapore must register a prospectus with the Monetary Authority of Singapore[95]. Certain issues are exempted from the registration requirement[96] which may be used for crowdfunding purposes. Small offers of less than SGD 5 million[97], private placement of securities to less than 50 persons[98], offers made to institutional[99] and accredited[100] investors are some examples of such exemptions. In such provisions, the Singapore Securities and Futures Act stresses the importance of not making any advertisement of the offer. The consultation paper reinforces this stand and suggests that exempted offers are intended to be offers that are restricted in scope, these offers should not be subject to any mass solicitation, advertising or canvassing. As a result, in the event that the crowdfunding platform allows unrestricted access to the general public as to the details of offers of securities published on its platform, any publication of information on an offeror and the terms of the offer would be regarded as a breach of the advertising restriction.

h. United Kingdom

In October 2013, the UK Financial Conduct Authority issued a consultation paper regarding its proposed regulatory approach to crowdfunding[101]. Investment-based crowdfunding generally amounts to a regulated activity under UK law and the FCA published new rules[102] bringing lending platforms within the ambit of the FCA and that companies operating such platforms will be required to be authorised by the FCA. Such

[94] Monetary Authority of Singapore, Facilitating Securities Based Crowdfunding, Consultation Paper, P005-2015, February 2015, available at http://www.mas.gov.sg/~/media/MAS/News%20and%20Publications/Consultation%20Papers/Facilitating%20Securities%20Based%20Crowdfunding

[95] Section 240, Securities and Futures Act (Chapter 289)

[96] Section 272, Securities and Futures Act (Chapter 289)

[97] 272A, Securities and Futures Act (Chapter 289)

[98] 272B, Securities and Futures Act (Chapter 289)

[99] Section 274, Securities and Futures Act (Chapter 289)

[100] Section 275, Securities and Futures Act (Chapter 289)

[101] A Guide to the Financial Markets Conduct Act 2013 Reforms, Financial Markets Authority, November 2013, available at http://www.fca.org.uk/static/documents/consultation-papers/cp13-13.pdf

[102] Crowdfunding and the Promotion of Non-Readily Realisable Securities Instrument 2014, available at http://www.fca.org.uk/static/documents/policy-statements/ps14-04.pdf

lending platforms have a minimum capital requirement of GBP 20000 and must have appropriate arrangements in place in the event of platform or firm failure. While there is no checklist of information to be provided to clients, platforms are required to disclose information which is fair, clear and not misleading. In terms of equity crowdfunding, contributors are restricted to the following categories:

- Certified high-net-worth individual: annual income in excess of £100,000 or net assets (excluding primary place of residence, pensions and rights existing under certain contracts of insurance) in excess of £250,000.
- Certified/Self-certified sophisticated investor: assessed by an authorised firm as being sufficiently knowledgeable to make accurate and reasoned investment decisions. Certain individuals can self-certify if they fall into one of the prescribed categories; such categories include those who have worked in private equity for the two years leading up to self-certification.
- Restricted investor: An investor who will not invest more than 10% of their net assets in a non-readily realisable security[103].
- Where the FCA-authorised firm will itself comply with the suitability requirements.
- The investor has confirmed before the promotion that they are a retail client of another firm that will comply with the suitability rules in relation to the investment promoted
- The investor is a corporate finance contact or a venture capital contact under the FCA rules.

The FCA also places the onus on the crowdfunded firm to assess that the investor has the knowledge and experience needed to understand the risks involved with investing.

i. United States

In April 2012, the United States Congress adopted the Jumpstart Our Business Start-ups Act (JOBS Act), bringing about an exemption under the US securities laws that permits the sale of securities via crowdfunding, thus opening the doors to those businesses that have been unable to utilize existing crowdfunding methods[104]. The position of the US Securities Act, 1933 prior to the JOBS Act, limited the options for financing available to venture capital firms or angel investors[105]. Specifically under Title III of the JOBS Act, the "Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012" or the "CROWDFUND Act" amends Section 4 of the Securities Act of 1933[106] to exempt certain fundraising activities from the registration and prospectus requirements that are otherwise mandatory for the sale or delivery of securities[107].

Issuers seeking an exemption under the JOBS Act may raise upto USD 1 million within a 12 month period. Further, investors may invest upto USD 2000 or 5 percent of the annual income or net worth of such investor if either the annual income or the net worth of the investor is less than USD 100,000. If either the annual income or net worth of the investor is equal to or more than USD 100,000, the individual cap on investment

[103] A non-readily realizable security refers to any security which a security which does not fall within the ambit of (a) a readily realisable security; (b) a packaged product; or (c) a non-mainstream pooled investment

[104] Thaya Brook Knight, Huiwen Leo and Adrian A. Ohmer, "A Very Quiet Revolution: A Primer On Securities Crowdfunding And Title III Of The Jobs Act", 2 Michigan Journal of Private Equity and Venture Capital Law 135

[105] Andrew C. Fink, "Protecting the Crowd and Raising Capital Through the Crowdfund Act", 90 University of Detroit Mercy Law Review 1

[106] 15 U.S.C. 77d

[107] Section 5 of the Securities Act, 1933 (15 U.S.C 77e)

is increased to 10 percent of the annual income or net worth of such investor. Such issues must also be conducted through a broker that meets the requirements of section 4A(a) of the Securities Act, 1933 and issuer must comply with the requirements of section 4A(b) of the Securities Act, 1933. Offers made to accredited investors fall under a separate exemption[108].

The JOBS Act further provides for the obligations that portals and issuers are required to meet, in order to seek an exemption from the far more stringent and onerous requirements of the US Securities Act. As one of the first legislations to regulate crowdfunding, the JOBS Act created a new and largely unexplored market for raising capital[109], which has later been emulated by other jurisdictions. It set out the primary mechanism by which a company having a low share capital may offer shares to investors, whether accredited or otherwise, with reduced disclosure, registration and procedural requirements than what would otherwise be required.

Thus, we see that across jurisdictions, the treatment of equity crowdfunding has either been prohibited outright, keeping in mind extant regulations of public offers or that there have been tailored regulations which seek to encourage this financing without apparently compromising investor protection.

V. Proposed Crowdfunding Regulations in India

In June 2014, SEBI released a consultation paper on crowdfunding in India, seeking responses on key issues raised. It also set out suggested principles on which crowdfunding regulations in the future may be based. These principles are described below.

a. Access to Markets and Eligibility for Fundraisers

Crowdfunded companies are typically early stage startups which either have limited access to capital or have exhausted available resources. Any regulation intended to promote crowdfunding must necessarily protect the crowdfunding mechanism against misuse by companies which would otherwise have had other sources of capital. The proposed eligibility criteria for such companies seeking to raise funds through crowdfunding is as follows:

(i) The size of the issue must not exceed INR 100 million
(ii) The company must not be promoted, sponsored or related to an industrial group which has a turnover in excess of Rs. 25 Crores or having an established business
(iii) The company must be unlisted and less than 48 months old
(iv) The company cannot be engaged in real estate or other activities prohibited under India's industrial policy
(v) The issuing company, its directors, promoters or associates must not have been prohibited from accessing or operating in the capital markets or restrained from buying, selling or dealing in securities under any order or direction passed by the SEBI.
(vi) The issuing company, its directors, promoters or associates have not been mentioned as a 'defaulter' or a 'wilful defaulter' by RBI or CIBIL.

[108] Section 4(5) of the US Securities Act, 1933
[109] Andrew C. Fink, "Protecting the Crowd and Raising Capital Through the CROWDFUND Act" 90 University of Detroit Mercy Law Review 1 (2013)

(vii) The director(s) or promoter(s) have not been disqualified to be appointed as director(s) under the Companies Act 2013.

(viii) The issuing company, its directors, promoters or associates are 'fit and proper' persons as specified under the Schedule II of the SEBI (Intermediaries) Regulations, 2008[110].

b. Accreditation of Investors and Investment Limits

It has been proposed that participation in crowdfunding in India be restricted to Accredited Investors. The term collectively refers to Qualified Institutional Buyers[111], companies registered in India with a net worth of INR 200 million or more, individuals with a net worth in excess of INR 2 million (excluding the value of primary residence). Individuals who do not meet the above criteria may still participate in crowdfunding activities as eligible retail investors provided that they meet the following benchmarks:

(i) minimum annual gross income of INR 1 million

(ii) have filed Income Tax return for at least last 3 financial years

(iii) are well advised in investment matters by availing the services of an investment advisor or a portfolio manager or have passed an appropriateness test conducted by an institution accredited by NISM or the crowdfunding platforms

Such eligible retail investors must further ensure and certify that they do not invest more than INR 60,000 in any particular crowdfunded issue and do not invest more than 10% of the net worth (excluding the value of primary residence) in crowdfunding activities.

It appears that participation in crowdfunding is restricted to investors who are (a) knowledgeable or have experience in investments or at least have access to investment advice; along with (b) able to absorb losses on crowdfunded issues.

[110] Add defn

[111] Under the provisions of Regulation 2(zd) of the Securities Exchange Board of India (Issue of Capital and Disclosure) Regulations 2009, a qualified institutional buyer refers to:
(i) a mutual fund, venture capital fund, Alternative Investment Fund and foreign venture capital investor registered with the Board;
(ii) a foreign institutional investor and sub-account (other than a sub-account which is a foreign corporate or foreign individual), registered with the Board;
(iii) a public financial institution as defined in section 4A of the Companies Act, 1956;
(iv) a scheduled commercial bank;
(v) a multilateral and bilateral development financial institution;
(vi) a state industrial development corporation;
(vii) an insurance company registered with the Insurance Regulatory and Development Authority;
(viii)a provident fund with minimum corpus of twenty five crore rupees;
(ix) a pension fund with minimum corpus of twenty five crore rupees;
(x) National Investment Fund set up by resolution no. F. No. 2/3/2005-DDII dated November 23, 2005 of the Government of India published in the Gazette of India;
(xi) insurance funds set up and managed by army, navy or air force of the Union of India;
(xii) insurance funds set up and managed by the Department of Posts, India;

Even so, the maximum number of investors (excluding QIBs, companies and employees) involved in a crowdfunded company remains at 200, in line with the Companies (Prospectus and Allotment of Securities) Rules, 2014[112].

c. Regulation of Portals

The SEBI Consultation paper proposes that crowdfunding platforms be categorized into three kinds:

- Class I Entities - Recognized Stock Exchanges with nationwide terminal presence (RSEs) and SEBI registered Depositories;
- Class II Entities - Technology Business Incubators (TBIs); and
- Class III Entities - Associations and Networks of PE or Angel Investors

Class II entities must meet certain eligibility criteria, namely, being promoted by the Indian or a State government. They must be registered as a society or a not-for-profit corporation[113] and be atleast five years old, during which time, they must have achieved self-sufficiency and have a minimum net worth of INR 100 million. TBIs are further restricted to displaying only those companies which share a common focus thrust areas as the TBI.

Class III entities on the other hand must have a track record of a minimum of three years with a minimum member strength of 100 active members from the relevant industry. They must be registered as a not-for-profit corporation with a minimum paid up share capital of INR 20 million.

The lack of a detailed review on the fundraising company opens up the possibility of fundraising companies to conceal information relevant to the future of the company, whether actively or passively[114]. It has been proposed that crowdfunding platforms must therefore act as gatekeepers, conducting reviews and checks and where necessary, deny access to companies seeking funding.

Crowdfunding platforms must conduct screening and a basic due diligence, including background and regulatory checks on the company, its promoters, directors and shareholders holding in excess of 20% of the equity of the company. Platforms must also filter out good business plans which, in their opinion, would be worthy of listing on the platform. This filtering mechanism takes place through a screening committee set up within the platform. It has been proposed that such screening committees should have a minimum of 10 persons serving, which must consist of professionals with expertise in mentoring of startups and early stage ventures (at least 40%), professionals with experience in banking or capital markets (atleast 40%) and nominees of the owner of the crowdfunding portal, provided that they are persons of high caliber and qualifications and not on the payroll of the platform.

d. Procedures

[112] Regulation 14(2)(b) of the Companies (Prospectus and Allotment of Securities) Rules, 2014
[113] Under Section 8 of the Companies Act, 2013
[114] Andrew C. Fink, "Protecting the Crowd and Raising Capital Through the CROWDFUND Act" 90 University of Detroit Mercy Law Review 1 (2013)

A company meeting the eligibility criteria is required to apply to the crowdfunding platform to undergo screening and due diligence. Once approved, the company's details along with the requirement of funds may be displayed on the crowdfunding platform. The platform is then accessed by accredited investors who analyze and evaluate the company and its funding requirements. If adequate interest in the company exists, the company may then proceed to circulate a private placement offer letter to the interested investors.

In terms of disclosures, companies are required to circulate information similar to that of a private placement offer letter under the Companies Act, 2013[115]. These disclosures would include:

- Name of the company & Registered office address
- A description of the current/new venture for which the funds are being raised (Anticipated Business Plan)
- Issue Size and specified target offering amount and intended usage of funds
- A description on the valuation of securities offered
- Past history of funding, if any
- History of any prior refusal from any Crowdfunding Platform
- A description of financial condition of the company including Audited financial statements of 1 year, if any (Balance sheet, Profit and Loss Account, Cash Flow Statements)
- Price of securities offered and the rights and liabilities attaching to the securities
- Ownership details and capital structure
- Details regarding Board, Management and Group entities, persons with a shareholding of 20% or more, etc.,
- Principal risks to the issuer's business
- Grievance redressal and Dispute resolution mechanism, such as arbitration mechanism
- Such other information as SEBI may specify

Upon the circulation of the private placement offer letter, accredited investors may choose to invest in the company or may decide to withdraw their commitment. The crowdfunding platform acts as an escrow agent, collecting investment amounts and disbursing them to the fundraising company upon the issue of securities to the investors.

In terms of end-use restrictions, funds raised through crowdfunding cannot be used to provide loans or investments in other entities. Companies are prohibited from using multiple crowdfunding portals in a 12 month period and such crowdfunding portals used must be recognized by SEBI.

It would seem then, that the proposed regulations on equity crowdfunding in India merely reinforce the rule in Section 42 of the Companies Act, 2013. The mechanism of crowdfunding under the proposed SEBI regulations merely serve to introduce the fund-seeking company to potential investors. Post the initial introduction, through the crowdfunding platform, companies would be required to carry out the same process as required in a standard private placement of securities.

e. Provisions relating to Secondary Market

[115] Section 42, Companies Act, 2013

One of the chief concerns with equity crowdfunding is the lack of liquidity post the funding. In other words, crowdfunding platforms only allow an issuer to sell its own securities to raise capital and seldom provide a secondary market for such securities. While it may be argued that the intention of crowdfunding activities is to raise capital and not for the resale of securities[116], exit provisions would protect investors in the event of default or insider mismanagement.

In terms of ongoing disclosures, companies which have raised capital through crowdfunding are required to disclose the following on a bi-annual basis

- Audited financial statements (Balance sheet, Profit & Loss statement, Cash flow statement etc.)
- Utilization of funds raised in accordance to the object of the issue as specified at the time of the issue
- A detailed view of the current state of business and the progress made since last disclosure
- Any other funding raised since the last disclosure
- Any penalty, pending litigation or regulatory action against the company or promoter(s) or director(s)

The SEBI consultation paper emphasizes the difficulties in providing a secondary platform for the trading of crowdfunded securities and provides for the transfer of such securities in the following ways:

1. Through a buyback of securities under the Companies Act, 2013
2. To another accredited investor
3. To a family member or relative or friend of the existing investor.

In this respect, SEBI seems to have followed the Jobs Act which provides that securities offered through crowdfunding may be transferred only

1. To the issuer of the securities;
2. to an accredited investor;
3. as part of an offering registered with the Securities Exchange Commission; or
4. to a family member of the purchaser or the equivalent, or in connection with certain events, including death or divorce of the purchaser, or other similar circumstances, in the discretion of the Commission

In order to have a truly liquid secondary trading platform, investors must wait for an initial public offering and listing of the company scrips.

f. Analysis

There are a number of issues arising out of the proposed regulations on crowdfunding. The first concerns the participation of investors in crowdfunding. Investors who would be termed as 'accredited' are few, when compared to the larger numbers of retail investors. Consider the definition of crowdfunding under the SEBI Consultation Paper – "solicitation of funds (small amount) from multiple investors through a web-based platform or social networking site for a specific project, business venture or social cause" (*sic*). While it is possible to have multiple accredited investors interested in a particular project or startup, it would be difficult to label investments made by accredited investors as 'small amounts'. Restricting participation in crowdfunding activities to accredited investors is simply another way of saying that the traditional

[116] Transferability is a core characteristic of the corporate form. See Armour, John, Henry Hansmann and Reinier Kraakman, "The Essential Elements of Corporate Law: What is Corporate Law" http://www.law.harvard.edu/programs/olin_center/papers/pdf/Kraakman_643.pdf

mechanism of venture capital and private equity investors could be made more efficient by using the internet. The higher entry barriers for retail investors, that being of knowledgeable in investments or at least have access to investment advice, along with being able to absorb losses on crowdfunded issues, only exacerbates the removal of the crowd from crowdfunding[117]. A further restriction is applied on the number of retail investors to 50 as well.

The restriction on being able to participate in crowdfunding activities by accredited investors only is a slight cause for concern. While crowdfunding in its truest sense is meant to engage with investors who would otherwise be unable to participate in regular capital markets, the high thresholds for accreditation or even for eligibility as a retail investor means that participation in crowdfunding would remain isolated from large sections of potential retail investors. Additionally, investments into crowdfunded companies are ultimately subject to the Companies (Prospectus and Allotment of Securities) Rules, 2014. Rule 14(2)(c) of these rules mandate that the size of each investment must not be less than INR 20,000.

Even with the inclusion of qualified retail investors, it would be impossible for a startup to be truly crowdfunded. The SEBI consultation paper suggests minimum investment limits for Qualified Institutional Buyers as 5% of each company that they invest in, through the crowdfunding mechanism. Therefore, in the event that Accredited Investors, including QIBs are not attracted to a particular startup, a crowdfunded issue would fail. Providing equity or loan capital to small and medium businesses requires skill, expertise, experience and a good deal[118]. Given that accredited investors would be likely to have access to greater resources and skill, expertise and experience in investing in startups and therefore would be more likely to identify startups which would have a likelihood of success, this seems to be an effective mechanism to ensure that only those companies or projects worthy of an Accredited Investor's attention would succeed. This would also ensure that retail investors are not able to participate in startups which have been rejected by Accredited Investors, thus protecting such retail investors from startups having a possibly poor outlook.

In a number of ways, the proposed regulations on crowdfunding simply reinforce the existing Indian law on corporate fundraising. The entire exercise of applying to a crowdfunding platform and having its funding requirements showcased for accredited investors remains a precursor to a standard private placement mechanism under Section 42 of the Companies Act, 2013. The act of posting a company's details and its funding requirements constitute only an endeavor to draw the attention of accredited investors and in no way does it constitute an invitation to subscribe to the securities offered by the company.

Surprisingly companies seeking crowdfunding are prohibited from directly or indirectly advertising their offering to public in general or from soliciting investments from the public. Clearly, SEBI would prefer not treating crowdfunding as a public issue. Companies are also prohibited from directly or indirectly incentivizing or compensating any person to promote its offering.

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[117] Ibrahim, Darian M., Equity Crowdfunding: A Market for Lemons? (March 17, 2015). Minnesota Law Review, Forthcoming; William & Mary Law School Research Paper No. 09-292. Available at SSRN: http://ssrn.com/abstract=2539786

[118] John Kay, Regulators will get the blame for the stupidity of crowds, Financial Times, March 25, 2014, available at http://on.ft.com/1m3XFhi (last accessed on 25th May 2015)

In terms of transfer of shares, SEBI has taken a slightly more liberal view allowing 'relatives' and 'friends' of the existing investor to purchase securities from the existing investor. The absence of a clear definition of what would constitute a legitimate transferee for crowdfunded securities may give rise to a number of opportunities for informal, unregulated secondary markets for such securities.

The proposed regulations seem to suggest that accredited investors would be likely to have access to greater resources and expertise in investing in startups. While this is undoubtedly true, this bring us to the question as to why such accredited investors, who operate within well-established networks[119] would use crowdfunding mechanisms at all. There are a large number of platforms which provide existing mechanisms for angel investors and startups to establish contact, express interest and take things forward. Equity based crowdfunding simply puts these platforms online.

The procedures to be adopted by crowdfunding platforms would also lead to increased transaction costs in crowdfunded issues. The SEBI Consultation Paper suggests that crowdfunding platforms must conduct screening and a basic due diligence, including background and regulatory checks on the company, its promoters, directors and shareholders holding in excess of 20% of the equity of the company. Platforms must also filter out good business plans which, in their opinion, would be worthy of listing on the platform. This filtering mechanism takes place through a screening committee set up within the platform.

Given that sophisticated investors who express an interest in the company seeking funds would carry out a detailed due diligence and background check on the company, its promoters, directors and employees, this additional requirement would increase the burden on not only the company seeking funds, but also reduce the efficacy of crowdfunding platforms.

The proposed regulations by SEBI seem to heavily regulate access to the market by high thresholds for entry by companies, investors and platforms. In such a scenario, it is unlikely that equity crowdfunding will become a popular mechanism for fundraising in India.

VI. Conclusion

Two very important aspects seem to be missing from the proposed SEBI regulations. The first is that of peer-to-peer lending. Peer-to-peer lending involves a borrower seeking funds on a debt basis, a set of creditors who agree to lend funds to the borrower and an intermediary – usually the crowdfunding platform- who agrees to put the loan arrangement together for a fee and on pre-existing terms and conditions. While the SEBI consultation paper does refer to debt based crowdfunding, the same mechanisms as for equity crowdfunding would apply, except that the securities floated and invested in are in the nature of a debt. However, in the absence of the issue of debt securities, say in case of term loan secured by mortgage or a hypothecation, the proposed SEBI regulations would not be applicable. While there is presently little or no restriction on who may lend money, perhaps this is an area where the Reserve Bank of India may consider regulating.

[119] Ibid

The second aspect missing from the proposed SEBI regulations is that of cross-border crowdfunding. It would be possible to have a foreign company raise funds in India and for foreign investors to participate in crowdfunding activities in India, subject to extant inward and outward bound investment regulations and policies. However, given the nature of crowdfunding, and that of the global reach of the internet, it is possible that Indian investors may be involved in crowdfunding activities in other jurisdictions. An interesting question arises as to whether SEBI's role in protecting such investors extends to beyond Indian borders.

Further, as noted in Part IV of this paper above, countries have differing levels of regulation in terms of crowdfunding. It is interesting to note that the crowdfunding provisions in New Zealand do not provide for upper limits on investment, nor does it create a distinction between sophisticated and retail investors-making it one of the most crowdfunding friendly jurisdictions. Jurisdictions where crowdfunding activities are not regulated, or have minimal regulations, it would be easier to raise funds and then have those funds invested in an Indian company. The opportunities arising from the resultant regulatory arbitrage could then be used by fund-seeking companies in India, or any other jurisdiction which does not have a favorable view of equity crowdfunding.

These two issues, namely the cross-border investment and the cross-border fundraising issues, come together to create an interesting scenario. Assume a company incorporated in India, which requires funding. Such funding is not forthcoming from accredited investors. It simply sets up a parent in a crowd-funding friendly jurisdiction which then seeks crowdfunding from investors around the world. An Indian retail investor, who was hitherto unable to participate in the equity of the Indian company, is now able to do so. The funds raised by the parent company are then invested to the Indian subsidiary. This possible scenario brings to light the global nature of internet based corporate fundraising. The cross-border aspect of the platforms, and more particularly the uncertainty surrounding contract law application in different jurisdictions, has yet to be dealt with effectively[120].

Nevertheless, equity based crowdfunding remains a new and exciting paradigm in corporate finance. Any growth of technology brings up new challenges for policy makers and regulators. SEBI seems to have taken a rather cautious approach to crowdfunding for the time being, keeping in mind one of its key roles of investor protection. Of course, it remains to be seen how equity-based crowdfunding is actually regulated in India, if at all.

[120] Eleanor Kirby and Shane Worner, "Crowd-funding: An Infant Industry Growing Fast", Staff Working Paper No. [SWP3/2014], IOSCO Research Department