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INDIAN CROWD FUNDING SCENARIO – MAJOR LEGAL CHALLENGES

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INTRODUCTION:

The concept of crowd funding in India is not new. History gives evidence that temples and other worshipping places were involved in these activities and many such places were built by using public donations. However, raising funds over internet is new, especially to the business environment in India.

India has proven to be the incubator for many thriving e-commerce businesses. Despite this fact, there is a lack of trust in online transactions. In recent past the government's decision of demonetising certain denomination of currencies people have started using other payment methods. This is changing the above mentioned scenario. Now, people are showing interest in digital transactions. This can be seen as a major step towards the evolution in the Indian crowdfunding scenario.

After the trust deficit which was created by 2008 global financial crisis between investors and the business houses, raising funds have become a difficult process. As a response, crowd-funding has emerged as a viable alternative for sourcing capital to support innovative, entrepreneurial ideas and ventures.

Equity-based crowdfunding is still not legalised in India making it prone to a few legal issues. On the contrary, the United States recently passed the Jumpstart Our Business Startups (JOBS) Act, legalising equity crowdfunding. In India, the concept of crowdfunding is gaining immense momentum leading to a hypothecated fear that these funds could scale up at any time. Owing to the recent currency demonetisation, peers are worried that money-laundering schemes might run in the name of crowdfunding activity.

The SEBI needs to set up a regulatory framework for finding and restricting such activities, if any, persist. In addition to that, crowdfunding activities involving the sale of securities need to be regulated either under existing SEBI norms or under Collective Investment Scheme/Alternative Investment Funds. Together, these initiatives will bring about a greater transparency and trust in the entire Indian crowdfunding scenario.

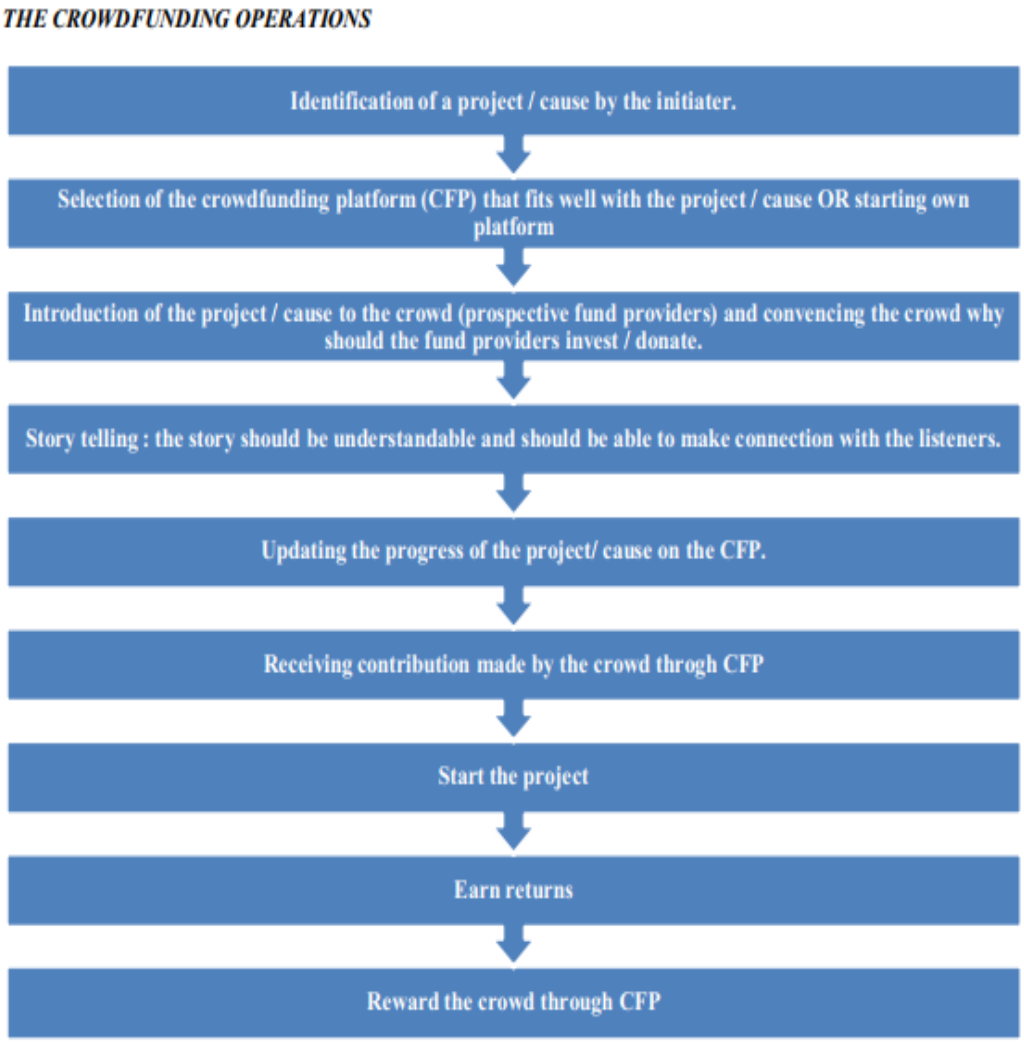
CONCEPT OF CROWDFUNDING:

Although lacking a precise definition, crowd funding is generally understood as "the practice of funding a project or venture by raising many small amounts of money from a large number of people, typically via the Internet." The predecessor to crowd funding is crowdsourcing. Crowdsourcing involved "collecting contributions from many individuals to achieve a goal.
Crowdfunding according to SEBI is the "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."

Crowdfunding was a natural evolution of this, the step from sourcing information to sourcing financing from many individuals. Belleflamme, Lambert and Schwienbacher stated that crowd funding involves an open call, mostly through the Internet, for the provision of financial resources either in form of

donation or in exchange for the future product or some form of reward to support initiatives for specific purposes.

WORKING OF CROWDFUNDING: Please see the figure below:



Crowd funding can be carried out in four ways:

1. Donation Crowdfunding- Donation crowdfunding denotes solicitation of funds for social artistic, philanthropic or other purpose, and not in exchange for anything of tangible value. For example Kickstarter and Milaap are donation based crowd funding platforms.
2. Reward Crowdfunding- It is a form of funding where 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. As a variation of the rewards crowdfunding model, fundraisers may also engage a pre-purchase model. In this type of model the investors receive the product of the invention that the entrepreneur is raising funds to produce. Some of the reward crowd funding are Wish berry and Roicethub.
3. Peer-to Peer Lending- In Peer-to-Peer lending, an online platform matches lenders/investors with borrowers/issuers in order to provide unsecured loans and the interest rate is set by the platform, Some Peer-to-Peer platforms arrange loans between individuals, while other platforms pool funds which are then lent to small and medium-sized businesses.

4. Though peer-to-peer lending did not appear to involve securities, loan/notes/contracts can be traded on a peer-to-peer platform or a secondary market and thus, these loans may become securities, with the contract between the lender and the borrower being the security note.
   In this type of model, investors are not given any kind of protection because collateral security is not provided by the borrower to cover the default and hence investors may lose on money if borrowers don't pay up.
5. Equity based Crowdfunding- It is a model of crowdfunding where equity shares are issued to the investors in lieu of the money provided to the entrepreneurs to finance their project. Start-up businesses raise money for their projects at the seed stage of the company by advertising in crowd funding or social platforms which also serve as intermediary between investor and the entrepreneur.

EXISTING REGIME AND ISSUES FOR FUND RAISING IN INDIA:

As per Chapter - The Companies (Prospectus and Allotment of Securities) Rules, 2014, in case of a private placement of securities, private placement offer or invitation cannot be made to more than 200 persons in the aggregate in a financial year (excluding Qualified Institutional Buyers and employees of the company being offered securities under a scheme of employees' stock option).

Crowdfunding: Private placement or Public Offer?

Recently, LinkedIn was asked by SEBI to clarify if it provides a fundraising platform to the public in contravention of Section 42 of the Companies Act, 2013. Section 42 enables companies to make private placement through issue of a private placement offer letter; through these private placements, the company may issue shares to up to fifty persons. Notably, a company may only make an offer for the issue and allotment of shares to up to two hundred persons in a financial year, excluding qualified institutional buyers and employees.

Two companies of the Sahara Group SHICL and SRIECL floated OFCD and collected 19000 crores from investors by way of private placement. The Red Herring Prospectus (RHP) declared that the companies do not intend to list with the Security Exchange Board of India. The RHP also provided that the unsecured OFCDs would be raised by way of private placement to friends, associates,group companies, workers/employees and other individuals associated/affiliated or connected in any manner with Sahara Group of Companies without giving any advertisement to general public. The prospectus was not registered with the Registrar of Companies and SEBI as the Sahara Group had intended to raise money in a private placement basis.

One of the group companies, Sahara Prime City Limited intended 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. While processing the prospectus, SEBI received complaint from one RoshanLal alleging that Sahara group was issuing Housing Bonds without complying with Rule/Regulation/Guideline by RBI/MCA/NHB, SEBI also received complaint from "Professional Group of Investors Protections" dated 25.12.2009 and 4.1.2010 which prompted SEBI to ascertain the correct factual position.

The Whole Time Member of SEBI while taking cognizance of the matter passed an order dated 23rd June, 2011 thereby directing the two companies to refund the money so collected to the investors and also restrained the promoters of the two companies including MrSubrata Roy from accessing the securities market till further orders. Sahara appealed against the order in SAT and SAT confirmed the order of SEBI and then Sahara preferred an appeal from SAT order in Supreme Court of India.

One of the questions which arose before the Supreme Court of India was whether the fund raised through OFCD was a private placement or not?

Court said that even though Sahara group had wanted the placements to be private but however since they had issued to more than 50 persons, it was violative of Section 67(3) of the Companies Act, 1956. As this section specifically provides that in case of subscription of more than 50 members, it will be deemed to be a public offer. Supreme Court also observed that since introducers were needed for someone to subscribe to the OFCDs, it is dear that the issue was not meant for persons related or associated with the Sahara Group because in that case an introducer would not be required as such a person is already associated or related to the Sahara Group." Court observed that almost million agents were dispatched all over the country to invite people to subscribe to their OFCD and hence it was a public placement in garb of private placement done to bypass relevant rules and regulations.
Another question which arose was whether mandatory listing under Section 73(1)" can be avoided if the company intends the placement of securities to be private.

Sahara group argued that no company can be forced to list itself in the stock exchange. However Supreme Court said that if offer is made to more than 49 persons, then Section 67(3) is attracted and then it does not matter whether the company whether the company wanted it to be a private placement or not and they would have to follow section 73 mandatorily without choice. The Supreme Court observed that Section 73(1) of the Act casts an obligation on every company intending to offer shares or debentures to the public to apply on a stock exchange for listing of its securities."

In the aftermath of the Sahara Case, to avoid companies in future from taking the plea of 'intention of private placement'. Ministry of Corporate Affairs introduced a new section in the Companies Act 2014. The newly introduced section i.e. section 42 provides that private placements can be made by companies by issuance of private placement offer letter. The offer of securities or invitation to subscribe securities shall be made to such number of persons not exceeding fifty or such higher number as may be prescribed" and issue and allotment of shares upto two hundred persons in a financial year except institutional buyers and employees of the company.

Explanation Ito Section 42 provides that if 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 recognised stock exchange in or outside India, the same shall be deemed to be an offer to the public. This explanation has been deliberately inserted to prevent another Sahara debacle in the future.

The section also says that even if the subscription does not exceed the prescribed limit and it is a private placement for all purposes yet it shall file with the Registrar a return of allotment in such manner as may be prescribed, including the complete list of all security-holders, with their full names, addresses, number of securities allotted and such other relevant information as may be prescribed"
Companies Act, 2013
Some of the regulations under the Companies Act, 2013 that will apply are:

- A private placement can only be made to 200 investors in a financial year and can only make an offer to 50 people at one particular instance. The limit of 200 would exclude banks, mutual funds and other financial institutions and the employees of the company.
- A company that offers a private placement to more than 200 people in a year or 50 people in an instance would be deemed to be making a public offer and would require following the relevant procedure.
- No company offering a private placement would release any kind of public advertisement.
- The company should have a prior record of the investors the offer is being made to and the offer shall be made in the name of the investor.

SEBI guidelines for Crowdfunding:

Some of the other notable guidelines from SEBI's update include (Source: SEBI – Consultation Paper on Crowdfunding – 2014):

- Only 'Accredited Investors may invest;
- Qualified Institutional Buyers ("QIBs") to hold atleast 5% of issued securities;
- Retail Investor contribution: Minimum- INR 20,000 and maximum- INR 60,000;
- Maximum number of retail investors- 200;
- Only start-ups less than two years old eligible to participate;
- Disclosure requirements such as anticipated business plan, intended usage of funds, audited financial statements, management details etc.;
- Registered crowdfunding platform to conduct regulatory checks and basic due diligence of start-ups and investors; and Constitution of 'screening committee' by each platform comprising 10 persons with experience in capital markets, mentoring start-ups etc.

Legal Bottlenecks – In proposed Crowdfunding regulation:

Section 2(68Xiii) prevents private companies to invite public to subscribe to their shares. Whereas Section 42(2) of the Companies Act, 2013 limits the investors who can subscribe to such shares upto two hundred persons. Crowdfunding is a unique and unconventional model and it has both the characteristics of both public and private placement. The question that arises is whether equity crowdfunding should be treated as public offer or not and unfortunately the consultation paper is silent about it.

The next issue that arises is the question of jurisdiction as crowdfunding lies in the middle of extremes, private placement and public offer. SEBI claims by issuing the Consultation Paper that it can make regulations on crowdfunding but however it is based on a shaky premise. MCA has the power to make rules on residuary matters but the scope of such application has been limited to matters which have been specifically provided in the Act. Since crowdfunding is a new concept, it has excluded from the scope of Section 24 of the Actand hence MCA cannot exert jurisdiction over crowdfunding matters. Also the Securities Laws (Amendment) Act, 1995 demarcates a clear boundary between the activity of MCA and SEBI and crowdfunding having components of both private placement and public offer fall within the ambit of overlapping jurisdiction of the SEBI and MCA. Hence SEBI cannot have exclusive jurisdiction over crowdfunding activities and framing of any rule to control such activities would be fundamentally flawed.

Another issue which is of deep concern is that crowdfunding platforms can only be set up by Class I entities. Class II entities and Class III entities. While the eligibility criteria of Class I entities are governed by the Securities Contracts (Regulations) Act, 1956 and Depositories Act,1996, Class II and III entities are defined in the Consultation Paper itself. Such pigeonholing into three distinct entities would curb donation or reward based crowd funding platforms to run equity based crowd funding campaigns. While such classification will help to prevent frauds, it will nevertheless prevent business from developing as no business entity can develop in an atmosphere of doubt and suspicion. Indian regulators should take a leaf from foreign jurisdictions so that the platforms are given opportunities to explore. Indian regulators should keep in mind that there will always be risks in this kind of investment but wisdom lies in managing the risk well and not altogether stifling the competitiveness of these nascent crowdfunding platforms.

CONCLUSION:

It has been observed that there are three modes of raising funds on certain online platforms for start-ups. Under the first mode, the profile is visible to all; in the second mode, the basic information about

the company is visible to all, but specific details of the company is given only permission; and, under the last mode neither the basic nor detailed profile is visible on any platform.
In Turkey, Pursuant to Article 1 of the Draft Law , the fund-raising persons through crowdfunding platforms are excluded from the definitions of the "publicly held companies" and "issuer" as stated under the Capital Market Law. As per Article 3 of the respective Draft Law, even if the number of the shareholders of the fund-raising joint stock companies through crowdfunding from the public exceed five hundred shareholders, such companies will not be deemed to be publicly held. As such, crowdfunding is free from the restrictions applicable to publicly held companies under the capital market legislation. In line with the above, it is stated under Article 2 of the Draft Law that the provisions under the Capital Market Law regarding the responsibilities to prepare a prospectus or export document would not be applicable to crowdfunding.

Hence, although the last two modes may not be in violation of private placement norms, the first may potentially constitute an illustration of the types of crowdfunding platform referred to by SEBI in its caution note. It is unlikely that the crowdfunding platforms that adhere to private placements norms violate any law. Yet, SEBI's observation that: "investors are hereby cautioned that all dealings on such unauthorized electronic platforms would be in contravention of the relevant securities laws," raises concerns about the validity of crowdfunding and has caused distress among investors and fund-raisers alike.
Therefore, India requires a comprehensive law on equity crowdfunding. At present, the status of cross-border crowdfunding is unclear.

A mechanism such as the one present in the Italy which allows a crowdfunding platform to control information asymmetry and protect the interests of the shareholders is welcome. Alternatively, it is suggested that there can be relaxations in procedural, registration, and disclosure requirements as envisaged in the laws of the USA. Such relaxation should be supplemented with a specific legislation on crowdfunding as it has aspects that cannot be strictly categorised into a private placement or a public offer.

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