

# Scenario of crowd funding and its legal aspects: Global and Indian Perspective

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## Abstract

Today the world of social media and networking across cultures and countries, paves a new path for fund raising, especially for start-up entrepreneurs. Crowd funding is the use of small amounts of capital from a large number of individuals to finance a new business venture. Crowd funding makes use of the easy accessibility of vast networks of people through social media and crowd funding websites to bring investors and entrepreneurs together, with the potential to increase entrepreneurship by expanding the pool of investors beyond the traditional circle of owners, relatives and venture capitalists. This paper aims to provide a brief overview of the global scenario of including the various prevalent models under it, the associated benefits and risks, the regulatory approaches in different jurisdictions etc. The paper discusses legal and regulatory challenges in implementing the framework for crowd funding. This paper narrates framework for ushering in crowd funding 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.

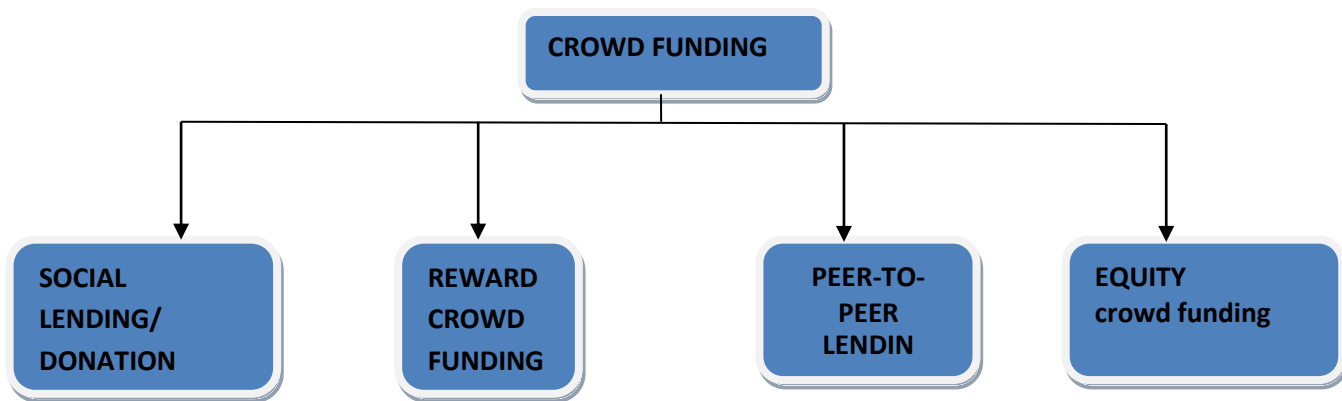
**Key words:** *crowd funding, entrepreneurs.*

## Introduction

Crowd funding is the use of small amounts of capital from a large number of individuals to finance a new business venture. Crowd funding makes use of the easy accessibility of vast networks of people through social media and crowd funding websites to bring investors and entrepreneurs together, with the potential to increase entrepreneurship by expanding the pool of investors beyond the traditional circle of owners, relatives and venture capitalists. Crowd funding sometimes called "online financing," is a new way for individuals and businesses to fund projects and products (like books and inventions) by using the power of the Internet. Crowd funding has been used for many years by the entertainment industry and now others have begun using the Internet to set up websites and take money as donations to help fund their ideas.

## Types of Crowd-Funding

As per IOSCO Staff Working Paper - Crowd-funding: An Infant Industry Growing Fast, 2014 ('IOSCO Paper'), Crowd-funding can be divided into four categories: donation crowd funding, reward crowd funding, peer-to-peer lending and equity crowd funding.



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

### **Donation crowd funding**

Donation Crowd funding denotes solicitation of funds for social, artistic, philanthropic or other purpose, and not in exchange for anything of tangible value.

### **Reward crowd funding**

Reward Crowd funding refers to solicitation of funds, wherein investors receive some existing or future tangible reward (such as an existing or future consumer product or a membership rewards scheme) as consideration.

### **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. Some of the platforms charge a fee based on the loan origination and have an incentive to push investors into larger loans which may not suit an investor's risk profile.

### **Equity Based crowd funding**

In Equity Based crowd funding, in consideration of funds solicited from investors, Equity Shares of the Company are issued. It refers to fund raising by a business, particularly early-stage funding, through offering equity interests in the business to investors online. Businesses seeking to raise capital through this mode typically advertise online through a crowd funding platform website, which serves as an intermediary between investors and the start-up companies.

### **Benefits of crowd funding**

I. Crowd funding provides a much needed new mode of financing for start-ups and SME sector and increases flows of credit to SMEs and other users in the real economy.

ii. Financial crisis (2008) resulted in failure of number of Banks and, consequently the Basel III Capital adequacy norms have been made applicable to Banks. As a result, Banks have become increasingly

constrained in their ability to lend money to the ventures or start-ups which may have high risk element. Hence, there is a need for funding for SME through alternative sources.

iii. SMEs are able to raise funds at lower cost of capital without undergoing through rigorous procedures in this mode.

iv. Crowd funding provides new investment avenue and provides a new product for portfolio diversification of Investors.

v. It increases competition in a space traditionally dominated by a few providers (providing finance to Start-ups and SMEs).

vi. The operators of a crowd funding platform may engage in vetting or due diligence of projects to be included on their website, to maintain the reputation of the website.

## **Risks of crowd funding**

### **Substitution of Institutional Risk by Retail Risk**

Presently, the risk in financing Start-ups and SMEs is borne by the Venture Capital Funds (VCFs) and Private Equity (PE) Investors. In crowd funding, these entities solicit investments in smaller sums from large number of investors. Hence, the risk taking by VCF/PE (informed investors) is substituted with retail investors, whose risk tolerance level may be very low.

### **Risk of default**

There is no or less recourse to the investors against the issuer, in case of default or fraud. Funds are not directly solicited by the issuer and issuer also do not come out with any offer document. Funds are solicited by the platform and such platform may or may not conduct proper due diligence of the issuer. If a platform is being temporarily shut down, or closed permanently, no recourse is available to the investors.

### **Risk of Fraud**

There is possibility of genuine websites being used by fraudsters claiming to be promoters of projects or of false websites being established, simply to defraud the investors or to entice individuals to provide credit card details etc. Thus, there is a risk of misuse as well as cyber-security and/or identity theft.

### **Central role of the Internet:**

Crowd funding platform is an internet based market place for issuers to sell their own securities to raise capital. Thus the central role of the Internet and its wide reach would increase the number of persons potentially affected, which can be significantly greater than the traditional means of fundraising. Younger investors may get influenced simply because of its link to social media and the Internet. Funds could be raised from investors residing at various countries without complying with requirement of local laws of various jurisdictions.

### **Systemic Risk:**

- a) Due to the “individual” nature of crowd funding, there is a possibility that investors may not practice good diversification principles.
- b) There may be no secondary market in which investors can sell their investments and exit and

hence, there is a risk of liquidity.

- c) There is also possibility of Money laundering.
- d) These platforms could expose other financial sectors to the risk of default, as occurred during the sub prime mortgage crisis. If the rapid growth rate in peer- to-peer lending continues, these risks could become systemic.
- e) There are Cross-border implications, if the funds are solicited through internet, as there are disparities in Contract Act or securities law application in different jurisdictions.

### **Information Asymmetry**

- a) There is high chance of information asymmetry associated with these platforms, where one party invests/trades based on some information which is unknown to other set of investors. Since there is lack of hard information, there is too much reliance on soft information based on the social networking platforms in this model, which increases the risks.
- b) There is no monitoring of these platforms, as to which account the money goes.
- c) There is lack of transparency and reporting obligations on issuers including with respect to the use of funds raised.
- d) There is possibility of omission of information and misinformation providing distorted view of the issuer or the actual investment, which may result in over- estimation of the actual return. This may induce the investors to invest in a product that would not align with their risk tolerance.

### **Substitution of Existing Regulatory Framework**

Peer to Peer Lending acts as a Bank by matching lenders/investors with borrowers/issuers, without complying with any of the rigid requirements of Banks. The Disclosure and due diligence involved in crowd funding platform cannot be compared with existing framework of public offering through filing of Prospectus with adequate information, which is also subject to the scrutiny of the Regulators. Further, other public issue requirements for equity shares like to have minimum track record for the issuers, minimum promoters' contribution, lock in, and for debt securities like requirement to have trustees, rating by Credit rating agencies etc. may not be applicable in the crowd funding platforms.

### **Regulatory framework for crowd funding in various Jurisdictions:**

Two areas that have seen rapid growth in recent years are Peer-to-Peer lending and Equity crowd funding. Financial Reward (FR) crowd-funding globally has grown rapidly in the last 5 years, with data suggesting that the peer-to-peer lending market doubles each year. It accounts for approximately \$6.4 billion outstanding globally. Collectively, the US, UK and China make up 96% of the overall FR crowd funding market, with USA accounting for 51%, China for 28% and UK for 17%.

In Donation crowd funding and Reward crowd funding, only donations or grants are solicited and no financial return in the form of a yield or return on investment is expected by the donor/grantor. Hence, such funding mostly falls outside the purview of Securities market regulator. (In India, payment of donations are mainly governed by the provisions of Income Tax Act). Peer-to-Peer Lending, depending upon whether pure lending or any debt securities are issued, are regulated by Banking or Securities market

regulator. Crowd Sourced Equity Funding are mostly regulated by Securities market regulator.

### Regulation of Peer-to-Peer lending

Peer-to-Peer lending is also termed as 'direct consumer lending' or 'marketplace lending'. The Peer-to-Peer lending is approached differently by various regulators, treated as banking by some jurisdictions and as an intermediary in some others, while some jurisdictions like Israel and Japan have prohibited it altogether.

As per IOSCO Paper, though the nature of regulations concerning Peer-to-Peer lending varies with nations; these can be broadly divided into different categories.

Regulatory	Description	Countries
Unregulated	In these jurisdictions either the regulation has classified peer-to-peer lending as an exempt market or there is a lack of definition in legislation	Brazil, China, Egypt, South Korea
Intermediary Regulation	This regulates peer-to-peer lending platforms as an intermediary. This usually requires registration of such platform as an intermediary, and other regulatory requirements depending on the jurisdiction.	Australia, Argentina, Brazil, New Zealand
Banking Regulations	This regulated peer-to-peer lending platforms as banks.	France, Germany, Italy
US Model	This is a two tier system. This requires the registration of peer-to-peer lending platforms with the SEC, as well as applying for a licence to conduct business on a state by state basis.	USA
Prohibited	Both peer-to-peer lending	Israel, Japan

### Indian Scenario- Existing Legal Framework

The provisions in the existing legal framework for raising funds by companies are regulated under Companies' Act 2013 and Securities Act i.e. SEBI Act, 1992, Securities Contracts (Regulation) Act, 1956, Depositories Act, 1996. Raising of pooled managed investment funds by various entities such as Alternative Investment Fund (AIF), Mutual Fund (MF) etc. is regulated under Securities Laws.

#### Public Issue of Securities by Companies

Companies making public issue of securities need to comply with public issue requirements prescribed in Companies Act, 2013 and Rules made thereunder, apart from the requirements of SEBI Regulations.

Companies Act requires a company proposing to make a public issue to make a listing application to recognized stock exchanges. It requires the issuing company to file a Prospectus with Registrar of Companies. Further, detailed disclosure requirements for Prospectus are also specified.

Under Section 24 of the Companies Act, 2013, the provisions relating to issue and transfer of securities by listed companies or those companies which intend to get their securities listed on any recognized stock exchange in India shall be administered by SEBI. Hence, SEBI regulates public issuance of securities and those private placements which are proposed to be listed on stock exchange(s).

SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 (ICDR) requires issuers making public issue of specified securities to comply with requirements prescribed there-in which includes appointment of merchant banker, registrar to issue, filing of draft offer document with SEBI, eligibility requirement such as track record, minimum promoter's contribution, lock-in requirements, requirement to have a monitoring agency, etc., apart from detailed disclosure requirements. However, in case of debt securities, there is a simpler regime and the issuer need to comply with SEBI (Issue and Listing of Debt Securities) Regulations, 2008 (ILDS), which requires compliance with basic requirements like having a Debenture trustee, Credit Rating, disclosure requirements, etc. Further, once securities are listed in a Recognized Stock Exchange, the issuer has to comply with the continuous listing requirements.

### **Private Placements of Securities by Companies**

Taking into account the recent misuse of private placement route by some companies which issued huge number of debt securities to public under the garb of private placements, Companies Act, 2013 and Rules made thereunder, have put some restrictions on private placements, which was previously lightly regulated.

As per Chapter III - 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).

Such offer can be made **only to such persons whose names are recorded by the company prior to the invitation** to subscribe, and that such persons shall receive the offer by name, and that a complete record of such offers shall be kept by the company and complete information about such offer shall be filed with the Registrar within a period of thirty days of circulation of relevant private placement offer letter.

All money's payable towards subscription of securities through private placement shall be paid through cheque or demand draft or other banking channels but not by cash. Further, rules require that the payment to be made for subscription to securities shall be made from the bank account of the person subscribing to such securities and the company shall keep a record of all such bank accounts. The company shall allot its securities within sixty days from the date of receipt of the application money for private placement, else money has to be repaid to the investors. Company offering securities through private placement **shall not release any public advertisements or utilize any media, marketing or distribution channels or agents to inform the public at large about such an offer.**

Ministry of Corporate Affairs has also notified Companies (Prospectus and Allotment of Securities) Rules, 2014. As per the said Rules, a private placement offer letter shall be accompanied by an application form serially numbered and addressed specifically to the person to whom the offer is made and no person other than the person so addressed in the application form shall be allowed to apply through such application form. The value of such offer or invitation per person shall be with an investment size of not less than Rs.20,000 of face value of the securities.

A return of allotment of securities shall be filed with Registrar of Companies within 30 days of allotment along with a complete list of all security holders containing the full name, address, Permanent Account Number and E-mail ID of such security holder.

Companies Act, 2013 mentions that any offer or invitation that is not in compliance with the provisions of Section 42 shall be treated as a public offer and all provisions of Companies Act, 2013, and the Securities Contracts (Regulation) Act, 1956 and the Securities and Exchange Board of India Act, 1992 shall be required to be complied with, including the above mentioned requirements.

However, as mentioned above, Companies Act, 2013 provides a window for making private placement offers to Qualified Institutional Buyers (QIBs) and the 'limit of 200' is not applicable to such QIBs. QIBs are the entities such as a MF, Foreign Portfolio Investor (FPI), AIF, Scheduled Commercial Bank; IRDA registered Insurance company etc. as defined in SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009.

### **Provisions regarding SME Funding**

SEBI has taken various steps in the recent past to enable Start-ups and SME to raise funds through various routes such as SME Segment of Exchanges, Institutional Trading Platform (ITP), Category I- SME Fund under AIF Regulations. These channels are briefly defined in the following sections:

#### **SME Segment**

SEBI has specified framework for a SME segment (platform) on Recognized Stock Exchanges, where Small and Medium Enterprises (SME) can list their securities. A company which has its post-issue face value capital not exceeding ten crore rupees shall list only in SME platform. A company, which has its post issue face value capital more than ten crore rupees and upto twenty five crore rupees, has an option to list in SME platform. In case the post-issue face value capital exceeds Rupees twenty five crore rupees, the issuer should compulsorily list only on main board of the Stock Exchanges.

However, a listed issuer whose post-issue face value capital is less than twenty five crore rupees may migrate to SME platform if its shareholders approve such migration by passing a special resolution through postal ballot. An issuer listed on SME exchange proposing to issue further capital pursuant to which their post-issue face value capital may increase beyond Rs. 25 crore shall migrate to the main board, subject to obtaining in-principle approval of the main board before issue of such securities.

Various relaxations have been provided to SMEs listing on SME segment under SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009. Some of them are:

Draft Offer document may be filed directly with the exchange and not necessarily with SEBI.

Eligibility criteria for an issuer under Regulation 26 are not applicable to companies listing under SME segment.

Minimum application value of Rs.5000-7000 is not applicable (min. application value shall not be less than Rs. one lakh per application).

Minimum number of prospective allottees is fifty (instead of 1,000 in Main board).

Similarly, relaxations have also been provided with respect to the continuous listing requirements for

Companies listed in SMEs:

- Requirement to file half yearly financial results instead of quarterly
- Exemption from publishing financial results in newspaper
- SME companies may send abridged annual report to their shareholders.

However, the same need to be displayed on the website of the exchange and company.

Apart from the above, there is a compulsory market making requirement for companies listed on SME segment for a minimum period of three years from the date of listing to ensure liquidity in the market.

SME Segments were launched on BSE and NSE on December 14, 2012 and September 18, 2012 respectively. There are 60 SMEs listed on the BSE SME Exchange and 5 SMEs listed on the NSE SME Exchange (Emerge) as on June 11, 2014.

### **Institutional Trading Platform (ITP)**

SEBI has permitted listing of Small and Medium Enterprises (SME), including start-up companies, on the SME exchange Institutional Trading Platform (ITP), without being required to make an initial public offer. The main features of the ITP Platform following are:

- Only such SMEs which do not have their securities listed on any recognized stock exchange are permitted to list their specified securities exclusively on the ITP.
- The listing process of ITP does not involve an IPO, or private placement or any issue of securities.
- While such companies are listed on the platform, they are not permitted to raise capital.
- Since the trading lot has been mandated as 10 lakh, participation in this platform is restricted to informed investors.
- The companies listed in ITP are SMEs and start-up companies which get visibility by listing in the stock exchanges, without any public issue of their securities.
- The regulatory framework for ITP also envisages that the SMEs listed in this platform will mandatorily exit the platform if (a) a period of 10 years have elapsed since the company was listed in the ITP (b) the paid-up capital of the company is more than twenty five crore rupees (c) the revenue of the company is more than three hundred crore rupees (d) company reaches market capitalization of more than five hundred crore rupees.

This platform is merely meant to provide the initial impetus for such SMEs rather than a sustained listing over a long term horizon.

In addition to the visibility to SMEs, this framework also provides a trading platform for the scrips of Start-up Companies held by Alternative Investment Funds (AIFs), VCFs etc. and enhances the liquidity in such scrips, which in-turn provide enabling environment for SME and start-up enterprises to flourish.

BSE launched its ITP on February 11, 2014. There are 6 companies listed on ITP of BSE. NSE launched its ITP on October 28, 2013 and there is 1 company listed on it as on June 11, 2014.



## Provisions related to Alternative Investment Funds:

SEBI (Venture Capital Funds) Regulations (“VCF Regulations”) were framed in 1996 to encourage funding by entrepreneurs’ early-stage companies in India. However, since registration of VCF was not mandatory under VCF Regulations, all players in the alternative funds industry were not registered with SEBI. Hence, it was felt that there was a regulatory gap which needed to be addressed. Further, SEBI Board had approved the proposal for a clear regulatory framework for privately pooled investment vehicles under AIF framework to inter-alia pave way for increased investment in start-ups, SMEs, etc. and also provide for a mechanism to monitor and assess systemic risks and risks to financial market stability posed by the activities of some funds such as Hedge funds. Considering the same, SEBI notified the framework for registering and regulating Alternative Investment Funds (AIF) through SEBI (Alternative Investment Funds) Regulations, 2012 on May 21, 2012.

These Regulations cover all privately pooled investment vehicles in India raising funds from Indian or foreign investors for investing in accordance with a defined investment policy for the benefit of its investors. However, Mutual Funds, Collective Investment Schemes, Family Trusts, Employee Welfare trusts, Securitization trusts, any other funds regulated by other regulators, etc. are exempted from the ambit of the AIF Regulations.

These regulations seek to cover the funds broadly under 3 categories.

- Category I – which includes Venture Capital Funds, SME Funds, Social Venture Funds, Infrastructure Fund, etc. (which invests in sectors or areas which the government or regulators may consider as socially or economically desirable);
- Category II – which includes private equity funds or debt funds (which does not undertake leverage or borrowing other than to meet day-to-day operational requirements) and
- Category III – which includes Hedge Funds - (employ leverage including through investment in derivatives)

As per the said Regulations, AIF should be prohibited by its trust deed/memorandum and articles of association/partnership deed from making an invitation to the public to subscribe to its securities. AIF shall not accept from an investor an investment of value less than Rs. 1 Crore and no scheme of the AIF shall have more than 1,000 investors. Further, each scheme of the AIF shall have a minimum corpus of Rs. 20 crore. Further, the manager or sponsor shall have a continuing interest in the AIF of certain percentage of the corpus.

Category I AIFs are further categorized in 4 sub-categories:

- (i) Venture Capital Funds
- (ii) Social Venture Funds,
- (iii) SME Funds,
- (iv) Infrastructure Funds.

## Future of crowd funding in India:

The sources of funding for Start-ups include private equity, angel investor and loan arrangements from financial institution. Any offering of public equity takes place only after the product or business becomes commercially viable. However, in Equity based Crowd funding, funds may be solicited at an earlier stage, for instance, pilot development. Thus, giving the Company, access to funds beyond the traditional sources mentioned above.

It is essential to formulate balanced crowd funding regulations in India that lower the cost of capital and increases liquidity while ensuring adequate investor protection and minimizing investment risks.

SEBI proposed guidelines in 2014, via a 'Consultation Paper on crowd funding in India' for crowd funding aimed at improving access to funds for start-ups and small-to-medium enterprises.

The key SEBI guidelines on crowd funding are:

1. Only "Accredited Investors" may invest
2. Qualified Institutional Buyers ("QIBs") to hold 5% of issued securities; at least 5% of issued securities
3. Retail Investor contribution: Minimum- INR 20,000 and maximum- INR 60,000
4. Maximum number of retail investors- 200
5. Start-ups which are less than two years old only, eligible to participate
6. Disclosure details on proposed business plan, intended fund usage, audited financial statements, management details etc.
7. Registered crowd funding 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.

## Conclusion

In the global scenario of the crowd funding with the associated benefits and risks, even in the present regulatory approach, it is proven that the crowd funding has the potential to grow as a way of raising funds for the budding entrepreneurs. Short falls in the existing legal framework should overcome with necessary provisions. In India, where the investment procurement is still a challenging task within the existing regulatory framework, crowd funding can be emerged as a main source of fund raising. All we need a suitable legal frame work where the crowd funding can fit in.

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