

CROWDFUNDING: IS INDIA READY?

RUPIN PAWHA, Partner, Juris Legal & Financial Services

PRASHANT PRANJAL, Associate, Juris Legal & Financial Services

ANANYA MOHAN, Intern, Juris Legal & Financial Services

1. Introduction

In June 2014, the Securities and Exchange Board of India (the “SEBI”) released a Consultation Paper on Crowdfunding in India (the “Consultation Paper”) to provide a brief overview of crowdfunding and a step towards forming rules for regulating it in India.¹ SEBI asked for suggestions and public comments till July 2014 after which it will come out with draft regulations. The Consultation Paper mentions the legal position of crowdfunding in different countries and the different types of crowdfundings. It also talks about the different components which Indian crowdfunding model might possibly have.

As per the Consultation Paper, ‘crowdfunding’ is solicitation of funds (generally in small amounts) from multiple investors through a web-based platform or social networking site for a specific project, business venture or social cause.

Though the topic is very wide and it is not possible to discuss all the issues relating to crowdfunding in one article, the authors in this article have tried to answer and discuss some of the very vital issues. The first and the most significant issue which arises is whether crowdfunding amounts to public offer or private placement. The primary question under Indian law would be whether an offer under crowdfunding would amount to a public offering in terms of section 23 and Chapter III [Part I] of the Companies Act, 2013 (the “Companies Act”) that requires a prospectus and associated compliances. Another issue is regarding the regulation of an online trading platform in a scenario where India is still lagging behind in terms of internet security and risk awareness. The authors shall also throw light on whether websites shall require registration as an intermediary; possible registration procedures, approvals for setting up a crowdfunding platform, eligibility criteria and qualifications of investors and crowdfunding platform. These are still early days for crowdfunding in India and it is not the right time to comment upon how the India market will react to this setup. But these are issues worth considering in advance of crowdfunding becoming prevalent in the Indian markets.

2. Governing Laws

¹ Consultation Paper on Crowdfunding in India, http://www.sebi.gov.in/cms/sebi_data/attachdocs/1403005615257.pdf

The SEBI in the Consultation Paper has shown interest in introducing crowdfunding in India in form of equity, debt and fund based crowdfunding. As of now SEBI has not shown interest in peer-to-peer based crowdfunding. In this paper, the discussion will be on legal and regulatory huddles involved in starting equity based crowdfunding.

Under the existing laws, crowdfunding schemes will be governed by the provisions of two legislations, viz. Securities and Exchange Board of India Act 1992 (the “**SEBI Act**”) and the Companies Act. Under SEBI Act, the main issue is regarding jurisdiction of SEBI and intensity of regulation. Under the Companies Act, the main issue is regarding private placement and public offer made by companies while issuing securities to investors.

2.1. Companies Act

From the definition of crowdfunding as given in part 1 of this article, it is quite clear that crowdfunding is based upon the solicitation of funds from the public. Section 2 (68) (iii) of the Companies Act prohibits a private company from making an invitation to the public to subscribe to securities of the company. So company or startup which will be needing money from the investors should not be a private limited company whereas the main purpose of this funding scheme is to target small and new private limited companies. Here the entire scheme is hit by Section 2(68)(iii) of the Companies Act.

Further Section 42(2) of the Companies Act requires that the invitation to subscribe to securities of a private limited company shall be made to such number of persons not exceeding 50. In case an offer or invitation is made to 50 or more persons for the issuance of securities, such an offer could fall within the purview of a ‘public offer’, requiring a prospectus and associated compliances, including listing of such securities on a recognized stock exchange, which could be quite meaningless as well as expensive for a startup.²

The company can stay out of the purview of this section by making distinct offerings, each of which offering is made to less than 50 persons. However, a company may not be out of the woods by merely making the offer to less than 50 persons. It may be noted that under Section 42 of the Companies Act, if the offer or invitation to subscribe to shares is made to a selected group of persons through a private placement offer letter, then it shall not be regarded as an offer to the public. However, typically in case of crowd funding, the offer or invitation is made through the internet to unknown and not specified persons, and hence, it would be tough to control the number of offerees.

2.2. SEBI Act

With regard to the above discussed issue, it is important to look into the Securities Appellate Tribunal (the “**SAT**”) order dated October 18, 2011, with respect to the issue of securities by two unlisted Sahara Group companies, to approximately 30 million persons.³ SEBI, in its order dated June 23, 2011, had found that the companies had raised a huge amount of money from the public without adhering to norms governing public issues in India in relation to

² Chapter III [Part I], Companies Act, 2013.

³ http://www.sebi.gov.in/cms/sebi_data/attachdocs/1318927478423.pdf

disclosure and investor protection.⁴ One of the main findings of the SAT in its order was that a private placement is made to known persons whose number is less than 50 and therefore an issue to more than such a number is a public issue. The SAT observed that in the current case the companies had made a ‘public issue’ by approaching more than 30 million investors, but by avoiding the requirements of the law. SAT expressly stated in this regard, “the fact that information memorandum was circulated to more than thirty million persons through ten lakh agents and more than 2,900 branch offices is nothing but advertisement to the public”.

Another important issue deliberated upon by the SAT which is also important in case of crowdfunding was whether the SEBI has jurisdiction to regulate unlisted companies. SAT held that SEBI has jurisdiction over unlisted companies too as long as they can be said to be ‘persons associated with securities market’. The SAT also went on to state that when it comes to regulating the securities market and protecting the interests of investors in securities, the SEBI Act is a standalone enactment and SEBI’s powers under it are not fettered by any other law including the Companies Act.

Going by this order of the SAT, raising of funds by private companies through the internet using crowdfunding platform, where the number of persons to whom securities are being offered is 50 or more who are not specified, may be termed as a public offer and hence attract stringent and onerous compliance requirements including listing of such securities on a recognized stock exchange in India.

From the above discussion it is quite clear that there is a restriction on public offering other than through a prospectus based offer and mandatory listing except for private placement of securities.

3. Whether Websites will Require Registration as Intermediaries?

Another issue that we need to keep in mind while analyzing the regulatory framework for crowdfunding is whether the internet websites on which in these securities are offered will require registration as intermediaries under the SEBI Act, and hence be subject to the SEBI (Intermediaries) Regulations, 2008 (the “**Regulations**”), and other securities regulations.

Section 12(1) of the SEBI Act states that no intermediary who may be associated with securities market shall buy, sell or deal in securities, except in accordance with the conditions of the certificate of registration obtained from the SEBI as per the SEBI Act and the Regulations. A crowdfunding platform shall come within the definition of intermediaries and will require mandatory registration provisions.

Securities as defined under Section 2 (h) of the Securities Contract Regulation Act, 1956 (the “**SCRA**”) include shares of any incorporated company. The Preamble of the SEBI Act states that “it is an Act to provide for the establishment of a Board to protect the interests of investors in securities...”. Under Chapter IV of the SEBI Act, the powers and functions of the Board have been discussed. Section 11 (1) states that “...it shall be the duty of the Board to protect the interests of investors in securities...”. Thus from the preamble as well as

⁴ <http://www.sebi.gov.in/cmorder/SaharaIndiaRealEstate.pdf>

provisions contained in Chapter IV (Section 11) of the SEBI Act, whenever there is an issue of securities by any company and the interest of an investor is on stake, the SEBI will have jurisdiction. The same was stated by the SAT in the Sahara matter which was later upheld by the Supreme Court.

Going by above discussion, if securities are being issued by a company, which is raising funds through the crowdfunding website, it is possible that, the website may be considered as an intermediary dealing in securities, which is bringing the fund raising company and the investors together and hence may require a certificate of registration from the SEBI. In addition, such intermediary shall be bound by the norms listed in the Regulations including making regular disclosures, maintenance of books, accounts and records, ensuring redressal of investor grievances, appointment of a compliance office, abiding by a code of conduct specified in the Regulations and being subject to scrutiny and inspection by the SEBI. From a reading of these related legislations and subordinate legislations, it seems like the website offering services to bring the crowd and the investee company together resulting in issuance of securities may be considered an intermediary and be subject to registration requirements and other ongoing compliances, which may or may not be acceptable to most such service providers.

4. Possible Structure of Crowdfunding Platform

A possible structure which can be proposed in the draft regulations may be in a form where the offer is made through a web based recognized crowdfunding platform only to registered investors who have been given access to the platform. A crowdfunding platform must get itself registered with SEBI and fulfil all the requirements as specified by the regulator and for intermediaries.

Further a company interested in raising funds must get itself registered with a crowdfunding platform by giving a copy of its business model or proposed business plan (in case of a start-up). A copy of the certificate of incorporation and other documents such are Memorandum of Association and Articles of Association should also be submitted to the crowdfunding platform. This will help investors know a company well before investing and will give an opportunity to the companies to present themselves and fetch more funds.

The crowdfunding platform will also maintain a list of registered investors who will be given access to the platform to invest in the companies displayed on it. The registered investors will be allowed to register only after examination of KYC compliances and fulfilment of other requirements like net worth or income, signing of Risk Acknowledgement etc. Post registration, these investors will be given a Login ID and password to access the platform.

Now the main issue would be restricting the offering to a private placement and not crossing the lines to come under the scanner of public issue. For restricting the offering to a private placement, what the authors suggest is that a company seeking to raise funds can approach each individual registered investor and give an invitation to subscribe the company's shares. Such invitation should be made to such number of investors not exceeding 50 in number, as per the requirement of Section 42 of the Companies Act.

Further, a chat window should be provided on the crowdfunding website where the company can have a private pre-offering discussion with the investors, tell them about the business plan and ask them whether they are interested in investing. If an investor shows interest in investing, then an invitation to subscribe to shares of that company can be sent to them.

Amendment to the Companies Act is another way by which the offer can be restricted to a private placement.

5. Conclusion

There are no specific regulations for crowdfunding in India and in the light of the current laws with respect to raising money from the public, a startup cannot really opt for crowd funding, as the same will lead to violation of prohibition against soliciting investment from the public by private companies. There is a crying need of a set regulation for crowdfunding in India.

However, using the Internet for raising funds can have its own issues. Clear laws need to be put in place on whether Internet sites through which crowd funding would be done should follow the regulations of SEBI. India has still not reached that stage where it can deal with internet security and awareness amongst people about how to deal with spam and fake web-portals. The lawmakers, while framing the regulations, should keep in mind that what kind of security features and IT Policies should be put in place to make the crowdfunding platform safe and secure from all sorts of cyber risks and hazards.

The authors are of the view that the lack of regulations surrounding investments through crowdfunding could leave the investors in a lurch if the companies are found to be badly governed. Regulator(s) need to consider what information about the business, the use of funds raised and the start-ups' founders should be disclosed to investors to guide them in their investment decisions.

The IPO market for the last five years has not been very robust. A public company after spending a lot of money gets itself listed on the stock exchange and fails to raise money during the period when the issue is open. This clearly shows that people have lost faith in IPOs as in the past a number of good graded IPOs have failed to give a good result. The popularity of crowdfunding is increasing day by day and thus it is better to regulate it than to keep it unregulated or banned.