Equity-Based Crowdfunding as an Early-Stage Financing Alternative: Critique of the Regulatory Proposals in India

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> [The following guest post is contributed by **Shwetha Chandrashekar,** who is a Senior Associate in Bangalore, India at GameChanger Law Advisors. She can be contacted onshwetha@gamechangerlaw.com.]

With over 4200 start-ups, India is the fastest growing start-up ecosystem worldwide. It has the third-largest number of start-ups in the technology sector following the US and the UK.[1] However, India is experiencing an exodus of start-ups to jurisdictions with more favourable regulatory regimes. Singapore, for instance, offers many benefits for start-ups including less stringent compliance requirements, tax credits for investors, zero capital gains tax and grants for research and development.[2] In contrast, Indian start-ups suffer from high taxation on angel investments[3], weak patent laws[4] and excessive bureaucracy in both incorporation and fundraising stages.

Recognizing start-ups' potential in boosting the economy, the securities market regulator, Securities and Exchange Board of India ("**SEBI**") has introduced reforms aimed at improving access to funds for start-ups and small-to-medium enterprises ("**SMEs**"). SEBI amended the SEBI (Alternative Investment Funds) Regulations, 2012 ("**AIF Regulations**") to regulate 'angel funds'. Relaxations in SME listing norms were introduced under Chapter XB of the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 ("**ICDR Regulations**") to allow for stock exchanges to have a separate SME trading platform. Keeping up with this positive trend, in 2014, SEBI released a 'Consultation Paper on Crowdfunding in India' inviting suggestions from all stakeholders on regulatory proposals.

This post aims to analyse equity-based crowdfunding as an early-stage financing alternative in India in light of SEBI's proposals. The first part introduces crowdfunding and examines its benefits and risks, underlining the need for a regulatory framework. It then discusses financing avenues

available to start-ups to study if existing regulatory provisions can be used to regulate crowdfunding. Finally, it critically analyzes SEBI's Consultation Paper to understand if economic objectives of crowdfunding are fulfilled and provides recommendations on the way forward.

Equity-Based Crowdfunding: Benefits And Risks

Equity-based crowdfunding involves solicitation of funds by start-ups from investors through an intermediary online platform in return for issuance of securities such as equity shares.[5]

Crowdfunding has recently gained traction as a viable fundraising alternative, with jurisdictions around the world introducing laws to regulate it.[6] The recent global economic meltdown has made access to secured loans difficult for start-ups that have little or no collateral to offer. Private equity ("**PE**"), venture capital ("**VC**") investments and public offerings are inaccessible to many start-ups which are usually sensitive to a higher cost of capital and are not far enough in their life cycle for conventional financial intermediaries to adequately assess risk and commit to an investment.[7]

Therefore, crowdfunding serves to benefit start-ups by improving much-needed access to early-stage capital. Owing to the nature of crowdfunding, investment risk is spread out[8]. On a macro level, providing easier access to funds to start-ups stimulates economic growth by facilitating capital flow. This triggers positive socio-economic impact through job creation and can be a much-needed alternative source of financing in a capital-scare economy. Crowdfunding offers retail investors a lower cost and potentially high return investment vehicle, helping them diversify their portfolio.

However, crowdfunding poses a unique potpourri of regulatory complexities associated with public issue (such as disclosure and due diligence requirements) coalesced with risks of PE and VC investments (such as default, failure and fraud). Failure statistics reveal that nine out of ten start-ups fail.[9] The most popular example of risks of fraud is that of Bubble and Balm, a UK-based soap company which was one of the first companies to be funded through equity-based crowdfunding, which in 2011 after raising £75,000 abruptly closed its business in 2013 leaving its investors in the lurch.[10]

Owing to the absence of a secondary market, investors cannot sell their securities to recover their investments.[11]Further, accurate valuation is problematic as financial activities of young start-ups are difficult to analyse and forecast.

Prohibitive disclosure costs result in a start-up's inability to meet high disclosure standards.[12] The resulting information asymmetry coupled with lack of investment experience of retail investors is a problematic combination.Therefore, crowdfunding calls for a finely-balanced regulation that recognizes the need for raising low-cost capital, facilitating access to funds and increasing liquidity on the one hand and the importance of ensuring investor protection and lowering systemic risks on the other.

Existing Routes of Financing and the Regulatory Regime in India

Presently, the regulated routes of fundraising in India are:

– Seed or Angel Investments are regulated under the Companies Act, 2013 ("**Act**") for private placement (an offer by a company to a select group of persons[13] to subscribe to its securities) for unlisted companies. Listed companies need to further adhere to the ICDR Regulations.

– PE and VC Funds are regulated under the Act and AIF Regulations.[14]

– Initial public offers ("**IPO**") or follow-up public offers are governed by the Act and ICDR Regulations.

The private placement route will not apply to crowdfunding as the latter entails solicitation of small-sized funds from a large number of unidentified investors. Smaller retail investors, who are likely to contribute far less capital per individual, would not meet the minimum investment criteria stipulated under the current regulations pertaining to PE and VC.

A public issue involves the appointment of merchant bankers, filing of a prospectus with SEBI, previous track record requirements, minimum promoter's contribution etc., apart from detailed disclosures. An IPO usually occurs later in the lifecycle of a company, requiring the issuer to disclose among other things, minimum net tangible assets, distributable profits and net worth for a historical track record of a certain number of years. In contrast, crowdfunding being an early-stage fundraising alternative, aims at helping start-ups kick-start their business ideas. For a young venture with limited funds, fulfilling these requirements is daunting and impractical.

The existing regulatory climate necessitates creating carve-outs from current financing regulations and formulating a de novo regulatory framework for crowdfunding. It poses avenues for regulatory arbitrage by fraudulent fundraisers as was demonstrated in a recent Supreme Court case, *Sahara India Real Estate Corporation v. SEBI*.[15] This case involved one of the biggest investor frauds in India in which Sahara raised over USD 3 billion from nearly 30 million investors from amongst their intricate network of associated group companies, employees and other related individuals. It argued that its capital raising methods were not governed by IPO regulations because it did not intend to list its securities on any stock exchange. Therefore the investment route neither qualified as a private placement nor as a public issue but was akin to a crowdfunding model without the involvement of any online intermediary platform. In that case, the Supreme Court clamped down on the funding model used by the companies.

The case highlights the potential and reach of crowdfunding as a financing alternative and the need for a crowdfunding regulatory regime. It further exhibits SEBI's proactive watchdog role prompted by the lack of knowledge and experience of retail investors.

As a result of the Sahara case, a provision was introduced in the Act which states that irrespective of whether a company intends to list its securities, if an offer to allot securities is made to more than fifty persons, it would be deemed to be an IPO. This would currently bring crowdfunding squarely under the IPO regulatory umbrella.

Recognizing the potential and need for crowdfunding as a financing option for start-ups, SEBI floated the Consultation Paper in 2014 to address the lacuna in current regulations. The next section analyses the proposals to ascertain whether they adequately fulfil crowdfunding objectives.

SEBI Consultation Paper on Crowdfunding in India, 2014: A Critical Analysis

Some of the key SEBI proposals are:

– Only 'Accredited Investors'[16] 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.

SEBI's definitions of 'Accredited Investors', 'Eligible Retail Investors'[17] and the requirement for QIBs to collectively hold a minimum of 5% of issued securities, are contrary to the economic objectives of crowdfunding. While the intention is to ensure investor protection by permitting investments from only sophisticated investors, this requirement may render crowdfunding inaccessible to other classes of retail investors.

VCs and QIBs tend to invest in ventures that are typically 2+ years into their lifecycle that can provide reasonably accurate projections and viable business models. The proposals target start-ups less than 2 years of age, which makes crowdfunding an unlikely investment opportunity for VCs and QIBs due to information asymmetry. Without achieving the requirement for QIBs to

collectively hold a minimum of 5% issued securities, the start-up cannot raise capital through the crowdfunding route. Hence, this stipulation should be deleted as it may defeat genuine fundraising efforts.

To protect the interests of unsophisticated investors, the maximum investment amount should be in proportion to ERI's net income as opposed to net worth. The minimum investment amount requirement must be removed to facilitate smaller investments from larger number of investors. To facilitate optimal access to this investor group, the definition of ERIs must be expanded.

The restriction on maximum number of retail investors per crowdfunding round contradicts the bedrock concept of crowdfunding, 'safety in numbers'. 5000 investors investing USD 100 each is easier to secure and provides greater individual investor protection than 100 investors investing USD 5000 each. The in-built protection of 'wisdom of the crowd' embodied in crowdfunding, ensures that over time the crowd of unsophisticated retail investors mostly make sound investments in genuine ventures weeding out fraudulent ones. A survey conducted in the UK reveals that majority of investors in equity-based crowdfunding are retail investors with no previous investment experience.[18] Interestingly, New Zealand, one of the most crowdfunding-friendly jurisdictions, does not differentiate between sophisticated and retail investors.[19]

SEBI proposals restrict crowdfunding to only unlisted public companies. In practice, most start-ups in India register as private limited companies. Therefore, the crowdfunding route should be expanded to include other types of corporate entities to enable them to leverage the benefits of crowdfunding.

The stringent disclosure norms laid out by SEBI closely resemble existing private placement requirements. While the importance of adequate disclosures to safeguard investor interests is undisputed, associated prohibitive costs need careful consideration. Instead, the crowdfunding platform should bear costs associated with disclosures and recoup those costs by levying a nominal fee on the investors and start-up, thereby reducing the burden on start-ups and achieving transparency.

Formulating guidelines with respect to differential voting rights will help young ventures devise an investment policy to facilitate subsequent investment rounds. The crowdfunding platform should have industry-based advisory committees comprising of industry-experts for mentoring start-ups on long-term fundraising strategy. This combined with appointment of a trustee to represent the investors' collective interests and rights will help adequately balance investor-investee interests.

Owing to the involvement of internet and social media, crowdfunding could transcend borders where foreign investors could participate in crowdfunding rounds by Indian start-ups and vice-versa. The proposals are silent on whether cross-border crowdfunding is proposed to be permitted. If yes, how will foreign investors be treated vis-à-vis Indian investors? In case of fraud in foreign jurisdictions, how will Indian investors be protected? SEBI must therefore create adequate safeguards to tackle cross-border crowdfunding issues and jurisdictional arbitrage.

Conclusion

The emergence of India as a start-up hub and its burgeoning start-up ecosystem necessitate finding alternate fundraising modes for these enterprises to start, scale and succeed. The Sahara case experience demonstrates why the extant fundraising regulatory environment is inadequate and not aligned to crowdfunding objectives. There is clearly a case for a balanced crowdfunding regulation that lowers cost of capital and increases liquidity while ensuring adequate investor protection and minimizing investment risks.

An analysis of the Consultation Paper reveals a rather cautious approach by SEBI that tends favourably towards investor protection and falls short in upholding the economic objectives sought to be achieved by crowdfunding. In order to make equity-based crowdfunding a viable early-stage financing alternative in India, SEBI must consider making amendments to its proposals in line with recommendations made in this paper and from other stakeholders.

– Shwetha Chandrashekar

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[1] National Association of Software and Services Companies, 'Start-up India – Momentous Rise of the Indian Start-up Ecosystem' (Report) (October, 2015)accessed January 16, 2016.

[2] P. Abrar, 'India's Tech Stars Shifting to Silicon Valley'*The Hindu* (June 30, 2015) .

[3] 33% 'Angel Tax' on angel investments received by the start-ups taxed as 'Income from other Sources' in accordance with Section 56(2) of the Income Tax Act, 1961.

[4] P. Kilbride, 'Explained: Why India ranks second last in global IP index and how it can improve', (February 05, 2016) .

[5] E. Kirby and S. Worner, 'Crowd-funding: An Infant Industry Growing Fast' (IOSCO Research Department, Staff Working Paper No. [SWP3/2014]) ('Kirby').

[6] Title II (Accredited Crowdfunding) and Title III (Retail Crowdfunding) of the Jumpstart Our Business Startups Act, 2012 (US); Decreto Crescita Bis, 2012 (Italy); Financial Conduct Authority Regulation on equity crowdfunding, 2014 (UK); Securities and Investments Commission, 'Guidance Note on Crowdfunding' (2012) [12-196MR ASIC] (Australia).

[7] Vidhi Centre for Legal Policy, 'Responses to SEBI Consultation Paper on Crowdfunding' (July 16, 2014) p. 3('Vidhi').

[8] Kirby (4).

[9] E. Griffith, 'Why Startups Fail, According to their Funders' *Fortune* (September 25, 2014) <http://fortune.com/2014/09/25/why-startups-fail-according-to-their-founders/>.

[10] L. Warwick-Ching, T. Powley and E. Moore, 'Alarm Bells For Crowdfunding As Bubble Pops For Soap Start-Up' *Financial Times* (July 31, 2013) .

[11] Kirby (20).

[12] R.S. Weinstein, 'Crowdfunding in the US and Abroad' (2013) 46 Cornell International Law Journal 434.

[13] The maximum number of investors that are permitted to participate in a private placement under the Companies Act are 50 per investment round or 200 in a financial year.

[14] The PE and VC regulations call for strict corporate compliance and governance framework with a heightened focus on investor protection. Some of the mandatory requirements are (i) Maximum 1000 investors; (ii) Minimum corpus of each AIF fund/scheme must be at least INR 200 million; and (iii) Minimum investment from each investor must be at least INR 10 million.

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

[16] Accredited Investors under the SEBI proposals are: (i) QIBs; (ii) Companies with a minimum net worth of INR 200 million; (iii) High Net Worth Individuals with a minimum net worth of INR 20 million or more; or (iv) Eligible Retail Investors

[17] "**Eligible Retail Investor**" or "**ERI**" shall mean a retail investor who has received professional investment advisory or availed of the services of a portfolio manager and has a minimum annual income of INR 1 Million and who has filed an income tax statement for atleast the last 3 financial years.

[18] Nesta, 'Understanding Alternative Finance: The UK Alternative Finance Industry Report 2014' (Report) (November 2014) <https://www.nesta.org.uk/sites/default/files/understanding-alternative-finance-2014.pdf>.

[19] Financial Markets Conduct Act, 2013 (New Zealand) <http://legislation.govt.nz/act/public/2013/0069/latest/DLM4090578.html?src=qs>.