

## Funds Hotline

July 03, 2014

### CROWD – GET READY TO FUND!!! SEBI PROPOSES A NEW FRAMEWORK

- Following other developed economies, SEBI proposes to allow Indian startups / SMEs to raise capital from multiple investors through Crowdfunding.
- Such startups / SMEs will be approved by a 'Screening Committee' of the online Crowdfunding platform.
- Option to invest in such startups will be provided to eligible 'Accredited Investors' only.
- SEBI has currently issued a Consultative Paper for inviting comments and suggestions.

To promote the startup ecosystem in India, the Securities and Exchange Board of India ("SEBI") has rolled out a 'Consultation Paper on Crowdfunding in India' ("Consultation Paper") proposing a framework in the form of Crowdfunding to allow startups and SMEs to raise early stage capital in relatively small sums from a broad investor base. Crowdfunding, if introduced and regulated, will allow startups in raising capital in addition to the recently introduced Institutional Trading Platform ("ITP"). For more details on the ITP, please refer to our hotline [here](#).

In this hotline, we analyze the proposed framework for Crowdfunding as provided in the Consultation Paper alongwith the funding opportunity that it provides. As the Consultation Paper also covers a global study on the subject, we will also analyze herein the framework of Crowdfunding, as it is prevalent in certain developed economies to better understand the proposed framework for India.

#### WHAT IS CROWDFUNDING?

The Consultation Paper defines Crowdfunding as *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*. In simple terms, it means a crowd sourced funding for a project or venture through small pecuniary contributions from multiple investors. However, SEBI has attempted to customize this concept of Crowdfunding to 'strike a proper balance between investor protection and the role equity markets play in supporting economic development and growth'<sup>1</sup> and to avoid systemic risks being created in the economy. In doing so, they have effectively removed the 'Crowd' from the 'Crowdfunding'; however, it still is a good progress in the journey of creating an enabling environment for the startups in India, which unlike the peers in developed countries, face hardship when it comes to availing bank credits or institutional funding.

#### MODALITIES INVOLVED IN CROWDFUNDING

SEBI has emphasized on the following elements while conceptualizing the Crowdfunding model for India: (i) type of entities allowed to raise capital ("Eligible Entities"), (ii) type of investors allowed to invest ("Eligible Investors"), and (iii) type of entities allowed to set up internet based Crowdfunding platforms ("CF Platform") enabling online solicitation from Eligible Investors ("Eligible Platform Offeror").

1. **Eligible Entities:** The Consultation Paper proposes that the Eligible Entity has to be *inter alia* an 'unlisted public company' incorporated in India, not more than 48 months old, and not promoted, sponsored or related to an industrial group which has a turnover in excess of INR 250 million (approx. USD 4.16 million) or has an established business. To ensure that only genuine entities raise funds through this mode, it is provided that the directors, promoters or associates of the Eligible Entity should not be suffering disqualifications, *inter alia*, from regulators such as SEBI and Reserve Bank of India.
2. **Eligible Investors:** Only 'Accredited Investors' are proposed to be allowed to invest via Crowdfunding. "Accredited Investors" includes: (i) Qualified Institutional Buyers<sup>2</sup> ("QIB"), (ii) Indian companies and high net-worth individuals having a net worth of INR 200 million (approx. USD 3.33 million) and INR 20 million (approx. USD 0.33 million), respectively, and (iii) Eligible Retail Investor (ERI), who is an Indian citizen / NRI complying with the proposed criteria.
3. **Eligible Platform Offeror:** SEBI has prescribed certain specific requirements to check the integrity, experience and solvency of the owners of the CF Platform and the key members associated with it. In doing so, it has prescribed three classes of entities (Class I, II and III) to be eligible for offering the CF Platform in India. Class I entities (stock exchanges and depositories) are already under SEBI's domain and have a successful track record in securities market; Class II entities (also referred to as the technology business incubators) have a specialized domain knowledge in the field of startup mentoring and funding; and, Class III entities are associations and networks of private equity or angel investors.

#### CROWDFUNDING MODEL PROBABLE FOR INDIA

There are four different Crowdfunding models prevalent globally.<sup>3</sup> Out of these, the Consultation Paper proposes to explore the Security Based Crowdfunding model for India; since, issuance of securities is within the regulatory domain of SEBI. SEBI has explored the following options under this model:

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1. **Equity based Crowdfunding ("EbC"):** Eligible Entity can raise upto INR 100 million (approx. USD 1.66 million) by issuing equity shares to Accredited Investors, provided, no single investor shall hold more than 25% stake in the Eligible Entity, and the promoters of the Eligible Entity maintains a minimum of 5% equity stake for at least 3 years.
2. **Debt based Crowdfunding ("DbC"):** Eligible Entity can raise upto INR 100 million (approx. USD 1.66 million) by issuing debentures or debt securities to the Accredited Investors in compliance with the conditions provided under the Companies Act, 2013 ("CA 2013").

**Issuance process under EbC and DbC:** It appears that the Eligible Entity will have to largely comply with the requirements for private placement of securities provided under CA 2013 and the rules therein. However, one significant diversion from section 42 of CA 2013<sup>4</sup> makes the Crowdfunding model helpful, i.e. the Eligible Entity can make invitation to subscribe to a wide base of Eligible Investors in a cost effective manner without making any public offer. Once invitation to subscribe is provided on the CF Platform, the Eligible Entity will gauge the demand from its invitation and make offer to subscribe to select Eligible Investors (not more than 200 in number (excluding QIBs)) who have made commitment about the funds they want to invest. Offer to subscribe will be given in the form of 'private placement offer letter' which shall also contain the prescribed disclosures like the financials, capital structure, details regarding directors, management and group entities, principal risks involved in the business, description about the price of securities arrived at, the rights and liabilities attaching to the securities, etc.

3. **Fund based Crowdfunding ("FbC"):** Another form of Crowdfunding proposed by SEBI is the formation of a separate category of funds under Category I Alternate Investment Funds under the SEBI (Alternative Investment Funds) Regulations, 2012 to offer FbC as a new 'Category I AIF – Crowd Funds' ("**Crowd Fund AIF**"). Crowd Fund AIF will be allowed to be displayed on any CF Platform set up by either as Class I or Class III entities. Thereafter, they can solicit funds online from a maximum of 1,000 Eligible Investors. The pooled monies from Eligible Investors can be invested by the Crowd Fund AIF into various Eligible Entities displayed on the CF Platform. FbC can address restrictions applicable to EbC and DbC like maximum number of investors to which offers can be made.

## CROWDFUNDING IN DIFFERENT JURISDICTIONS – A COMPARATIVE STUDY

The Consultation Paper also does a comparative study of prevalent and proposed regimes on Crowdfunding in different jurisdictions globally. In order to better understand the framework proposed for India, it may be useful to look at some of the interesting practices adopted, or proposed to be adopted, by certain countries with respect to the key features of Crowdfunding:

1. **Regulation of Crowdfunding:** Crowdfunding in USA is governed under the Jumpstart Our Business Startups Act, 2012 ("**JOBS Act**"). Title II of the JOBS Act deals with equity offers to accredited investors and Title III deals with crowd sourced equity funding. Title III of the JOBS Act has not yet come into force. Similar to India, Australia also hasn't recognized Crowdfunding yet and the Corporations and Market Advisory Committee of the Australian Government has issued a concept paper and is currently framing the legislation for equity based Crowdfunding. In UK, a new regime has been introduced effective from April 1, 2014 whereby two forms of platforms are recognized i.e. loan based crowdfunding platform and investment based crowdfunding platform. Japan also acknowledges equity based crowdfunding platform.
2. **Limitation on investment:** In USA, in a 12 month period, investors can invest 10% of their annual income or net worth, whichever is greater, if either their annual income or net worth is equal or more than USD 100,000. In UK, there is no limit for investors who are advised by professionals, linked to corporate finance or venture capital firms, or those certified as high net worth and for other investors, the limit is 10% of their assets (excluding homes and pensions). In Canada, a maximum investment of \$2,500 is allowed in a single investment and \$10,000 per year.
3. **Limitation on capital raise:** In a period of 12 months, USA allows a maximum limit is USD 1 million, UK allows EUR 2.5 million and Canada allows \$1.5 million. In Australia, it is proposed at \$2 million in a 12 month period.
4. **Restrictions on the secondary market:** Several jurisdictions lay restrictions on a secondary market of securities issued through Crowdfunding. In USA, the lock-in applicable is 1 year after the date of purchase, except when transferred: (i) to the issuer of securities; (ii) to an accredited investor; (iii) as part of an offering registered with the Securities Exchange Commission; or (iv) to a family member of the purchaser or equivalent. In UK, for getting a return on investment, investors will need to wait until sale of the company occurs or a management buyout or floatation occurs. The Consultation Paper proposes that the securities can be transferred by an investor if transferred to (i) the issuer; (ii) another accredited investor registered with the CF Platform; or (iii) a family member or relative or the equivalent.

## ISSUES IN THE PROPOSED FRAMEWORK FOR CROWDFUNDING IN INDIA

Although, SEBI acknowledges the fact that it is necessary to improve access to capital for startups and SMEs, it cannot be denied that the Crowdfunding framework has been proposed on a conservative premise *'to check any systemic risks being created in the economy wherein retail investors are lured by some unscrupulous players by substituting the tried and tested existing framework for fund raising'*<sup>5</sup>. Without questioning the wisdom in adopting this conservative approach and on our preliminary reading of the Consultative Paper, we believe that in the interest of developing a successful Crowdfunding ecosystem in India, the following should be considered before regulations governing Crowdfunding are put forth:

1. **Access to startups organized as private limited companies, one person company, limited liability partnerships and sole proprietorships:** It appears under the Consultation Paper that access to CF Platform shall be available to unlisted public companies only. It might be an oversight but the intention may be to cover private companies as well in the gamut. Considering that this model is meant to facilitate startups and ensuring compliances applicable to public companies is burdensome and costly, pragmatic approach demands that entities like private limited companies, one person company, limited liability partnerships and sole proprietorships that are generally used by startups should also be provided access to this CF Platform.
2. **Coordination between regulators for necessary clarifications:** Under the framework proposed in the Consultation

Paper, there is a need for clarity on the specific provisions of the CA 2013 and the SEBI Act, 1992 (and regulations thereunder) from which exemptions would be available, particularly, provisions pertaining to (a) re-classification of a private company upon issuing advertisements related to subscription to more than 200 individuals, (b) private placement, (c) disclosures, and (d) offer document / prospectus.

3. *Justification for the issuance price:* Under the 'private placement offer letter', the description about the valuation of securities offered has to be provided; however, it is not clear if this valuation should be certified by a chartered accountant or a SEBI registered merchant banker. Having said that, SEBI may, in the interest of the investors, consider that such valuations are certified by a chartered accountant or a merchant banker.
4. *Exemption from treatment as deposits:* Entrepreneurs may be willing to source capital through Crowdfunding by issuing debt securities under DbC. In such a situation, if the Eligible Investors are organized in a form other than a company, the monies received will be treated as 'deposit' under CA 2013. This attracts certain non-achievable compliances for the Eligible Entity. Hence, for making DbC successful, SEBI may consider availing an exemption from the Ministry of Corporate Affairs such that any amount raised by the Eligible Entities from issue of debentures is not treated as 'deposits' under CA 2013.

## CONCLUSION

Crowdfunding comes with many advantages compared to existing avenues available to startups and SMEs. Capital raise under the CF Platform not being a public offer and thus not triggering public offer related pre-conditions, and the related costs and compliances therein, is a good starting point for this platform available for such new generation companies. This will also enable the Eligible Entities to reach out to a wider section of investors and investor groups for raising capital.

As there is an absence of track record requirement for the Eligible Entities and such Eligible Entities can raise funds even before their venture actually becomes commercially viable, such capital investment through Crowdfunding will be in the form of a risk capital. Thus, there is a greater need to have this space appropriately regulated rather than being over regulated (which may have an overkill on the budding entrepreneurs and promoters and their creative and innovative business ideas).

– Mukul Aggarwal, T.P. Janani & Sambhav Ranka

You can direct your queries or comments to the authors

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<sup>1</sup> Page 28 of the Consultation Paper.

<sup>2</sup> As defined under the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009, as amended from time to time.

<sup>3</sup> As per IOSCO Staff Working Paper titled 'Crowd-funding: An Infant Industry Growing Fast', Crowdfunding is categorized into four categories: (i) donation based Crowdfunding (where issuers directly seek donation from the grantors), (ii) reward based Crowdfunding (where issuers directly offers rewards like movie tickets, new computer game, download of a book, etc.), (iii) peer-to-peer lending (where an online platform matches lenders/investors with borrowers/issuers in order to provide unsecured loans), and (iv) equity based Crowdfunding (where in consideration of funds solicited from investors, equity shares of the company are issued).

<sup>4</sup> As per Companies (Prospectus and Allotment of Securities) Rules, 2014 under Section 42 of CA 2013, it is provided that the invitation / offer to subscribe cannot be made to more than 200 persons (excluding QIBs and employees of the company being offered securities under a scheme of employee stock option).

<sup>5</sup> Page 26 of the Consultation Paper.

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