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RESEARCH ARTICLE

THE NEED FOR REGULATION OF EQUITY CROWDFUNDING IN INDIA

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Abstract

In the dynamic stream of seeking investment, Crowdfunding has emerged as a systematic way of seeking investment in India. It is a convenient way by which people can raise capital seamlessly and in an efficient manner using an internet-based platform. Securities and Exchange Board of India (SEBI) has released a consultation paper in 2014 and defined crowd funding 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.” The July 2017, BCG report suggests that India ‘netizens’ will be 850 million by 2025, which is greater than the combined population of G-7 countries. Amongst the ways in which investment is taking place, Peer to peer lending (P2P) amounts to US\$25 billion, donation (US\$2.9), rewards (US\$2.7 billion) and Equity Crowdfunding (US\$2.5 billion). The Nasscom-KPMG report estimates that the total fintech software and services market in India was around \$8 billion in 2016 and likely to grow 1.7 times by 2020. Massolution's Global Crowdfunding Report expects Crowdfunding to become a \$300 billion industry by 2025. Crowdfunding in developing countries raised US\$430 million in 2015, with India, the Philippines, and Nepal in the top three. All these data suggest to the fact that, there is an increased awareness in the crowd about raising capital from non-conventional sources when all of the conventional sources, demonetisation and introduction of Goods and Services Tax Act (GST) has failed to address the concerns of budding entrepreneurs and have deafened their upcoming venture. Though the evolution of Fin-tech in India seems to shift the gears of new entrepreneurship and is constantly making a difference in a person's life; it has its own concerns. Recognising the advent at which these crowd-funding operations grew in India, the Government took some steps in regulating crowd-funding business in India. SEBI did so by incorporating regulations on reward-based Crowdfunding and donor based Crowdfunding, but is largely silent on the regulation of equity based crowd funding and online based Crowdfunding. This causes a serious dilemma as to what should the solution be considering the progressive role it is playing in our country. It is pertinent to observe the fact that there is an ‘untapped potential’ in the Indian market for which we need proper compliance laws and regulatory procedures. The need arises to, mitigate frauds, and comply with privacy laws and also to ensure that fraudulent activities do not take place. This paper is an attempt to amplify the problem relating to

‘no regulatory practices’ in the Indian sub-continent with regard to Crowdfunding.

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Introduction:-

Crowdfunding in India:

SEBI in its response paper has defined Crowdfunding as ”a means of raising money for a creative project (for instance, music, film, book publication), a benevolent or public-interest cause (for instance, a community based social or co-operative initiative) or a business venture, through small financial contributions from persons who may number in the hundreds or thousands. Those contributions are sought through an online crowd-funding platform, while the offer may also be promoted through social media”.

SEBI in its response paper has taken note of Crowdfunding from IOSCA Staff Working Paper which has defined various types of crowd funding. According to IOSCA, there are four types of Crowdfunding which are: Equity Crowdfunding, Peer to Peer lending, Social lending and donation and Reward Crowdfunding.

Online Crowdfunding in India is still at its nascent stage, where the investors and the issuers need to learn quickly what will and will not work. The only regulation is on the Peer to Peer lending which is regulated by Reserve Bank of India (RBI). For the same reason, appropriate systems and processes should be put in place.

The Need for Regulation of Equity Crowdfunding in India:

The crash of the Indian stock market in 2008 brought in repercussions which was highly unanticipated. It caused lot of loss of capital which deteriorated the people financially. Ever since the fall, there was a greater need to tap financial resources in the country and for that the investors seek investment. The introduction of Goods and Services Tax (GST) and Demonetisation (which happened in 2016) have dented the investment market in India. It has now become less favourable for small firms and enterprises to exist owing to the stiff competition and lesser avenues in place. The Small and Medium Enterprises were worse hit because of demonetisation and introduction of Goods and Services Tax (GST) subsequently. All India Manufacturer Organisation (AIMO) conducted a study and found out those micro/small scale industries suffered 35% loss of jobs and there was a dip in revenue by 50%.

All these factors contributed in creating a fear among the people about the prospects of generating new capital. Since many people lost their business and capital in the market crash, it also created a market of people who sought investment which was easy on their pocket and which would give them substantial results in the future. As a result of which, Fin-tech market and especially Crowdfunding emerged as a convenient means to raise funds from the people. It is pertinent to note that Crowdfunding has helped many projects over the years like, building roads, funding education, investing in small ventures (without the risk of diluting equity) and has even produced films. Though the practice still continues, we simply cannot ignore the risks associated with Crowdfunding.

Existing legal regime on Equity Crowdfunding in India:

Equity Crowdfunding is not legal in India. Although there is a response paper floating about the Equity Crowdfunding in India, it has yet not been recognised by either the SEBI or any other Government platform.

Companies Act and SEBI (ICDR) 2018 have set the tone in which public issue should take place. Websites like ‘Lets Venture’ and ‘Equity Crest’ provide the users with “Equity Crowdfunding” in India. But the process used by these websites are illegitimate as there is no legal recognition to the platforms to issue shares. This is a direct hit to the established regulation on securities law and that is the reason on why a compliance is required to cater this complex issue. This also raises a question on the mechanism employed by the watchdog, SEBI.

Requirements for investing in Crowdfunding Portal:

According to SEBI’s response paper, only “Accredited Investors” can invest in any Crowdfunding platform. These investors are risk averse and are aware about the technicalities involved in raising money and raising capital. They also possess the knowledge, awareness and a niche in dealing with money.

SEBI in its response paper has also put a cap on the investment which can be invested in a single financial year. The ERI’s and HNI’s also have to sign a Risk Acknowledgment about the risk of the illiquid nature of investment. This

is similar to what Italy's jurisdiction had to offer with respect to the investors. Additionally, an investor can choose to opt out of his investment before the campaign closes.

One of the key observation and critique made regarding the Crowdfunding websites in India is that although it has been determined about who can be the investors, the same is not properly implemented. It raises a question on the credibility of the Crowdfunding platform as well as the investors. For instance, a Crowdfunding website, Fuel a Dream, has many entrepreneurial projects which any prospective investor can invest in. It has a wide range of campaigns from investing in ideas from Spill Proof Cotton shirts with Nano Technology to wallets to cycles and many more. According to the definition laid down by SEBI, only Accredited Investors can only participate and invest. But the loophole arises here. If any person is interested to invest in a project which he/she likes or with which they connect, any person of any age, can login into the website either by Facebook account or Gmail account and pay in that Start-up. There is no requirement to certify anywhere. The money is directly deposited in the portal.

Entities who can set up Crowdfunding platform:

SEBI in its response paper has proposed that only a certain class or entities can be allowed to set up a Crowdfunding platform. For the same, it has divided the entities into three different parts; Class I Entity, Class II entity and Class III Entity. Class III entity also comprises a mix of Class I and Class II entity.

Many of the Crowdfunding companies have sprouted recently and it becomes difficult for them to comply with the conditions laid down by SEBI. The entrepreneurial projects and products which are displayed in any Crowdfunding website appeal to the masses by an emotional cry for money. Although these Crowdfunding companies (the portal) have registered themselves under the Companies Act, 2013 they might not have not attained 'self-sufficiency' or even have a minimum net worth of Rs 10 crore. This poses a question on compliance and the role SEBI is playing in regulating these companies. The worry likewise emerges over the fact that who is to take the blame when these sites shut down their operations and flee with the money collected.

Requirement of opening up a Demat Account:

The discussion paper laid down by SEBI also holds a qualification that any investor who wishes to invest should hold a DEMAT account. The payment has to be made either in cheque or a demand draft or other banking channel and credit cards will not be accepted. But the gateway payment for many Crowdfunding websites in India allows credit cards and e-wallets to be used. Since newer forms of payment mechanism are being used, it is pertinent to comply and accept different and innovative forms of payment.

Other requirements to comply:

The Response paper suggests that the issue can be made available by using the online mode of raising equity shares and the prospective investor can raise a sum of Rs 10 crore using Equity mode of Crowdfunding.

The issue also has to comply that any single investor cannot hold more than 25% of stake in a company and the promoter is required to lock in his equity take for a minimum period of three years and is to hold 5% of equity stake in the company. This is a welcome step and would be a step ahead in insuring that the rights of the prospective investors are protected and that they are not misused. The problem arises when the issue is not in accordance with either the Company's act. It is the role of SEBI under Section 11 of the SEBI Act to protect the interest of the investors. It should do so by regulating equity market and security exchange facilitation in Crowdfunding platform. Thus a greater ambit role has to be played by SEBI in regulation of Equity Crowdfunding norms in India.

Equity Crowdfunding in Violation of Section 2(20) of Companies Act, 2013:

Section 2(20) of the Companies Act, 2013 lays down the definition of Company. Section 23(2) of the Companies Act, 2013 lays down the way by which a Private Company may issue securities. It can be done by way of Rights issue, Bonus issue and Private Placement. The problem with 'Online Crowdfunding' is with respect to the definition of 'Company' as laid down in the Companies Act, 2013. Since, many of the start-ups are in their nascent stage, a prospective company or a Start-up may not have registered itself with the Registrar of Companies and neither would have followed the protocol as laid down in Section 7 of Companies Act. The fictional company may very easily dupe people and fraudulently can make money using smarter technology and tools.

Equity Crowdfunding in Non-compliance with Section 42 of Companies Act, 2013:

Another objection faced by Crowdfunding is the non-compliance with Section 42 of Companies Act, 2013. For a private company, which chooses to raise capital by way of private placement, the offer of the securities shall be made to persons not exceeding 200. Since the Companies Act has exempted the clause of minimum capital in a company, it has now become easier for the companies to open a company but considering the gray area in the Crowdfunding regulation, many entrepreneurs take the benefit of the non-compliance which causes a risk to the investors and also the economy. It is also submitted that when these private companies seek investment online using the platform of 'Crowdfunding' they are seeking a 'public offer' as is explained under Explanation III of Section 42.

The private placement offer letter has to be circulated online to the selected accredited investors which should not be more than 200 (excluding QIB's). Many websites do not offer such vital information while providing about any information of a Start-up. Because any number of investors can invest in a start-up or a company using Crowdfunding, it is in direct violation with the Companies Act, 2013 as the private placement can be circulated only to 200 people in the lifetime of a company. This is also in contradiction to the question discussed by SEBI whether or not to increase the limit of the investors from 200 to 1000 to which it did not give any effective solution. This is largely a big loophole in the Response paper.

Although the response paper stipulates and deliberates on various jurisdictions of the world and also lays down the way it is being implemented; it is submitted that there is a contradiction between the Company's Act and SEBI response paper on Crowdfunding regarding offer to the public and there is no certainty for the investors.

Violation of ICDR Regulation, 2018:

The ICDR is applicable to the companies which are listed or unlisted issuer. It provides a detailed provision with respect to certain issue of securities. Since in Equity Crowdfunding, there is a transaction of securities, ICDR becomes applicable.

Regulation 6 of ICDR requires certain factors which have to be met for an Initial public offer. The issuer should have net tangible assets of at least three crore; average operating profit of at least fifteen crore and a net worth of at least Rs 1crore. Regulation 7 requires an issuer to comply with 'General conditions' where the issuer has to make an application to one or more stock exchange to get listed and it has entered into an agreement with a depository for dematerialization of securities. Regulation 7(2) requires that such an offer document shall not exceed 25% of the amount raised by the issuer. Regulation 14 requires that the promoters shall hold minimum 20% of the post issue capital by either way of subscribing to the equity shares or by way of subscribing to convertible securities. Regulation 45 stipulates that a minimum subscription of at least 90% of the offer should be received by the issuer else it needs to refund the amount within 15 days from the date of issue of the closure.

The sort of interpretation that we can come up with, is laid down in the fact that it would cause a confusion in placing 'Equity Crowdfunding' in an ambit in which can be regulated by either a Regulation or an Act.

Fraudulent method and context at the behest of Crowdfunding:

On analysing the data from various resources regarding banking and digital fraud in India, The National Payments Corporation of India (NPCI) narrowed 19 banks and 641 customers from which the amount involved in the fraud was around Rs 1.3 crore. In 2017 December, the Minister of Information and Broadcasting, Ravi Shankar Prasad, said that the cases of digital frauds were around 25,800 in India which caused a monetary loss of 1.8 billion rupees. There have been instances using Crowdfunding as a portal where a borrower has used the platform of Crowdfunding to generate funds for the purpose of paying rent, smoking illegal contraband substances, duping people to collect cancer treatment money and many others. Thus it is very easy to dupe the customers and people transacting online. If there is such a blatant neglect, we may not be able to protect the genuine investors.

As a result of neglect by the websites which seeks to issue investment by way of Crowdfunding, we find an animosity which creates a problem for investors and poses a question on the regulation method imposed by SEBI. Although we have a Regulatory body in place, there still are many grey areas where norms are not complied with which exposes the economy to a "higher risk" in case of a default. Thus, there is a greater need for regulation.

It is understandable that the issue of raising new capital from the market is difficult. But considering the risks associated with raising capital in case of no regulation makes the market more volatile and susceptible to fraud. As

many companies are engaging themselves in raising capital through the 'unconventional mode' using new techniques like Cryptocurrency, E-wallets and even Crowdfunding; it becomes important to recognise it as a 'valid method of investment'. The legislation should make these companies come under the umbrella of stricter 'Regulation and Compliance'.

Conclusion:-

The investment market has undergone sea changes in the last few years owing to which people have started benefiting from the use of non-conventional method of investment. Hence, there is a greater need to generate feasible regulations so that avenues are regulated in the market and that the people have faith in the corresponding laws and the 'Justice' delivery system.

Crowdfunding regulation is at a nascent stage but the 'Crowdfunding portals' have been existing for several years and hence it becomes pertinent to bring these websites under a parent regulatory medium so that they are made more accountable to the people's money and there is a confidentiality of the transactions.

The Crowdfunding laws on 'Equity Crowdfunding' should be developed in a way which are in harmonious construction with parallel corporate laws. The Companies Act, 2013 read with SCRA 1996 and Depositories act can be modified to make way for regulation of Equity Crowdfunding in India. These websites could be regulated by increasing the power of the Registrar of Companies (RoC) which can look into the registration process of the companies online along with other certain regulatory compliances required in the Companies Act.

If any investor wishes to transact in any of the Crowdfunding operators, then it can do, only with the help of an authorized broker. An authorised broker is registered and regulated by SEBI. Thus Rule 3 of the Regulation needs to be made adaptable to the changing times and should also include a stockbroker who can trade in online dealing of 'Crowdfunding securities'.

Another challenging aspect with regard to Crowdfunding is the cross-jurisdictional matters which can make the issue more complicated in case of defiance to the Information Technology Act or Indian Penal Code. For the same purpose, there is an active role to be played by the Central Government in signing up the international conventions particularly Budapest Convention and also Mutual Legal Assistance Treaties which can broaden the scope of countries transacting in India so that the alleged perpetrator can be made liable for his actions and subsequently is prosecuted. There can also be another recourse to the matter, if there is any fraudulent activity which might take place, and for the protection of investors, it is appropriate if SEBI issues a guideline which clearly stipulates that only an Indian citizen or an Indian company or enterprise should be able to invest in Crowdfunding operations in the country and not a foreign enterprise as there may be transactions which might fuel black money in the market. This will also reduce the problem of cross-border jurisdictional issues.