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Need for Separate Equity Crowdfunding Regulations in India

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ABSTRACT

Crowd funding is a method of acquiring project funding, by soliciting contributions from a large group of people typically via internet or through social networking websites like Facebook, Tumblr, LinkedIn, Twitter or crowd funding websites (Ketto, Kikstarter, GoFundMe, Crowdrise etc). The website platform acts as a mediator between the Project Initiator or Entrepreneur and crowd or investors in sourcing funds from the crowd at large. With the swift growth of the crowd funding industry, a number of associated risks also arise, which in turn have attracted the attention of securities regulators. The country presents itself as an ideal laboratory for crowd funding. It has a burgeoning but vibrant start-up culture that has spawned the growth of innovation and start-ups, which have constant funding needs. The Government too has played its part by introducing measures such as the “Start up India” initiative in January 2016 to create jobs and boost economic productivity through new businesses using modern technology.

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.

This paper includes factors ascertaining the need for crowdfunding in India. There have been instances where the downfall of economy were witnessed which leads to the evolution of Crowdfunding in Indian markets. This paper would be dealing with the 2008 financial crisis and how it leads to justify the need of having crowdfunding mechanism in India. Likewise, it would be relevant to summarize the reasoning behind the happening of Sahara case and what all measures is necessary to take while raising fund from Investors. Further, the chapter would involve the risks and benefits for Equity Crowdfunding in India along with the possible structure of crowdfunding platforms.

Keywords: *Crowdfunding, Regulations, Financial Crisis, Equity crowdfunding*

¹ Author is an Advocate in India.

I. OVERVIEW OF 2008 FINANCIAL CRISIS

In 2008, the greatest jolt to the global financial system was felt; it pushed the world's banking systems towards the end. The World monetary crisis is regularly accepted to have started at some point in mid-2007 with a credit crunch, when lost certainty by US investors in the estimation of sub-prime home loans caused a liquidity crisis. This brought about the US Federal Reserve infusing a lot of capital into financial related markets. The crisis became volatile in September 2008 when the stock markets around the globe crashed.²

II. MAIN CAUSES OF GFC

The crisis was begun in 2000s, when the decline in housing prices was emerged in United States and certain European countries; this led to birth of subprime loan crisis. In 2001 the federal fund was reduced from 6.5 % to 1.75% between the month of May 2001 and December 2001 then The Federal Reserve (Fed), the central bank of the United States, have anticipated a mild recession. This enabled banks to extend consumer credit at a lower prime rate³ and which motivated them to lend even to "subprime," or high-risk, customers, though at higher interest rates. At this time the purchase of goods like appliances, automobiles and houses were

increased because of the advantages took by consumers of cheap credit. This leads to the creation of "House Bubble"⁴ in late 1990.

At the beginning of 1980s, banks were started offering subprime mortgage loans to costumers which were the result of change in banking laws. These loans were structured with balloon payments.⁵ Thereafter, by refinancing against rising mortgage payments when the house prices continued to grow, subprime lenders could protect themselves, investing against the increased value of their homes, or to earn profit they sold their houses for repaying their mortgages. Banks may repossess the property in case of default and sell it for more than the value of the original loan. Therefore subprime lending was a lucrative venture for many banks. Consequently, many banks actively promoted subprime loans to clients with bad credit or little assets, recognizing that those lenders could not afford to pay back the loans and even misled them about the risks associated. As a result, from the late 1990s to 2004–07, the proportion of subprime mortgages across all home loans rose from around 2.5 per cent to about 15 per cent a year.

Drawing attention to the rise of subprime mortgages was the common securitization process wherein banks pooled hundreds or even thousands of subprime loans and other less

² Justine Davies, Global Financial Crisis- what caused it and how the world responded, June 23, 2018, available at: <https://www.canstar.com.au/>

³ (the interest rate that banks charge to their "prime," or low-risk, customers, generally three percentage points above the federal funds rate)

⁴ a rapid increase in home prices to levels well beyond their fundamental, or intrinsic, value, driven by

excessive speculation

⁵ Those were large payments that are due at or near the end of a loan period or adjustable interest rates those are rates that remain fixed at relatively low levels for an initial period and float, generally with the federal funds rate

volatile types of mortgage debt and sold them (or portions of them) as securities (bonds) to other banks and creditors, including hedge funds and retirement funds, on capital markets. Bonds mainly consisting of loans became recognized as mortgage-backed securities or MBSs which allowed their investors to a portion of the principal and interest payments on the respective mortgages. Selling subprime mortgages as MBSs was seen as a safe opportunity for banks to improve their liquidity and decrease their risk to distressed loans, whereas buying MBSs was seen as a perfect way for banks and buyers to diversify their investments and make profit. During the early 2000s, as home prices began their meteoric climb, MBSs became generally popular and their values in capital markets rose subsequently.

Moreover, during 2004, the Securities and Exchange Commission (SEC) strengthened the net capital requirement (the ratio of capital or reserves to debt or liabilities that banks would retain as a precaution towards insolvency), which allowed banks to spend even more in MBSs. While the SEC's decision resulted in massive income for banks, it also subjected their investments to considerable risk, as MBSs' asset valuation was indirectly premised on the continuity of the housing bubble.

The lengthy period of world economic prosperity and development which preceded the recession, starting in the mid- to late 1980s and ever since known as the "Great Stabilization," had encouraged many U.S. banking managers, government leaders and analysts that intense economic instability was a thing of the past. This optimistic mentality — along with an

political atmosphere that stresses globalization and the right of financial institutions to regulate themselves — caused nearly most of them to disregard or dismiss obvious signs of an impending recession and to pursue risky investing, borrowing, and securitization activities in the case of bankers.

Financial pressures culminated in September 2008 after the bankruptcy of US financial company Lehman Brothers. This, combined with the collapse or close bankruptcy of a host of other financial institutions at the time, sparked a worldwide crisis in capital markets. Investors were pulling their capital from banks and hedge funds around the world because they didn't know who could be next to fall and how vulnerable each company was to subprime and other troubled loans. As a result, stock markets were unstable as all wanted to sell at the same time and several institutions were unable to access new funding.

Governments expanded their spending to boost demand and encourage jobs throughout the economy; pledged deposits and bank bonds to create trust in financial institutions; and acquired equity interests in some banks and other financial companies to avert bankruptcies that may have intensified the crisis on financial markets. While the global economy has undergone its sharpest recession since the Great Depression, a global depression was avoided by the policy response. Yet millions of people have lost their jobs, homes and large amounts of their wealth.

III. OVERVIEW OF SAHARA CASE

In 2005, Sahara India formed two Sahara India

Real Estate Company Limited (SIRECL) and Sahara Housing Investment Company (SHIC) companies by registering them under the Companies Act of 1956. The proposal was adopted at the annual meeting to raise the fund by the private placing of conditional, fully convertible debentures (OFCDs) and the delivery of a information memorandum to a few trusted creditors. The two companies collected 24,029.73 rupees from 30 million investors over a 3-year period. In 2009 SEBI observed an irregular fund-raising operation when a red herring prospectus was sent to SEBI for a Sahara India real estate company. In 2010 SEBI received a complaint from an individual, Roshan Lal, alleging that SHICL and SIRECL were using illegal means in issuance OFCD's. SEBI investigated the Sahara and issued an interim order stating that there is an irregular practice in issuing OFCD, and ordered SHICL and SIRECL to refund the money with interest to their shareholders. On the contrary, Sahara lodged a motion for a stay order in court.⁶

Sahara challenged SEBI's actions, and the litigation went all the way up to the Supreme Court of India. Ultimately, the Supreme Court found that Sahara's actions were in breach of securities regulation and affirmed SEBI's sanctions. The "Sahara effect" reverberated during the enactment of the Companies Act, 2013. As a result, the Government introduced a new provision in the legislation to deal with such

situations. Section 42 of the Companies Act, 2013. The Government has also increased the maximum number of offers to 200 person in each financial year (Companies Rules 2014: rule 14(2) (b)).⁷ In this milieu, equity crowdfunding is impermissible and cannot be undertaken unless the legal regime is altered. At the same time, given the rapid growth of crowdfunding as an attractive fundraising option and the Indian's Government's drive towards promoting small business and start-ups in India, it is impossible to turn a blind eye to the need for such reforms. SEBI in 2014 initiated a debate for such reforms by issuing a consultation paper seeking to explore the possibility of introducing crowdfunding in India. SEBI's consultation paper constitutes the single and most detailed effort in considering crowdfunding regulation in India.

IV. NEED FOR AN EXEMPTION OF EQUITY CROWDFUNDING IN INDIA

Equity crowdfunding in India is a debatable issue and it needs to address by the authority in order to provide appropriate law for the same. By doing so there will be clarity as to how crowdfunding should work and how people affecting by it should get remedy in case of default. Therefore, this concept should be exempted from current fundraising law of India; it would be highly effective and would attract more and more potential investors. This portion would described how crowdfunding works and what are the

⁶ Aniket Dhvaj Singh, CASE ANALYSIS: SAHARA INDIA REAL ESTATE LIMITED & ORS. V. SECURITIES EXCHANGE BOARD OF INDIA & ORS., December 2, 2016, available at: <https://legalvoiceblog.wordpress.com/2016/12/02/case->

[analysis-sahara-india-real-estate-limited-ors-v-securitiesexchange-board-of-india-ors/#_ftn](https://legalvoiceblog.wordpress.com/2016/12/02/case-analysis-sahara-india-real-estate-limited-ors-v-securitiesexchange-board-of-india-ors/#_ftn)

⁷ Arjya B. Majumdar and Umakanth Varottil, Regulating equity crowdfunding in India: Walking a tightrope, 2015, <http://ssrn.com/abstract=2804427>

application of existing fundraising laws in India and how having separate mechanism for crowdfunding would help the market.

V. CROWDFUNDING AND ITS KINDS

Crowdfunding involves using a mass distribution system, usually the Internet, to raise funding from the world at large, with the project developer collecting limited sums of individual support from a wide number of contributors or investors.⁸ It is specifically contains the concept of microfinance and crowdsourcing, it may carry out in 4 essential ways:

a) Donation based Crowdfunding:

The most favoured method of fundraising, particularly in India, is donation-based crowdfunding. A individual designs the initiative first, then uses social media and other methods of marketing to spread awareness of his cause. The person who joins the cause is considered a donor. Any individual is encouraged to contribute to the initiative in relation to the cause. There is no minimum or maximum sum needed to donate. A donor can donate whatever he / she wants.⁹

b) Reward based Crowdfunding:

Company owners on a crowdfunding site define their initiative or business plan, and fundraising target. Businesses make bonuses in exchange for

contributions. Reward Crowdfunding incentives helps small companies to get new projects off the ground without paying back a loan.¹⁰ In this sort of model the investors obtain the innovation commodity that the entrepreneur collects to collect funds. Wish berry and Rockethub are in the award crowd funding.¹¹

c) Peer-to-peer lending:

Peer-to - peer loans can be defined as using an online platform connecting borrowers / issuers with lenders / investors to provide unsecured loans. This specific form of crowd-based financing constitutes the basis of the crowdfunding market here considered by FR. The creditor may be either a person or a corporation needing a loan.¹² In comparison, smaller peer-to-peer crowdfunding sites aim for niche markets. Such include, but are not limited to; networks specialized in real estate finance deals, venture capital, business-to-business, graduation investment, funeral finance, art project financing, technology start-ups or customer loans for deals such as eBay transactions.¹³

d) Equity Based Crowdfunding

An equity interest is given in the company collecting capital, proportionate to the quantity

⁸ Thaya Brook Knight, Huiwen Leo and Adrian A. Ohmer, "A Very Quiet Revolution: A Primer On Securities Crowdfunding And Title III Of The Jobs Act", 2 Michigan Journal of Private Equity and Venture Capital Law 135

⁹ The reason why everyone loves donation-based crowdfunding, available at: <https://milaap.org/stories/donation-based-crowdfunding>

¹⁰ Jackie Zimmermann, Reward based crowdfunding: What it is, when it works, Dec 6, 2017, available at: <https://www.nerdwallet.com/blog/small-business/reward-crowdfunding/>

¹¹ Anubhab Sarkar, Crowdfunding in India: Major roadblock and the way ahead, available at: <http://docs.manupatra.in/newslines/articles/Upload/8C454250-DC94-4F64-9A8D-C29D04613916.pdf>

¹² Eleanor Kirby and Shane Worner, Crowdfunding: An Infant Industry Growing Fast, IOSCO Staff Working Paper Series 9, Working Paper Number SWP3/2014, IOSCO Research Department (2014)

¹³ Verstein, A. (2012), "Misregulation of Person to Person Lending", Lecturer and Other Affiliate Scholarship Series, Paper 8, Available at: <http://digitalcommons.law.yale.edu/ylas/8>, p 456

spent. Contributors carry on shareholders' risks and obligations in the venture. Equity crowdfunding usually entails a company asking for funds for a given cause (the fundraiser) on a crowdfunding website (the portal) and then describing the appeal for funds and when the funds will be used.¹⁴

VI. EXISTING FUNDRAISING REGIME IN INDIA

Indian law forbids businesses from agreeing to sell shares to more than two hundred prospective investors in a financial year, or from allocating shares to 50 or more customers without making a competitive auction. One or more merchant bankers to be called, a registrar to be published, a draft bid document with SEBI to be submitted, eligible requirements such as past track records, etc.¹⁵

A streamlined scheme applies in respect of a public issue of debt securities under the SEBI (Securities Issue and Listing) Law, 2008. After the Sahara Incident, the Ministry of Corporate Affairs adopted a new provision of the Companies Act, 2014 to prevent companies from taking the plea of 'intention of private placement' in the future. The recently added provision, Provision 42 states that businesses may make private placements by providing a letter of offer for private placement. The security bid or invitation to subscribe security shall be made to

the number of individuals not exceeding fifty or as large as may be indicated¹⁶ and issuance and distribution of shares for a financial year up to two hundred individuals except retail investors and business employees.¹⁷

Explanation I to Section 42 states that if a listed or unlisted company presents an offer to allocate or grant a subscription or plan to sell shares to more than the specified number of 50 persons if the purchase of shares has occurred or has not occurred, or whether the company wishes to list its securities or not on any approved stock market within or outside the company.¹⁸ The clarification was purposely added to avoid another potential Sahara fiasco. The section also specifies that even though the subscription does not surpass the specified cap and is a private placement for all purposes, it must also file a return of the allocation with the Registrar in the manner specified, containing the complete list of all security holders including their full names, addresses, number of shares assigned and any other appropriate information as may be specified.¹⁹

The Sahara event, where the two firms raised about INR 176.5 billion from 30 million investors, is no different from the process used by crowd-funded firms. Although Sahara relied on its office and agent network, fundraisers put significant emphasis on their social networking sites. One major distinction for crowdfunding

¹⁴ The fundraiser also sets out the rewards, financial or otherwise at the portal. Visitors to the portal (contributors) may choose to enter into an electronic transaction, based upon the representations offered by the fundraiser. Funds are electronically transferred from the contributors' accounts to the portal. Once the quantum of required funds is met, the portal releases

the funds to the fundraiser

¹⁵ SEBI (ICDR) Regulations 2009

¹⁶ S.42(2), The Companies Act, 2013

¹⁷ Rule 14(2)(b), Companies (Prospectus and Allotment of Securities) Rules, 2014

¹⁸ Explanation I to S.42, The Companies Act, 2013

¹⁹ S.42(9), The Companies Act, 2013

situations, for example, is the use of internet and online social networks. Given the large number of donors who are usually affiliated with crowdfunding, it is clear that these fundraising strategies must be in accordance with Section 42 of the Companies Act 2013.²⁰

Although no equity crowdfunding platforms have yet been developed in India, India's Securities and Exchange Board has recommended access to capital markets for start-ups and small and medium-sized companies to include an alternate early-stage investment channel, thus matching the same with investor protection.²¹

Usually, donors to crowd funding firms make limited contributions which, in most cases, will not meet the VCF's minimum contribution criteria or the AIF²² regulations. VCFs and AIFs would also require approval, and their contributions would be capped. Both VCFs and AIFs will have a diversified investment portfolio.

VII. CROWDFUNDING REGULATORY REGIME IN DIFFERENT JURISDICTION OTHER THAN UK & US

There are various countries which are being considered for exempting equity crowdfunding

laws because by incorporating separate laws there is less chance of mismanagement and default. Apparently, there exist issues in incorporating crowdfunding laws in India as well as other countries, some of these countries are:-

- **Hong-Kong**

In Hong Kong, ECF falls under the jurisdiction of the SFC (Securities and Futures Commission), which has provided some clarification on the concept of ECF as a transaction in which investors engage in a project or undertaking, typically a start-up, and in return obtain interest in shares or bonds issued by a corporation or participation in the gains or profits of a joint investment scheme.²³ An advertising, offer or document containing an offer to tender for shares is illegal, unless authorised by the Hong Kong Shares and Futures Commission.²⁴ However, an offer of securities made to professional investors²⁵ is exempt from this rule.²⁶ Although equity crowdfunding is only possible for skilled or sophisticated investors, there are no strict rules in Hong Kong on equity crowdfunding.²⁷

- **Japan**

In 2014 the House of Councillors passed a bill supporting crowdfunding in Japan. Start-up

²⁰ Arjya B. Majumdar, Regulating equity Crowdfunding in india- A response to SEBI's consultation paper, November, 2015, available at: <https://www.researchgate.net/publication/284182013>

²¹ Consultation Paper on Crowdfunding in India, Securities and Exchange Board of India available at http://www.sebi.gov.in/cms/sebi_data/attachdocs/1403005615257.pdf

²² SEBI (Alternative Investment Funds) Regulations, 2012 defines the legal system to be followed for national and foreign investors collecting private funds. They can be in the form of trusts, LLP, businesses but should be registered with SEBI

²³ Kristi Swartz, The future of equity crowdfunding in Hong-Kong, 29th august, 2018, available at: <https://www.regulationasia.com/the-future-of-equity-crowdfunding-in-hong-kong/>

²⁴ Section 103 (1) of the Hong Kong Securities and Futures Ordinance, 2002

²⁵ Schedule I, Part I of the Hong Kong Securities and Futures Ordinance, 2002

²⁶ Section 103(3)(k) of the Hong Kong Securities and Futures Ordinance, 2002

²⁷ Notice on Potential Regulations Applicable to, and Risks of, Crowd-funding Activities, Securities and Futures Commission, Hong Kong SAR, 7 May 2014,

companies are able to market unlisted goods over the Internet and to collect funds quicker. The legislation passes the Financial Instruments and Exchange Act to lower the total capital amount for businesses from JPY 50 million to JPY 10 million, which could be brokered with non-listed start-up shares for crowdfunding. The instrument limits a funder's investment in a start-up to JPY 500,000 to protect against excessively high-risk company activity. Via the creation of a fund, the intermediation of start-up capital funding also helps companies reduce the minimum capital amount by 36 from JPY 10 million to JPY 5 million. A fully financed company can rise up to 100 million JPY.²⁸ The registration provision should not be imposed on crowdfunding platform operators who only tackle minor issues, as the total offer is less than 100 million yen and the contribution sum per person is 500,000 yen or less.²⁹

- **Australia**

The Australian Securities and Investments Commission issued recommendations on crowdfunding in August 2012.³⁰ Such recommendations mirrored Australia's current fund raising legislation clearly setting out those conditions. There are two exceptions to the corporate legislation regulating fundraising operations in Australia where transparency is not required in the form of prospectuses-deals made

to professional investors and small-scale offerings.³¹ The provisions do not benefit crowdfunding and therefore Australian securities commission released recommendations in 2012 reiterating the current Corporate Act. However, the regulation stipulates that the hosting sites must be licensed and must be responsible for supplying the consumers with full knowledge about the product and should be held accountable for investor fraud.³²

VIII. CONCLUSION

The paper has given the reason as to why India needs to have separate regulation for equity crowdfunding. So in order to jump to the conclusion there are some reason through which the research questions of this research would get some base. 2008 financial crisis is one of the major reasons for the jolt in global financial system to which India was no exception. Later the chapter would also be dealing with the overview of Sahara case because of which India faced various financial challenges and also in promoting small business venture, thus taking into consideration of Sahara aftermath SEBI considered issuing the consultation paper for regulating Equity crowdfunding in India. The paper also dealt with the valid and most appropriate factors providing the need for an exemption in equity crowdfunding laws in India.

available at <http://www.sfc.hk/web/EN/files/ER/PDF/Notice%20on%20Crowdfunding.pdf>

²⁸ Hiroyuki Kezuka, CROWDFUNDING IN JAPAN, Dec, 2017, available at: <https://core.ac.uk/download/pdf/161421544.pdf>

²⁹ Ibid 16

³⁰ 12-196MR ASIC guidance on crowd funding, 13 August 2012, available at <http://asic.gov.au/aboutasi>

[c/mediacentre/find-a-media-release/2012-releases/12-196mr-asic-guidance-on-crowd-funding/](http://mediacentre/find-a-media-release/2012-releases/12-196mr-asic-guidance-on-crowd-funding/)

³¹ Matt Vitins, "Crowdfunding and Securities Laws: What the Americans Are Doing and the Case for an Australian Crowdfunding Exemption", 22 *Journal of Law, Information and Science*, 46, 92 (2013)

³² Ibid 7

Therefore, to conclude in one line I would say
Equity crowdfunding has a great future if we take
initiative for a better regulatory framework of the
same.
