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CROWDFUNDING IN INDIA

A RESPONSE TO THE SEBI CONSULTATION PAPER

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INTRODUCTORY NOTE

On June 17, 2014, the Securities and Exchange Board of India (“SEBI”) issued a consultation paper on regulating crowdfunding in India (“SEBI Consultation Paper”). Our report seeks to address the questions raised in the SEBI Consultation Paper and makes proposals for developing a regulatory framework that strikes an appropriate balance between promotion of entrepreneurship and protection of investors. We understand that the Ministry of Finance had published a ‘Handbook on adoption of governance enhancing and non-legislative elements of the draft Indian Financial Code’ in December 2013 (“Handbook”). The Handbook requires the financial sector regulators to incorporate specific aspects of consumer/investor protection in the law-making process (as per the recommendations made by Financial Sector Legislative Reforms Commission). Assuming that the crowdfunding regulations would take those recommendations into account, we have not discussed them in this report. We have also not attempted to make proposals on taxation issues relating to crowdfunding as it falls out of our current areas of expertise.

For ease of reference, we have reproduced the questions as appearing in the SEBI Consultation Paper. Please find below our responses.

Question 1

Given that Crowdfunding is still in nascent stages and most of the jurisdictions around the world have taken a guarded view by allowing it in a restricted manner, do you think India is ready for crowdfunding or is it premature to introduce such risky investment channel?

Proposal

Crowdfunding of ventures through issuance of securities should definitely be recognised and promoted as a valid investment route in India. However, the regulations should provide for appropriate safeguards to mitigate the risks associated with fraud and regulatory arbitrage.

Rationale

The traditional methods of raising finance like issuing shares to the public in the primary markets, private placements (to institutional and venture capital investors) and debt finance are not easily accessible for most small companies and new ventures. The eligibility requirements for raising finance through an initial public offer (“IPO”) are very high and most start-ups may not be in a position to meet those requirements in the early years of their operations. Venture capital investors (“VCs”) are usually very selective and not approachable for many small businesses and entrepreneurs. Moreover, the recent global financial crisis has shown that a market for bank loans may not be available at all times and alternative sources of finance need to be put in place to prevent widespread liquidity crunch when the banks are under distress. Start-ups and small companies are particularly vulnerable to such liquidity crunches.

In September, 2013, SEBI amended the SEBI (Alternative Investment Funds) Regulations, 2012 (“AIF Regulations”) to provide for the registration and regulation of ‘angel funds’. Angel funds may invest only in genuine seed stage companies that meet the criteria set out by SEBI under the AIF Regulations. By recognising angel funds as a separate class of investors and providing for a relatively liberal regime for their regulation, SEBI itself recognises the lack of capital available for seed stage companies in India. Despite a relatively liberal regulatory regime (as compared to other funds regulated under the AIF Regulations), only certain categories of high net worth investors would invest in angel funds, and angel funds may not, by themselves, be able to satisfy the funding requirements for the numerous seed stage companies in India.

In this backdrop, crowdfunding may provide a useful alternative for ventures with viable business plans but no reasonable access to the traditional modes of financing. Raising funds through donation or a pre-purchase arrangement is not a very sustainable model for attracting people to invest in a venture. On the other hand, if the investors are allowed to participate in the venture’s future cash flows through issuance of securities, it may be a more attractive proposition for them. Research shows that crowdfunding based on a profit-sharing model (through issuance of equity shares, for instance), can be quite conducive for early-stage start-ups with a significant funding requirement.¹

¹ Paul Belleflamme, Thomas Lambert, Armin Schwiendach, ‘Crowdfunding: Tapping the right crowd’ (2013) 29 J Bus Venturing 585 (‘Belleflamme’).

As long as the regulatory regime provides for sufficient safeguards to prevent frauds, raising equity capital through crowd-funding may go a long way in unlocking the true potential of early-stage ventures. Having said that, crowdfunding transactions are susceptible to frauds and regulatory arbitrage. Regulatory arbitrage occurs when the regulated entities take advantage of the variations between two or more regulatory regimes by subjecting themselves to a system that involves lesser costs or compliances. Allowing companies to raise funds through crowdfunding may create such arbitrage opportunities for transactions which could otherwise be subjected to SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009, SEBI (Collective Investment Scheme) Regulations, 1999, the AIF Regulations or the Foreign Contribution (Regulation) Act, 2011. In view of the above, issuance of securities through crowdfunding may be introduced in a phased manner to gauge its suitability for the Indian markets. Companies in sectors with dynamic entrepreneurial activity could be allowed to raise money through crowdfunding on a pilot basis (for instance, in the technology sector), before introducing this on a wider scale.

Question 2

Are the Accredited Investors mentioned in paragraph 9.1.4 suitable to participate in the risky investments of crowdfunding? Is there a need to expand or reduce the categories of investors or expand or reduce safeguards? Specify along with the rationale.

Proposal

It is recommended that the list of permissible investors be expanded to include small investors within the definition of 'Eligible Retail Investors' ('ERI').

Rationale

Crowdfunding is uniquely positioned to assist two groups of people in securing funding: (1) entrepreneurs trying to convert their ideas into viable businesses, and (2) small business owners trying to keep their businesses afloat or get them to grow. The usual sources of finance such as banks, venture capital, and retained earnings are difficult to access for such groups.² It has been estimated that the financial markets in the United States fall short of the demand for early-stage private equity financing by around \$60 billion each year, with particular shortage for start-ups.³ Venture capital firms are usually not an option for start-ups as well, as VCs are known to turn down most of their applicants.⁴ VCs usually focus on certain industries and have extensive due diligence requirements.

² See Steven C Bradford, 'Crowdfunding and the Federal Securities Laws' (2012) Colum Bus L Rev 1, 5 ('Bradford').

³ Bradford (n 2), 100 (quoting William K Sjostrom Jr, 'Relaxing the Ban: It's Time to Allow General Solicitation and Advertising in Exempt Offerings' (2004) 32 Fla St U L Rev 1, 3); David Mashburn, 'The Anti-Crowd Pleaser: Fixing the Crowdfund Act's Hidden Risks and Inadequate Remedies' (2014) 63 Emory LJ 127, 140 ('Mashburn').

⁴ United States General Accountability Office, GAO/GGD-00190 'Small Business: Efforts to Facilitate Equity Capital Formation' (September 2000) 20 <www.gao.gov/assets/240/230896.pdf> accessed 13 July 2014; Jill E Fisch, 'Can Internet Offerings Bridge the Small Business Capital Barrier?' (1998) 2 J Small & Emerging Bus L 57, 62; Bradford (n 2) 103.

They also look to invest in slightly less risky companies that have proven track records and which can also provide clearer exit opportunities.⁵

Angel investors fill only part of the gap, and personal resources, including funds from friends and families are usually insufficient to raise the required capital.⁶ In the years 2008, 2009, and 2010, angel investors reduced their investment in the “seed stage” companies in the United States⁷ and scholars and attorneys in the field estimate that only 1%-3% of funding applicants actually receive funds from angel investors.⁸

Since a large category of the ‘Accredited Investors’ (as defined in the SEBI Consultation Paper), particularly the Qualified Institutional Buyers (“QIBs”), are unlikely to invest in early stage ventures, those investors may not be interested in participating in crowdfunding at all. QIBs include mutual funds, VCs, foreign institutional investors, public financial institutions, commercial banks, etc. The underlying premise of ‘crowdfunding’ is to raise funds through relatively small contributions from a large number of people (the ‘crowd’), and not from a small group of sophisticated investors.⁹ The original idea behind crowdfunding was to open up the investment field to small, unsophisticated, individual investors who traditionally did not participate in security offerings.¹⁰ As the SEBI Consultation Paper itself notes, several jurisdictions (such as the United States, France, and Canada) allow small investors to participate in crowdfunding, while providing for appropriate safeguards for their protection.

In view of the above, small investors should not be restricted from participating in the crowdfunding process. Though investing in start-ups is inherently risky, the crowdfunding process can be structured in a manner that any loss to small investors is small and bearable.¹¹ While framing regulations to regulate crowdfunding, it needs to be borne in mind that the most likely investors in such issuances are small, unsophisticated individual investors who may be interested in investing small amounts in a new idea or business without exposing themselves to undue risks.

In order to protect the interests of such small, unsophisticated investors, similar protections to the ones proposed for ERIs may be provided. Such protections may include limits on the maximum amounts that can be invested in proportion to their net income (and not only net worth). Such investment limits, along with Risk Acknowledgement statements, disclosure requirements, investor education programs, special class action rights, appointment of a trustee (to represent the interests of retail investors) and checks conducted by the funding platform, should provide sufficient safeguards to protect the interests of the investors. Such safeguards will encourage small investors

⁵ Bradford (n 2) 102-03; Mashburn (n 3) 140.

⁶ Bradford (n 2) 5.

⁷ Mashburn (n 3) 140-41; Nikki D Pope, ‘Crowdfunding Microstartups: It’s Time for the Securities and Exchange Commission to Approve a Small Offering Exemption’ (2011) 13 U Pa J Bus L 973, 994-95 (‘Pope’).

⁸ Mashburn (n 3) 140; Pope (n 7) 994-95; Bill Payne, ‘Probability of Success in Raising Angel Capital’ (7 June 2011) <<http://billpayne.com/2011/06/07/probability-of-success-in-raising-angel-capital.html>> accessed 29 June 2014.

⁹ See Bradford (n 2) 7; Belleflamme (n 1).

¹⁰ See Andrew C Fink, ‘Protecting the Crowd and Raising Capital through the CROWDFUND Act’ (2013) 90 U Det Mercy L Rev 1, 1-2; Mashburn (n 3) 132; Bradford (n 2) 103-04.

¹¹ See Bradford (n 2) 99, 105-09.

to participate in crowdfunding, while at the same time also provide the issuers with the opportunity to raise money from the most likely investors. Please also refer to our response to *Question 4* (where we propose that the number of investors be increased beyond the numbers proposed in the SEBI Consultation Paper).

Question 3

Are the Investment Limits specified in paragraph 9.1.5 justifiable with respect to the respective investor classes? Are they too high or too low? Specify along with rationale.

Proposal

The Investment Limits specified in paragraph 9.1.5 may be modified in the following manner:

- (a) The requirement that QIBs collectively hold a minimum of 5% of the securities issued should be done away with.
- (b) The minimum offer value should be reduced for facilitating greater participation from the retail investors in crowdfunding.

Rationale

As mentioned in the previous response, QIBs are unlikely to invest in start-ups with no track record of operations.¹² In addition, it has been argued persuasively by a number of scholars that crowdfunding includes an in-built protection in the form of the “wisdom of the crowd”, which if channelised constructively, ensures that the fraudulent ventures are eventually weeded out and the crowd (of unsophisticated investors) makes sound investments over a period of time.¹³ Finally, other protections, such as the Investment Conditions specified in paragraph 9.1.6, the diligence related obligations of the funding platforms, and the oversight of SEBI itself would protect the investors from fraudulent companies.

In view of the above, it is submitted that requiring QIBs to collectively hold a minimum of 5% of the securities issued through crowdfunding may impose an unrealistic burden on the issuer companies and defeat their fundraising attempts. Such a requirement may also lead to a situation where the company succeeds in raising the requisite amount from HNIs and retail investors but cannot close the transaction due to a shortfall in QIB investment.

Further, it is submitted that the minimum offer value should be lower than Rs.20,000 of the face value of the securities per person. While it could be argued that the minimum offer value rule in Chapter III of the Companies (Prospectus and Allotment of Securities) Rules, 2014 does not entail that the minimum investment amount should also be Rs.20,000, it is advisable that the language in the rules be changed to facilitate smaller investments by retail investors in crowdfunding rounds (which would also potentially reduce their downside risk).

¹² See Bradford (n 2) 102-03.

¹³ See Bradford (n 2) 110.

Question 4

Is the limit of investors up to 200 besides QIBs or employees of the company under a scheme of employee stock option, as specified in Chapter III -The Companies (Prospectus and Allotment of Securities) Rules, 2014, adequate or is there a need to amend such rules to allow up to 1,000 investors, excluding QIBs or employees of the company under a scheme of employee stock option?

Proposal

It is recommended that the Companies (Prospectus and Allotment of Securities) Rules, 2014 be amended to allow private placements offers to 1000 investors or more for the purpose of crowdfunding. The following changes may also be considered in this regard:

- (a) The law relating to issuance of shares with differential voting rights also needs to be amended to allow issuer companies to issue securities with differential voting rights.
- (b) The issuer company may also be allowed the flexibility to enter into separate shareholders' agreements with large sophisticated investors.
- (c) The thresholds prescribed in the Companies Act for initiating petitions for oppression, mismanagement and class actions may need to be revisited for the purpose of crowdfunding investors.

Rationale

As discussed above, crowdfunding should be primarily aimed at individual investors. The Internet allows small businesses and budding entrepreneurs to connect with, and sell their ideas to, a large audience of such small investors, who will then help raise sufficient capital for the business.¹⁴ The main potential advantages of crowdfunding are: (a) crowdfunding helps provide an alternate source of funding for small businesses; (b) it helps start-ups judge the response of the market to their new product at an early stage; (c) it helps create a prelaunch community around the product to help promote the product (as investors who invest in a new product are more likely to promote and support the company and the product after its launch); and (d) it could also facilitate the raising of capital without geographical restrictions.¹⁵ Restricting the number of investors to 200 could severely hamper these potential benefits that make crowdfunding unique. While we note that the proposed cap for raising money through crowdfunding is Rs. 10 crore, limiting the number of investors to 200 could severely affect the potential of a venture to raise the desired amount. Given that most QIBs are unlikely to invest through the crowdfunding route, the other categories of investors need to be sufficiently large in number to raise any substantial amounts.¹⁶

¹⁴ See Belleflamme (n 1).

¹⁵ See Mashburn (n 3) 139-40; Ajay K Agrawal, Christian Catalini, Avi Goldfarb, 'The Geography of Crowdfunding' <<http://www.nber.org/papers/w16820.pdf>> accessed 13 July 2014.

¹⁶ Needless to say, given that the present limit on the number of persons to whom a private placement offer can be made seems to be inspired by the Supreme Court's observations in the case of *Sahara India Real Estate*

While such a large number of shareholders may increase the transaction costs and cause administrative difficulties for the promoters and the management¹⁷, such issues can be dealt with by restricting the rights given to shareholders through issuance of shares with differential voting rights.

In this regard, please note that at present, Section 43 of the Companies Act, 2013 read with Companies (Share Capital and Debentures) Rules 2014, requires certain conditions to be fulfilled for a company to issue equity shares with differential voting rights (for example, shares with differential rights shall not exceed 26% of the total post issue paid up equity share capital; the company should have a consistent track record of distributable profits for the last three years; it should not have defaulted in filing financial statements and annual returns for the preceding three financial years, etc.). These conditions are too onerous for start-ups and small businesses trying to raise funds through crowdfunding, particularly requirements such as having profits for three years, given that the requirements provided under Section 9.2.4 for a company to qualify under this route includes the requirement that a company is not more than two years old. At the same time, such companies cannot function efficiently, and would incur too high an administrative cost, if they have so many investors with full voting rights.

The Ministry of Corporate Affairs has recently published a draft notification that aims to exclude private companies from the requirement of fulfilling the abovementioned conditions to issue equity shares with differential voting rights. In the absence of such an exception (for both unlisted public companies and private companies)¹⁸, the administrative costs related to managing a large number of shareholders would be prohibitive for small businesses.

Given that shares issued through crowdfunding would be regulated at various levels by both the crowdfunding platform as well as being under the purview of SEBI, the traditional arguments of not allowing newly established companies to issue such shares with varied rights may not be justifiable. Finally, lack of such ability to issue shares with differential rights would further harm the chances of the start-up company for raising money through VCs at a later stage who would worry about investing in a company with a large number of unsophisticated shareholders. Such shares are also practical from the perspective of crowdfunding investors who would typically invest small amounts and would be primarily interested in getting a return, without expecting any substantial involvement in the day-to-day affairs of the company.

Further, there may be a need to revisit the thresholds for initiating cases for oppression, mismanagement and class actions in the Companies Act (Sections 244 and 245) if the maximum number of permissible investors is raised to 1000 or more. This may be required to strike a balance between protecting the interests of the investors and preventing misuse of the provisions to cause unnecessary problems for the company. Given that most retail investors will face coordination problems, it is recommended that a trustee be pointed to represent their interests and enforce their rights effectively.

Corporation and Others v SEBI, (2013) 1 SCC 1, the regulations will need to provide for appropriate safeguards to ensure that the crowdfunding mechanism is not used for similar transactions.

¹⁷Mashburn (n 3) 149-50.

¹⁸ We note that the SEBI Consultation Paper seems to suggest that only unlisted public companies will be eligible for crowdfunding. Please see our response to Question 6 in this regard.

It may also be considered to allow the issuer company to enter into a separate shareholders' agreement with investors who invest a substantial amount (say more than 25% of the target amount), by granting them special rights along the lines of the rights provided to sophisticated investors in typical M&A transactions. Such rights may include a board seat, veto powers over major business decisions, etc.

Question 5

Are the Investment Conditions mentioned in paragraph 9.1.6 enough to warn and guard investors regarding the risky nature of crowdfunding? Specify changes, if any, along with the rationale.

Proposal

- (a) The Risk Acknowledgement form should contain appropriate safeguards to ensure that issuers do not rely on it to escape from the liabilities arising out of fraudulent/misleading statements or conduct.
- (b) The dematerialisation process for issuer companies should be simplified.

Rationale

The Risk Acknowledgement form should not only state that the ERIs and HNIs understand the risk of illiquid nature of investment and potential loss of entire investment, but also that such an acknowledgement in no way abdicates the issuer from its obligation of not making any false or misleading statements or omissions. This will provide increased protection to the investors from fraudulent issuers.

There is also a need to modify the dematerialisation documentation requirements and simplify them so as to ensure that the issuer companies are able to dematerialise the shares at a low cost. As part of its account opening process, the National Securities Depository Limited requires the issuer company to submit audited Balance Sheets for last two years, a Net Worth Certificate from a Chartered Accountant, along with a fee. For a start-up company, some of these documents may be impossible to obtain (as the company has to be less than 48 months old in order to qualify for crowdfunding). Further, this may also raise the costs for the company unnecessarily. Therefore, it may be considered to relax some requirements to facilitate dematerialisation of shares for the purpose of crowdfunding.

Question 6

Given that the companies coming for crowdfunding lack any significant track record, are the conditions and requirements mentioned in paragraph 9.2 enough to fend off fraudulent investors? Specify changes, if any, along with the rationale.

Proposal

In addition to the safeguards discussed above, we have a separate submission to make on the eligibility requirements for the issuers. It is recommended that private companies also be allowed to raise funds through crowdfunding. If the number of permitted investors is increased to 1000 or more, the definition of a private company under the Companies Act will also have to be suitably amended (by excluding the crowdfunding investors from the two- hundred-members limit).

Rationale

The SEBI Consultation Paper seems to suggest that only unlisted public companies shall be eligible to raise funds through crowdfunding. It is submitted that such a condition would be detrimental to most start-ups and small businesses seeking to raise funds through crowdfunding. Most small businesses and start-ups are usually incorporated as private limited companies. A private company is easier to set up and administer than an unlisted public company, particularly for small businesses and start-ups. Some key differences between the private and public companies are: (i) A public company requires a minimum paid-up capital of Rs. 5 lakh as opposed to one lakh for private companies; (ii) The minimum number of members required for formation of a public company is 7 as opposed to 1 in case of private companies; (iii) There can be no restriction on the transferability of shares in a public company, unlike a private company - a private company may be a more appropriate vehicle for the purpose of crowdfunding to ensure that an unregulated secondary market is not created for the shares of the issuer companies; (iv) Public companies are subject to a number of additional filing and administrative costs in comparison to private companies, which may be too burdensome for small start-ups with insufficient funds.

It may also be noted that if the suggestion to increase the number of potential investors is accepted, an amendment would have to be made not only to the Companies (Prospectus and Allotment of Securities) Rules, 2014 but also to the definition of a private company under the Companies Act, by creating an exception for securities acquired through crowdfunding.

Question 7

Are the disclosure requirements for a company interested in raising funds through crowdfunding platform mentioned in paragraph 9.3.3, enough to enable investors in an informed decision making? Specify changes, if any, along with the rationale.

Proposal

Although it is difficult to dispute the need for disclosure of information as suggested in paragraph 9.3.3., given that most start-ups and small companies are unlikely to have the resources required for producing the required information, it is the crowdfunding portal which should assume the primary responsibility for enabling the issuers to produce the necessary information. Further, the disclosure requirements should contain appropriate safeguards to ensure that an entrepreneur's legal rights in intellectual property related to the business under consideration are adequately protected.

Rationale

One of the main goals of mandatory disclosure requirements for any public issuance of securities is to remove the asymmetries of information between the issuer and the investors. In the conventional capital markets, the information disclosed by an issuer in the primary markets (at the time of making the public offer) is analysed and verified by market intermediaries like stock analysts and investment banks, which helps investors in making an informed decision on the offer. The presence of such intermediaries is especially important for retail investors, who may otherwise not be in a position to understand or verify the disclosures made by the company on their own. After a company gets listed, ongoing disclosure requirements help in keeping the markets informationally efficient. Since prices in an informationally efficient market are an unbiased estimate of the value of the stocks under consideration, it follows that those prices are fair and thus help in maintaining liquidity in the secondary market (the stock exchange). If investors are of the opinion that the stock prices are not fair, such a belief is likely to affect their willingness to buy and sell in the market until the price reflects the stock's fair value. This may in turn deter people from investing in the capital markets in the first place, because such lack of liquidity could potentially undermine their exit at a desirable time.

In the context of crowdfunding, availability of information about the issuer company assumes special importance because of the following reasons: (a) A typical crowdfunding (retail) investor may not be sophisticated enough to understand the terms of the issue. Moreover, studies in behavioural psychology indicate that crowds may act in a manner where the subsequent decision makers are likely to make choices based on those made by the earlier decision makers.¹⁹ Such herd-behaviour is particularly common over the internet; (b) Unlike conventional public offers, there will be no secondary market for the securities issued by crowdfunding to ensure that the price of the securities reflect their fair value.

Notwithstanding the concerns highlighted above, it is important to underscore that a typical venture that resorts to crowdfunding is likely to be at a very early stage of its operations and may not have the resources to produce (on its own or by hiring external advisors) the necessary information required for enabling the investors to make an informed decision. It is here that the role of the crowdfunding portal becomes crucial. The crowdfunding portal could hire specialists to enable the issuer to draft the Private Placement Offer Letter. The language of the Offer Letter should be such that it is easy to understand for all. The portal could then factor the cost of generating this information in its fee as envisaged in our response to Question 17 of the SEBI Consultation Paper.²⁰ Liability for misstatements, etc. may however be restricted to the issuer company and its promoters (unless it can be shown that the funding portal was aware about the falsity of such statements or that it colluded with the issuer, in which case the liability should be extended to them as well).

In the absence of proper legal advice at the time of making disclosures, the issuer company may be at the risk of disclosing intellectual property (which could otherwise be legally protected under the laws of patent, copyright, etc.).²¹ Given that most early stage ventures may not have the resources

¹⁹ Joan MacLeod Heminway, 'Investor and Market Protection in the Crowdfunding Era: Disclosing to and for the "Crowd"' (2014) 38 VT LR 827.

²⁰ If the number of investors is not limited to 200 (as suggested in our response to Question 4), the portal should be able to recover such costs quite easily.

²¹ Sean M O'Connor, 'Crowdfunding's Impact on Start-Up IP Strategy' (2014) 21 Geo Mason L Rev 895.

to obtain such advice or file strong patent applications, etc., disclosure requirements focusing on product-details or business-methods could significantly undermine the legal interests of such ventures. In order to protect such interests, the disclosure regime should require that the potential investors registered with the funding portal agree to appropriate non-disclosure and non-compete obligations.

Question 8

Due to the lack of history and track record, it is important that issuers provide future projections of their business to facilitate investors in decision making. What should be the criteria to ensure that the projections are realistic and achievable and not misleading in nature?

Proposal

It is widely recognised that inclusion of forward-looking information in an offer document carries the risk of the promoters presenting an over-optimistic picture of the future potential of the business. Moreover, predictions about future prospects of a start-up on the basis of conventional valuation methods may not always be accurate. Consequently, instead of requiring companies to provide forward looking information, issuers may be required to obtain a compulsory rating about the viability of the business from an independent analyst or business specialist.

Rationale

The mandatory disclosure requirements in conventional public offers primarily focus on historical information about the company (like description of current and past activities, financial statements) because such information is usually verifiable. However, as discussed in the SEBI Consultation Paper, historical information about early stage ventures may not be sufficient for enabling the investors to make an informed decision about the venture.

The commonly used methods for determining the economic value of a company rely on projections about its future cash flows. In the case of start-ups, such projections are largely based on the company's business plan and its strategy for growth. Financial literature on the subject indicates that any estimation of future cash flows on the basis of this information alone may not be indisputable.²² Therefore, notwithstanding the issuer's good intentions, future projections about a start-up can paint a misleading picture about its profitability.

Scholars argue that instead of relying on disclosures alone, the regulatory framework for crowdfunding should use signalling mechanisms and on-going communication channels to verify the credibility of an offer. *Tomboc* suggests that such mechanisms may include (a) ratings system for the issuer companies, (b) use of social networks (as a signalling device for trustworthiness and to mobilise

²² David H Goldenberg and Michael D Goldenberg, 'Why Entrepreneurs and VCs disagree in valuing start-up firms: Imputing the Target Rate of Return using DCF vs. Option Based Approaches', (2009) 13 JPE 73.

shame in the event of default or fraud) and (c) online discussion boards to facilitate a constant dialogue between the investor community and the issuer company.²³

In view of the above, the crowdfunding regulations may require issuers to obtain a ‘compulsory rating’ from a registered financial analyst about the financial viability of the venture. The regulations may prescribe the methodology for the rating service and require the service providers to be registered with SEBI. In the absence of other traditional intermediaries (investment banks, underwriters, etc.) it is important that independent analysts or business specialists lend their reputation to the issuer company to signal the investors about the viability of the venture. Alternatively, the start-up community could be urged to organise itself voluntarily and develop a self-regulatory system for rating issuers on crowdfunding platforms. Given that many ventures may not have the financial resources to obtain such rating, the cost should be initially borne by the portal (and factored in its fee).

In addition to the above, the regulations may also require the promoters, directors and key employees of the venture to provide detailed information about their education, work experiences, and financial status along with a common vision statement for the company. The regulations may also require that the promoters make an introductory video about the venture and upload it on the funding portal as part of the disclosure requirements.

Question 9

What should be the continuous disclosure requirements for a company once it gets displayed on the platform? How it should be ensured that there is no information asymmetry between various prospective investors?

Proposal

Instead of requiring companies to make ongoing disclosures, the funding portal should be required to conduct periodic (six-monthly) reviews on the companies and keep the investors informed about any substantial developments. Further, online discussion forums on the funding portal should be developed as repositories of information relating to the issuer company, with equal access opportunities for all the registered investors.

Rationale

As mentioned before, one of the main purposes of the on-going disclosure requirements in the conventional capital markets is to keep the markets informationally efficient. Moreover, given that most listed companies are at an advanced stage of operations, there can be substantial changes in their financial and operational status within a matter of days. Consequently, it makes a lot of sense to keep the investors informed about the company through periodic disclosures and those linked to the occurrence of certain events. Such disclosures also enable the investors to discharge their corporate governance functions and prevent insider trading.

²³ Gmeleen Tomboc, ‘The Lemons Problem in Crowdfunding’ (2013) 30 J Info Tech & Privacy L 253.

While it is important that the investors in a start-up have access to information which may affect their rights to future returns, making such periodic and ad hoc disclosures will impose significant costs on the companies and require a lot of time and effort. Most early-stage ventures may not be in a position to spare the resources required for making disclosures (especially the information required under 9.3.6 (ii) and (iii)). Therefore, at least for a period of three years (immediately after the first round of crowdfunding), no direct ongoing disclosure obligations should be imposed on the companies. Nevertheless, the portal could be required to conduct periodic (six-monthly) reviews on the companies and keep the investors informed about any substantial developments, which could affect their rights in the company. The crowdfunding regulations should ensure that all the investors should have equal access to any information disclosed by the issuer (or the portal) to prevent insider dealing in the securities. No special information rights should be provided to any particular class of investors.

Moreover, as suggested by *Tomboc*²⁴, the crowdfunding platform could provide for an online social network and/or discussion forum for all issuers and investors registered with the portal, where the investors in the venture can monitor the returns made by other investors (in the same venture or other ventures) and keep each other informed about the ‘lemons’ (bad/fraudulent ventures). The issuers may also be required to designate a representative to answer questions posed by the investor community on the online forum (on a quarterly basis). The crowdfunding regulations may require that the investors participating on the online forum be identified by their real names and (investor categories) to enable the other investors to construe their comments accordingly (and use the ‘wisdom of the crowd’ appropriately). The participants on the forum should be prohibited from spreading any false or misleading information aimed at creating artificial demand for the securities in question.

Question 10

While Class I entities are already under SEBI’s purview and have a successful track record in securities market, Class II entities have specialized domain knowledge in the field of start up mentoring and funding. Is a joint venture between the two classes a better idea than to allow them to launch their own crowdfunding platforms separately?

Proposal

It is recommended that a joint venture between the two classes might be a better idea than allowing Class II entities to launch their own crowdfunding platforms.

Rationale

In terms of Paragraph 9.4.4.4 of the SEBI Consultation Paper, it is proposed that Technology Business Incubators (“TBIs”) be allowed to set up a crowdfunding platform as Class II entities.

To briefly recapitulate their role, TBIs have been designed to stimulate the establishment and growth of start-up firms by providing them with an array of targeted business support resources and services

²⁴ *Ibid.*

including physical infrastructure, business assistance, management guidance and consulting services.²⁵ Promoted by the central government and other bodies including National Science & Technology Entrepreneurship Development Board, they function as a not-for-profit venture.²⁶

Set out below are some of the concerns with allowing TBIs as stand-alone Class II entities for the purposes of setting up a crowdfunding platform:

- (a) Misalignment of Objectives and Resources: While the main objective of TBIs is to foster entrepreneurship, innovation and local economic development by nurturing growth of potential start-ups,²⁷ the crowdfunding platform's objective is to strike an even balance between improving access to finance to start-ups and affording protection to investors. Further, establishing a stand-alone crowdfunding platform by TBIs (not-for-profit-entities) would result in diversion of their resources from helping start-ups incubate into sustainable businesses to conducting due diligence, regulatory checks and protecting prospective investors. This might lead to a misalignment of objectives and resources between the TBI and the crowdfunding platforms established by them.
- (b) Conflict of Interest: The pre-incubation process for TBIs comprises of identifying potential entrepreneurs/start-up firms through a selection committee testing the market feasibility, growth potential, business plan and subsequently offer support in the manner mentioned above.²⁸ Unless there is a clear segregation between the ownership and management of the crowdfunding platform, two issues might arise: (i) issuers that already have the incubation support of the TBIs might experience an inherent bias in their favour through the crowdfunding process, to the detriment of other issuers; and (b) the experience and judgment of the aforesaid selection committee might influence decision-making of the proposed screening committee under the SEBI Consultation Paper, entrusted with determining the viability of business plans of proposed issuers.
- (c) Not-for-profit nature of TBIs: Given that TBIs are non-for-profit entities, they are not allowed to invest in for-profit enterprises, thus implying that crowdfunding platforms will be non-for-profit in nature too.²⁹ This might restrict the development of distinct and innovative crowdfunding platform models and also limit their competitiveness and efficiency in affording maximum protection to investors and promoting entrepreneurship and access to finance.

²⁵ Mingfeng Tang, Baskaran Angathevar and Jatin Pancholi, 'Technology Business Incubators in China and in India: A comparative analysis' (2011) 3(2) African Journal of Science, Technology, Innovation and Development <www.uns.edu.ar/globelics/wp-content/uploads/2011/12/ID-450-Tang-Angathevar-Pancholi-Innovation-economic-development-and-inequality-from-a-systemic.pdf> accessed 12 July 2014.

²⁶ *Ibid.*

²⁷ M Kamdar, 'An overview of Global and Indian Business Incubation Centers' (2013) <<http://shodhganga.inflibnet.ac.in/bitstream/10603/6527/9/09-chapter%202.pdf>> accessed 14 July 2014.

²⁸ 'Developing Eco-system for Knowledge to Wealth Creation - Role of Technology Business Incubators in Indian National Innovation System' National Science & Technology Entrepreneurship Development Board (NSTEDB) Conceptual Report (2009) <www.nstedb.com/Developing-Eco.pdf> accessed 14 July 2014.

²⁹ Given that the SEBI Consultation Paper is not clear on whether crowdfunding platforms are supposed to be non-for-profit in nature, it is assumed herein that crowdfunding platforms can be either for or non-profit.

Factors such as prohibition on investment advice, conflict of interest restrictions and reputational risks should limit the adverse effects of for-profit business models.³⁰

Therefore, in our view, it is more prudent to establish a joint venture between TBIs and Class I entities where TBIs offer operational support, identify and evaluate business plans and facilitate mentoring services, without owning a stake in the crowdfunding platforms.

Question 11

Any suggestions on some other possible entities, which can be included in Class II with a tentative list of qualifying criteria?

Proposal

Set out below are the qualifying criteria for additional Class II entities that should be allowed to launch their own crowdfunding platforms:

- (a) The entity has extensive experience in internet or technology based operations;
 - (i) ‘Extensive experience’ would mean experience in internet and technology based services for five years or more;
 - (ii) Expertise in building or managing secure systems, with a focus on data privacy and risk management;
 - (iii) Net worth has been positive in all the preceding five years; and
 - (iv) Net worth in the immediately preceding year is more than the capital contribution of the entity in the platform; and
- (b) The entity satisfies the ‘fit and proper person’ criteria specified in Schedule II of the SEBI (Intermediaries) Regulations, 2008;
- (c) The entity has the professional competence, financial soundness and general reputation of fairness and integrity in business transactions to the satisfaction of SEBI;

The entity is not involved in any legal proceeding connected with the securities market, which may have an adverse impact on the interests of investors.

Rationale

In terms of Paragraph 9.4.4.3 of the SEBI Consultation Paper, it is provided that Class II entities i.e. class of entities with “relevant experience and domain knowledge” be permitted to sponsor crowdfunding platforms, on satisfaction of certain requirements. In the past, innovative technology coupled with using internet as a “marketing, sales and distribution tool” to expand and complement existing markets, have defined the crowdfunding experience.³¹ Using a “creative marriage” of social

³⁰See Bradford (n 2).

³¹ Joan MacLeod Heminway, ‘The New Intermediary on the Block: Funding Portals under the Crowdfund Act’ (2013) 13 UC Davis Bus L J 177.

media and “small business capital formation tactics”,³² the major players in the crowdfunding phenomenon have been internet and technology companies. Given that these companies are established players with extensive experience in the crowdfunding sector, it would be counter-productive to restrict them from establishing platforms under the new regulations. Further, increased requirements under the SEBI Consultation Paper would require increased innovation and more sophisticated technology, capabilities and systems to manage risk control, data protection and due diligence. Therefore, it is highly recommended that entities with wide experience in internet/technology innovation be permitted to establish crowdfunding platforms. This will also be helpful in addressing concerns related to competitiveness and efficiency.

However, the crowdfunding platforms are not a conventional distributional conduit like before (for capital from investors to start-ups), but have to comply with various other significant, mandatory requirements. The platforms will now have to possess enhanced capabilities including: providing information (communicating detailed information to the investors and SEBI), certification (reducing fraud, due diligence and background checks), and finally, collectivisation (centralise information and consolidate monitoring).³³ Therefore, it is recommended that only internet and technology companies, which have the resources, capital and expertise to enable platforms that can fulfill their aforesaid obligations effectively, be allowed.

Question 12

Any suggestions on some other possible entities which can be included in Class III for the purpose of providing platform for FbC? Also specify their tentative qualifying criteria?

Proposal

It is recommended that, in addition to a network of PE and angel investors, networks belonging to investors in certain Category I Alternative Investment Funds under the AIF Regulations i.e. funds that strategise to invest in start-ups or early stage ventures or SMEs be included within Class III entities for the purposes of providing platform for FbC. These entities would include investors in SME funds and social venture funds specifically.

The qualifying criteria for entities mentioned above would be the same as the requirements prescribed for the associations or networks of private equity or angel investors in the SEBI Consultation Paper, namely:

- (a) With a track record of a minimum of 3 years;
- (b) With a minimum member strength of 100 active members from the relevant industry; and
- (c) Which are registered as Section 8 companies under Companies Act 2013 with a paid up share capital of Rs. 2 Crores.

Rationale

³² *Ibid.*

³³ *Ibid.*

Finding alternative-financing options is an exacerbated problem for starting and sustaining the growth of social ventures, given their ambiguous legal and organisational structures, dichotomous social and commercial goals and the aversion to traditional for-profit investors.³⁴ Coupled with the financial crisis and the reduced ability of the public sector to cope with the accumulated governmental debts, social ventures are uniquely positioned in tackling social and environmental challenges, while contributing to economic growth. Providing social ventures with a regulator-facilitated crowdfunding platform, that combines the power of social media coupled with an alternative rewards system (whether monetary or securities), can be a revolutionary financing option.³⁵ Given that Class III entities are allowed to host AIF I crowd funds that deploy funds raised from accredited investors into not-for-profit entities and social enterprises, networks of social venture funds might be more appropriate for establishing crowdfunding platforms specifically meant for this purpose, as opposed to private equities/angel investors.

Similarly, for SMEs, there are a number of other inefficiencies arising in the allocation of SME capital, which gives an opportunity for developing alternative sources for financing, like crowdfunding, for instance. While traditional banking products require leveraging of personal assets to secure funds, PE and angel investment opportunities are expensive and generally above the threshold of what SMEs typically deal in.³⁶ In this backdrop, crowdfunding facilitates a wide network of investors that can offer financing to SMEs, without the constraints of a traditional financing mechanism. Therefore, a tailored financing approach, which takes into account issues unique to SMEs, will be a more efficient way for them to raise funds and growth capital.

Whilst the proposed Class III entities will be allowed to establish crowdfunding platforms that offer financing to social ventures and SMEs, networks of social venture funds and SMEs, with a greater experience and expertise in identifying, funding and incubating potentially successful social ventures/SMEs, will be more well suited for this purpose. Therefore, in our opinion, networks of social ventures and SMEs should additionally be permitted to establish funds-based crowdfunding platforms and host the new Category I AIF funds under the SEBI Consultation Paper, which will invest in shares or debt securities in social/SME crowdfunded ventures.

Question 13

Any suggestions on some additional or reduced requirements on Crowdfunding Platforms?

Proposal

³⁴ OM Lehner, 'Crowdfunding Social Ventures: A Model and Research Agenda' (forthcoming) in (2013) 15(3) Routledge Venture Capital Journal <<http://papers.ssrn.com/sol3/Delivery.cfm?abstractid=2102525>> accessed 13 July 2014.

³⁵ *Ibid.*

³⁶ Cathie Sellars, 'Could crowdfunding fill the funding gap for SMEs?' (2014) <<http://insme.wordpress.com/2014/04/02/could-crowdfunding-fill-the-funding-gap-for-smes/>> accessed 14 July 2014; also see Amy Cortese, 'The Crowdfunding Crowd Is Anxious' *The New York Times* (New York, 5 January 2013).

Set out below are some of the additional requirements that can be imposed on the Crowdfunding Platforms:

- (a) Providing disclosure related to risks and other investor education materials, ensuring that investors understand the risks involved;
- (b) Ensuring that no investor can purchase securities beyond the limit prescribed in aggregate;
- (c) Ensuring that the funds raised are not released to the issuer/third party, until the investment threshold has been met;
- (d) Guaranteeing that investors will have a suitable exit mechanism in case the issuer fails to reach the threshold;
- (e) Providing an open communications platform in order for prospective investors to discuss the offering and its various aspects;
- (f) Enabling the issuer to produce the information required for making the necessary disclosures (as discussed in our responses to the disclosure related questions).

Rationale

Set out below are the reasons for the additional measures, as suggested above:

- (a) Given the risky nature of the securities, it is imperative that the crowdfunding platforms have a strong investor protection mechanism in place. An integral part of this mechanism would be educating the investors about probable risks in these investments and getting their assurances and acknowledgments in this behalf.³⁷ This would also limit the liability of a crowdfunding platform, provided due diligence concerns have been met.
- (b) Given the requirement that an accredited retail investor is not permitted to invest more than 10% of their net worth through crowdfunding, the crowdfunding platforms need to take appropriate measures to ensure that no investor has purchased securities, in aggregate from all the issuers, that exceed the aforesaid limitation.³⁸
- (c) Providing an open communications platform has several advantages. It can help reduce fraud by allowing investors to exchange relevant information, promote better-informed investors by knowledge sharing and take advantage of the “wisdom of crowds”, widely considered as the foundation of crowdfunding.³⁹

³⁷ Thomas Lee Hazen, ‘Crowdfunding Or Fraud funding? Social Networks And The Securities Laws—Why The Specially Tailored Exemption Must Be Conditioned On Meaningful Disclosure’ (2012) <<http://ssrn.com/abstract=1954040>> accessed 12 July 2014.

³⁸ ‘System and Method for Monitoring Compliance Regarding Investment Thresholds and Accredited/Non-Accredited Status of Investors’ PATENT US 20140149314 A1, <<http://www.google.com/patents/US20140149314>> accessed 10 July 2014, 1/7 (‘System and Method’).

³⁹ John S Wroldsen, ‘The Crowdfund Act’s Strange Bedfellows: Democracy and Start-Up Company Investing’ (2013) 62 U Kan L Rev 358 (‘Wroldsen’).

Question 14

Are the measures mentioned in paragraph 9.4.6 enough to ensure a seamless operation of the Crowdfunding Platform and avoidance of any conflict of interest? Suggest changes, if any, along with the rationale.

Proposal

Whilst the measures to ensure a seamless operation of the platform and avoid conflict of interest seem appropriate, set out below are some additional measures that can be undertaken in this behalf:

- (a) Crowdfunding platforms, their managers/directors and other employees should not be permitted to invest in offerings on their platforms and not have any financial interest in the issuers; and
- (b) Ensure inter-operability amongst platforms, so that investment limits by accredited retail investors are not breached through investments on different platforms.

Rationale

Set out below are the reasons for the additional measures, as suggested above:

- (a) If the crowdfunding platforms or their employees are allowed to participate in investments being offered on the platforms, concerns might be raised in relation to favouring or promoting these particular offerings.⁴⁰ Whilst the prohibition on providing investment advice will reduce the adverse effects of such conflict, in order to completely eliminate this risk and for reputational concerns, it is recommended that platforms/employees be restricted from investing on platforms.
- (b) In terms of Paragraph 9.1.4.1. of the SEBI Consultation Paper, an accredited retail investor is not permitted to invest more than 10% of its net worth through crowdfunding. At present, no mechanism has been prescribed to monitor the amount of investment made by a single investor on multiple crowdfunding platforms. In cases where an investor has made small investments on multiple platforms, at the closing of transactions, the investor may exceed the threshold.⁴¹ Therefore, inter-operability amongst the registered crowdfunding platforms needs to be enabled.

⁴⁰ See Bradford (n 2).

⁴¹ Wroldsen (n 39).

Question 15

Any suggestions on the role and responsibility of the screening committee and its composition etc.?

Proposal

While we agree with the nature of the composition of the screening committee, it might be prudent to define the category, ‘persons of high calibre and qualifications’, appointed by the owner of the crowdfunding platform and comprising 30% of the screening committee. These persons might include technical domain experts, academics, sector-specific experts and investor associations.

Given that the main objective of the screening committee is to create a filtering mechanism for ideas and business plans, set out below are the main roles and responsibilities of the screening committee:

- (a) To examine whether the issuer has a sustainable and efficient business model;
- (b) To examine the market feasibility, clarity of objectives, growth and scalability potential;
- (c) To examine the leadership potential and commitment of promoters;
- (d) To examine the level of innovation and use of technology; and
- (e) To investigate whether the issuer has the capacity to provide basic infrastructural support for its facilities and services.

Question 16

Given that only Accredited Investors may be allowed to invest through Crowdfunding Platforms, it is important that their due diligence is conducted properly to confirm their eligibility. Are the entities mentioned in paragraph 9.4.4 capable in doing the same? Any suggestions in this regard?

Proposal

While in our opinion, Class I entities (stock exchanges and depositories) and Class III entities (private equity and angel investors) will have the necessary capability and resources to enable due diligence of accredited investors through crowdfunding platforms established by them, in our opinion, SEBI should either promote (a) a centralised platform, along the lines of a KYC Registration Agency (“KRA”) model for other intermediaries; or (b) allow market based API solution/services, to further facilitate the verification of accredited investor.

Rationale

In terms of Paragraph 9.4 of the SEBI Consultation Paper, Class I entities (stock exchanges and depositories), Class II entities (TBIs) and Class III entities (networks of PE and angel investors) are permitted to establish crowdfunding platforms, which will then be entrusted with the task of

accredited investor verification. Whilst Class I and III entities will have the necessary resources and infrastructure to enable this due diligence of confirming investor eligibility (by virtue of being SEBI registered entities), Class II entities or the TBIs might find it cumbersome to divert their resources from helping start-up firms incubate, to verifying credentials of every prospective investor. For additional reasons mentioned in our response to question 10, in our opinion, it is preferable to allow Class II entities to set up a joint venture with Class I entities.

However, while the entities mentioned above are familiarised with the KYC compliance procedure, the process of verifying accreditation for investors involves collecting detailed financial information and documentation. This would require the entities/platforms to have elaborate manual systems to review the aforesaid documentation, making the process more expensive, redundant (in case of repeat investments) and liable to falsification and finally, also risk exposure of sensitive financial information belonging to prospective investors.⁴²

Set out below are two ways in which SEBI can streamline the accreditation process:

- (a) **KRA Model:** In the KRA model, while the intermediary is obligated to perform the initial KYC/due diligence of the client/investor the relevant information is recorded and stored by a centralised KRA, thus avoiding the need for the investor to duplicate KYC requirements with every intermediary.⁴³ Therefore, in the present case, the platforms could complete the verification process of an accredited investor, send the relevant information to a centralised agency, which will store, safeguard and retrieve or update the investor records, as and when the need arises. This will eliminate duplication of the verification process across all crowdfunding platforms and make it more cost effective and efficient, for both the platforms and accredited investors. Further, SEBI can require these centralised agencies to have appropriate safeguards and systems, that will address investor concerns relating to data privacy and unauthorised sharing. These KRAs could be set up as wholly owned subsidiaries of Class I entities (stock exchanges and depositories), as mandated in Securities and Exchange Board of India (KYC Registration Agency) Regulations, 2011.
- (b) **API Based Solutions:** SEBI could also consider permitting crowdfunding platforms to outsource the function of verifying investor accreditation to a third party i.e. application programming interface (API) based solutions. In the United States, the issuer is required to take ‘reasonable steps to verify’, whether an investor is accredited or not.⁴⁴ The issuers or the crowdfunding platforms (verifying on behalf of the issuers) typically outsource this verification process to third parties that use a highly secure API that exchanges automated information between the system and a host of third parties that can verify the financial information provided by potential investors, without the need for them to provide extensive financial documentation.⁴⁵ There are also API services that aggregate the accredited verification and

⁴² System and Method (n 38).

⁴³ Securities and Exchange Board of India {KYC (Know Your Client) Registration Agency} Regulations, 2011.

⁴⁴ Bo Sartainm, ‘What are Reasonable Steps to Verify Accredited Investors’ (2013) <<http://www.alleywatch.com/2013/09/what-are-reasonable-steps-to-verify-accredited-investors/>> accessed 9 July 2014.

⁴⁵ In the US, several API based services are being offered to verify whether an investor is accredited or not. Examples include- InvestorID, Crowdentals, Bancbox Invest and Accredify.

related records, act as an independent custodian and can provide the accreditation status to multiple crowdfunding platforms, at the time of an investment. They also aggregate transactional data from all available platforms and provide screening features to examine whether investors are complying with their investment limits or not.⁴⁶ The availability of accredited verification to investors and platforms for future transactions and its automated nature make the process much less time consuming, efficient and more appropriate, in addition to addressing privacy concerns.

Therefore, in our opinion, SEBI could either: (a) grant registration to KRAs that store the records of investors to avoid duplication of the investor verification process; and (b) permit platforms to outsource the verification process to API based third parties that use highly encrypted and automated models to carry the verification, making it more efficient and cost-effective.

Question 17

Making the platform's revenue directly dependent on the fee from the issuers may lead to a conflict of interest. What could be the possible alternative revenue mechanisms for the platforms, which may eliminate or reduce such conflicts?

Proposal

Adoption of the carried interest revenue model i.e. a pre-determined share in the profits of an investment might contribute substantially to reducing the conflict of interest between the crowdfunding platforms and the investors.

Rationale

While crowdfunding platforms primarily derive their revenue from listing fees and ancillary services (business plans, legal and accounting), the aforesaid revenue mechanisms typically lead to a conflict of interest.

An alternative revenue mechanism that might be instrumental in reducing the aforesaid conflict is the carried interest model. Under this model, the crowdfunding platform will receive a carried interest i.e. compensation equal to a share of the increase in value of the investment. Making the revenue dependent on the success of the investment will incentivise a highly curated due diligence on behalf of the crowdfunding platform, thus aligning its interests with the investors.⁴⁷ It can also foster a more nuanced and long-term association amongst the issuer, platform and the investor.⁴⁸ For instance - *Seedrs*, the first pan-European platform, does not take any upfront fee from the issuers,

⁴⁶ System and Method (n 38).

⁴⁷ Jonathan Sandlund, 'The Economics of Equity Crowdfunding' (2013) <www.thecrowdcafe.com/equity-crowdfunding-economics/> accessed 12 July 2014.

⁴⁸ Georgia Quinn, 'A Tale of Two Crowdfunding Platforms: Seedrs&Crowdcube' (2014) <www.crowdfundinsider.com/2014/03/34492-tale-two-crowdfunding-platforms/> accessed 10 July 2014.

but instead charges 7.5% of funds raised and takes another 7.5% of the carried interest, in case the company is growing and profitable.⁴⁹

In the United States, per the Securities and Exchange Commission (“SEC”) Crowdfunding rules dated 23 October 2013, crowdfunding platforms will be divided into two - broker-dealers and crowdfunding portals. A main differentiating factor for the two will be the way in which they charge compensation for their services. A transaction-based compensation can raise concerns related to conflict of interest, and therefore, such platforms will be required to register as broker-dealers. However, crowdfunding platforms such as AngelList LLC and FundersClub Inc. have been exempted by the SEC from registering as broker-dealers, provided that instead of receiving a commission or transaction-based compensation, they receive compensation equal to a portion of the increase in value of the investment as calculated at the termination of the investment in the investment vehicle (carried interest).⁵⁰

Therefore, in light of the above, crowdfunding platforms in India which are akin to crowdfunding portals under the SEC regulations, could be allowed to charge a carried interest, which could determine a bulk of the compensation and would align the interests of investors and platforms more seamlessly. This would however, be necessitated on the requirement that the platforms are not charging any commission or transaction based compensation, as they may accentuate the conflict of interest concerns.

However, making revenue carry-dependent also might give rise to certain risks for the crowdfunding platforms. Set out below are some of these risks:

- (a) High operating costs for the crowdfunding platforms;
- (b) Exposure to short-term irrationality of prospective investors and
- (c) Greater degree of accountability and reputational risks.⁵¹

⁴⁹ *Ibid.*

⁵⁰ SEC No Action Letters Dated March 26, 2013 and March 28, 2013, available at <www.sec.gov/divisions/marketreg/mr-noaction/2013/angellist-15a1.pdf> and <www.sec.gov/divisions/marketreg/mr-noaction/2013/funders-club-032613-15a1.pdf> accessed 9 July 2014.

⁵¹ Jonathan Sandlund, ‘The Due Diligence Dilemma in Crowdfunding Marketplaces’ (2013) <www.thecrowdcafe.com/due-diligence-dilemma/> accessed 10 July 2014.

Question 18

Should there be any restriction on the fee charged by a crowdfunding platform to an issuer for getting access to the platform or an accredited investor for registration or should this be left as a commercial decision by the platform based on market forces?

Proposal

In our opinion, the crowdfunding platforms should be permitted to set the quantum of fee, as long as it is not prohibitive, disproportionate and defeats the purpose of promoting access to finance for start-up firms and fledgling companies.

Rationale

Given that the crowdfunding platforms will primarily derive their revenue from a listing fee from the issuers, set out below are some past examples that are illustrative in examining whether crowdfunding platforms should be allowed to charge this fee depending on market-based pressures:

- (a) Listing Fee by Stock Exchanges: Whilst the SEBI Chandratre Committee on delisting of securities considered the issue of disparate fee structures across exchanges, it recommended (1998) that in order for stock exchanges to remain competitive, maintain brand equity and have robust investor protection systems, they should be free to determine their fee structure and quantum⁵². Agreeing with this recommendation, at present, SEBI permits the Board of Directors of stock exchanges to determine the quantum of their listing fees for prospective issuers.
- (b) Listing Fee for ITFs in SME exchanges: In order to facilitate access to finance for small and medium enterprises, in October 2013 SEBI decided to permit listing for SMEs on institutional trading platforms in SME exchanges, without the requirement of an initial public offer.⁵³ Whilst the purpose of permitting SMEs to list is similar to that of a crowdfunding platform, SEBI hasn't restricted the listing fee (initial and annual) that can be charged by the SME exchanges. However, the SME exchanges typically charge fewer fees than the regular exchange platform.

In view of the above, to maintain continuity, competitiveness and efficiency, SEBI should not restrict the fee that can be charged by a crowdfunding platform, either for the issuers or accredited the investors. However, the need for issuers to have access to alternative platforms for finance should not be ignored either. Therefore, SEBI should have the mandate to step in when the fee charged by a crowdfunding platform becomes excessive or exorbitant. One way to minimise conflict between promoting competitiveness and facilitating access to finance could be the 'carrier-compensation' model as mentioned in Question 17, where crowdfunding platforms could charge a nominal listing fee and make their revenue from profit sharing in an investment instead.

⁵² 'SEBI Report on Delisting of Securities' <www.sebi.gov.in/annualreport/9798/ar97981b2.html> accessed 2 July 2014.

⁵³ 'SEBI Allows SMEs to List on SME Exchange Without an IP' <www.nasscom.in/sebi-allows-smes-list-sme-exchange-without-ipo?fg=298607> accessed 12 July 2014.

Question 19

Any suggestions on the requirements in EbC to make it more transparent and investor friendly?

Proposal

Set out below are some of the concerns that will have to be addressed further, in order to make EbC more transparent and investor friendly:

- (a) Moral hazard risk and the liability of both the issuers and crowdfunding platforms;
- (b) Risks related to overfunding; and
- (c) Managing misaligned interests.

Rationale

Set out below is a brief analysis of the issues presented above and why it is necessary to address those in order to make equity-based crowdfunding more transparent and investor friendly:

- (a) Moral hazard risks: Several moral hazard risks might be a part of the crowdfunding process. First, there is the risk of entrepreneurs taking advantage of crowdfunding to misallocate resources or file for bankruptcy to the detriment of investors; however, a robust due diligence process should minimise this. Second, specifically in equity crowdfunding, a concern is an incorrect valuation of the equity. Unlike venture capitalists and other seed investors who are fewer and have more information and control, in case of equity crowdfunding, the investors have fewer opportunities to price the company and have to rely on the price offered by the issuers.⁵⁴ Therefore, SEBI should have a provision where a chartered accountant or a merchant banker certifies the valuations provided by issuers, similar to a private placement.⁵⁵
- (b) Overfunding risks: In case of equity-based crowdfunding, generating more investments than required can have adverse effects on the longevity of the start-up. First, excessive capital might lead to fledgling companies failing to use it efficiently, increased expectation of both the crowdfunding platforms and investors, and thus increased chances of failure. Second, even more significantly for the investors, in equity-based crowdfunding; there is an additional risk of the investors spreading their shares too thinly which would impact their rights as equity shareholders (voting, control).⁵⁶ Lack of experience, a track record and resources for

⁵⁴ M Stiernblad and E Skoglund, 'The future of Equity Crowdfunding - Is "The Crowd" Capable of Good Investment' (2013) <<http://lup.lub.lu.se/luur/download?func=downloadFile&recordId=3814918&fileId=3814919>> accessed 12 July 2014 ('Stiernblad').

⁵⁵ Mukul Aggarwal et al, 'Crowd- get ready to fund!!! SEBI proposes a new framework' (2014) <www.nishithdesai.com/information/research-and-articles/nda-hotline/nda-hotline-single-view/article/crowd-get-ready-to-fund-sebi-proposes-a-new-framework.html?no_cache=1&cHash=ba6faea21bee5d30450465b332c6fb10> accessed 14 July 2014.

⁵⁶ M Ibberson, 'What Happens When Crowdfunding Leads to Overfunding?' (2013) <www.crowdclan.com/when-crowdfunding-leads-to-overfunding/> accessed 15 July 2014.

the start-ups might accentuate this difficulty. Whilst the SEBI Consultation Paper requires issuers to have a provision for over-subscription, crowdfunding platforms should also facilitate a disclosure based regime for issuers to have a contingency plan in case of oversubscription and have provisions for promoting an orderly growth of the start-up while protecting the interests of the investors.

- (c) Managing misaligned interests: Given that investors and entrepreneurs have “inherently misaligned interests” in the short-run, it is important that there are mechanisms that maintain as many short-term protections for the investor as possible and align their long-term interests, particularly in cases of venture capital funding, through convertible preferred shares for instance.⁵⁷ However, typically, the investor can take three possible actions; first, create a strong, enforceable contract, second, pre-investment screening and third, monitoring and governing the project.⁵⁸ Given that monitoring might be difficult in case of a large number of shareholders, it should be incumbent upon the crowdfunding platform to offer standardised conditions that offer sufficient protection to investors (liquidation preferences, minority protections, equal information rights) and offer diligent pre-investment screening.

Question 20

Any suggestions on the requirements in DbC to make it more transparent and investor friendly?

Proposal

Certain concerns like disclosure requirements for platforms, financial liquidity and failure of DbC platforms should be addressed to make DbC more transparent and investor friendly.

Rationale

DbC is a safer alternative investment option given its suitability for investors with a low risk appetite with a low but a more certain return, preference in case of liquidation and cushioning from the volatility of the market. However, set out below are some of the suggestions to make DbC more transparent and investor friendly:

- (a) Disclosure Requirements for DbC Platforms: The Financial Conduct Authority, UK has prescribed a disclosure-based regime for DbC platforms, so that investors have sufficient information to make their investment decisions. Some aspects of this disclosure requirement include, *inter alia*: (a) risk of borrower default; (b) level of due diligence; (c) whether loan is secured; (d) rates of return and expected default rates; (e) clear default processes; (f) exit provisions including limits and risks and (g) failure of DbC platforms. SEBI could consider a similar regime for DbC platforms in India, where instead of requiring specific disclosures,

⁵⁷ D Isenberg, ‘The Road to Crowdfunding Hell’ (2012) <<http://blogs.hbr.org/2012/04/the-road-to-crowdfunding-hell/>> accessed 15 July 2014.

⁵⁸ Stiernblad (n 54).

DbCs should be given sufficient authority to determine appropriate disclosures taking into account nature and risks of investments and the need to maintain investor protection.⁵⁹

- (b) *Failure of DbC Platforms*: In terms of Paragraph 9.4.6 of the SEBI Consultation Paper, crowdfunding platforms are required to have a contingency plan in the event of closure or financial distress. Given that crowdfunding investors typically contribute in small amounts to issuers, in case of a DbC platform failure, there is evidence that issuers default on loan payments deliberately, since chasing repayment might be uneconomical for the investors.⁶⁰ Therefore, in case of DbC platforms, it becomes more necessary for them to have adequate arrangements to ensure that loan agreements continue to be administered and managed in the event that the platform fails.⁶¹
- (c) *Financial Liquidity*: A lock in period of up to ten years is prescribed for investors in a majority of DbC platforms. Given the lack of exit opportunities to trade and liquidate investments, a large number of investors and capital are restricted from accessing the crowdfunding market. In addition to allowing investors to trade debentures with other accredited investors, one option might be to facilitate put bonds that can give the investors the right to demand early repayment from the issuer, in the event of rising interest rates or poor project cash flows.⁶²

Question 21

Is there any need to prescribe the limit on the leverage a company can take through DbC?

Proposal

In our opinion, at present, no leverage limits should be prescribed on a company issuing securities through DbC.

Rationale

Set out below are the reasons why a leverage limit is not recommended on companies issuing securities through DbC:

- (a) *Accessing Debt through Traditional Crowdfunding*: In wake of the global financial crisis, start-ups and fledgling companies find it much harder to access credit given a “rising conservatism” across financial institutions that companies should be far less leveraged and have a more

⁵⁹ ‘The FCA’s regulatory approach to crowdfunding over the internet’, FCA Policy Statement <www.fca.org.uk/static/documents/policy-statements/ps14-04.pdf> accessed 12 July 2014.

⁶⁰ Shomik Panda, ‘UK moves ahead with crowdfunding regulation’ (2014) <<http://inlinepolicy.com/2014/uk-moves-ahead-with-crowdfunding-regulation/>> accessed 15 July 2014.

⁶¹ Norton Rose Fulbright, ‘FCA Rules for Loan Based Platforms’ (2014) <www.nortonrosefulbright.com/knowledge/publications/110985/crowdfunding#section5> accessed 16 July 2014.

⁶² Tom Du, ‘Four Recommendations for Expanding Debt Crowdfunding’ (2013) <www.corporateknights.com/article/4-recommendations-expanding-debt-crowdfunding?page=3> accessed 9 July 2014.

generous debt-equity ratio.⁶³ As a result, extremely high interest rates and increasingly restrictive loan standards and collateral requirements from traditional financing sources make it prohibitive for small companies/start-ups to access credit.⁶⁴

- (b) Need for SMEs to raise securities through debt: Given that start-ups/SMEs typically have a greater portion of intangible assets and uncertain cash flows, they find it even more difficult to raise funds through debts.⁶⁵ The increased cost and risk of losing ownership and control in case of equity capital make debt a more attractive proposition for both the issuers and investors alike. In order to grow long-term and manage their cash flows, debts are necessary for a start-up, specifically in early stages of its operations.
- (c) Safeguards for Investors in DbC: Similar to traditional debt financing, issuers in DbC are required to demonstrate creditworthiness through continuous reporting and disclosure requirements and the due diligence obligations of the crowdfunding platforms.⁶⁶ Additionally, many DbC platforms incorporate a safety clause, protecting investors in case of default.⁶⁷ Coupled with usually steep interests and market based control mechanisms like debt-service coverage ratios, for instance, make DbC a safer investment option. Recent data that venture capital firms invest predominantly (79%) in crowdfunding platforms further reflects this.

Therefore, in view of the prohibitive credit requirements of traditional financing mechanisms and the increased need for start-ups to have access to sufficient credit at the beginning of their operations, in our opinion, at present there should not be specific leverage limit for the issuers on DbC. Various protection mechanisms prescribed for investors by imposing obligations on issuers and crowdfunding platforms make the DbC investment much safer.

Question 22

Is there a need to change the rules regarding appointment of Trustee and creation of Debenture Redemption Reserve in case of private placement of debt with no intention of listing which seeks to issue debentures through recognized crowdfunding platform?

Proposal

It is recommended that a transitional approach should be adopted for issuers for the creation of Debenture Redemption Reserve, in case they seek private placement of debt with no intention of listing. Further, issuers should be exempted from the debenture trustee requirement.

⁶³ Jill Colpan, 'Raising Capital: Equity or Debt' *Bloomberg BusinessWeek* (4 December 2009) <www.businessweek.com/magazine/content/09_72/s0912030511552.htm> accessed 14 July 2014.

⁶⁴ Michael Ibberson, 'Has Crowdfunding Become the Ideal Bank Loan Alternative?' (2013) <www.crowdclan.com/has-crowdfunding-become-the-ideal-bank-loan-alternative/> accessed 9 July 2014.

⁶⁵ Stiernblad (n 54).

⁶⁶ Michael Ibberson, 'Debt-Based Crowdfunding: The Other Investment Opportunity' (2013) <www.crowdclan.com/debt-based-crowdfunding-investment-opportunity/> accessed 4 July 2014.

⁶⁷ Michael Ibberson, 'Equity or Debt Crowdfunding: Better Investment' (2013) <www.crowdclan.com/equity-or-debt-crowdfunding-better-investment/> accessed 13 July 2014.

Rationale

Section 71 of the Companies Act, 2013, provides for appointment of a debenture trustee (“DT”) in case of a public offer of debentures. Per the Companies (Share Capital and Debentures) Rules 2014 dated March 31, 2014, an unlisted company seeking private placement of debt is required to create a Debenture Redemption Reserve (“DRR”) from its profits that are available for dividends, and will be 25% of the value of debentures. Given that DRR can impact profitability and also increase the cost of funding significantly, it can become onerous and a significant barrier to entry for issuers on the DbC platform in the earlier part of the crowdfunding regime. Since issuers typically do not have access to formal financing sources, DbC is an effective way to lower their cost of financing at the beginning of their operations, at little risk of losing ownership or control like equity crowdfunding. Start-ups have limited profits at the outset, and it is financially unviable for issuers to create reserves out of these limited profits, given that they need to finance their working capital through DbC, specifically in case of debentures with short tenures.⁶⁸ However, since DRR is an effective way of providing a safety net to debt investors, issuers on DbC should be given a transitional period before they are required to comply with this. **However, it is not clear whether SEBI will have the mandate to provide for this transitional period, given that the Companies Act, 2013 and the aforesaid rules make DRR mandatory.** Further, given that DT is an onerous and expensive requirement for a start-up, and issuing debts on DbC platform does not amount to a public offer, such issuers should be exempted from the requirement of appointing DTs, unless there is an intention to list on a stock exchange.

Question 23

Any suggestions on the requirements in FbC to make it more transparent and investor friendly?

Proposal

SEBI should facilitate an FbC regime that ensures maximum participation from the investors and therefore provide fewer barriers to entry.

Rationale

The registration of *Crowd Funds* as Category I- Alternative Investment Funds under SEBI AIF Regulations facilitates a transparent financing structure with a robust investor protector mechanism, with appropriate risk management, continuous reporting and disclosure requirements. Therefore, given that Crowd Funds are purportedly the safest investment option amongst the three mechanisms prescribed in the Consultation Paper, SEBI should enable a greater outreach for the aforesaid funds, in the following manner:

⁶⁸ Tamal Bandyopadhyay, ‘Debenture redemption reserve blow to NBFCs’ (7 April 2014) <www.livemint.com/Opinion/byp3PqnnvdaEUMrDGtZhGI/Debenture-redemption-reserve-blow-to-NBFCs.html> accessed 12 July 2014; OP Thomas, ‘NBFCs brace for tough times with debenture reserve’ (30 April 2014) <www.dnaindia.com/money/report-nbfc-brace-for-tough-times-with-debenture-reserve-1983484> accessed 7 July 2014.

- (a) The proposed limitation on 1000 being the maximum number of accredited investors, that the crowd funds can solicit investments from, should be done away with.
- (b) The minimum investment limit for an accredited investor should further be brought down from the proposed Rs. 25 lakh, which will disadvantage greater participation in the AIF crowd funds otherwise.
- (c) For AIF funds deploying funds into companies that are charitable, the minimum limit for investment should further be brought down from Rs. 50,000 to Rs. 10,000.
- (d) There should be a clear segregation between the funds deployed for donation and for investment into for profit entities, given that the financial return expectations of investors are different in each case.

Question 24

Any suggestion to simplify the procedure as specified in paragraph 9.8 within the existing legal framework?

Proposal

For companies with no verifiable track-record, it is advisable to release the proceeds of the issue to a second escrow account (where the company may be one of the controlling parties) for direct payments to suppliers/employees/ advisors, etc. as per the statements made in ‘use of proceeds’ section of the disclosures.

Rationale

In order to ensure that the crowdfunding route is not misused by fraudulent issuers, the money raised through crowdfunding should remain in an escrow account under the joint control of the issuer and the funding portal, and released directly to third parties (ideally identified before the issuance) as per the ‘use of proceeds’ section of the disclosures. While it is possible that a fraudulent issuer may use this mechanism to divert funds to shell companies, the escrow arrangement could prevent such diversion by requiring the escrow agent to conduct proper checks and verification before releasing the money.

Question 25

Any suggestion on additional avenues of exit or liquidity of securities in crowdfunding?

Proposal

The crowdfunding regulations should encourage the use of online discussion forums (made available on the funding portal) to facilitate information exchanges between potential buyers and sellers (from within the community of registered investors).

Rationale

In conventional capital markets, it is the existence of a robust secondary market (a stock exchange) that encourages investors to invest in the primary market. As mentioned before, in the absence of an ‘informationally efficient’ secondary market, investors may not be able to exit at a desired time.⁶⁹ Retail investors are particularly prone to facing personal exigencies, which may require them to liquidate their holdings at any time and exit the venture. Any uncertainty about exit options may discourage investors from making the initial investment in the first place.

While a full-fledged secondary market for securities issued through crowdfunding may not be permissible given the regulatory framework for stock exchanges, the discussion forums/ social networks on the funding portal may be used as a platform to facilitate information exchanges between potential buyers and sellers. Any transfer of shares facilitated through such forums may be subjected to separate pricing and anti-manipulation guidelines to ensure that the prices are not rigged. The sale transaction itself can then be executed as per the Companies Act, 2013. In view of the proposals relating to investor education, etc., the retail investor community on the crowdfunding platform may be expected to better understand the risks associated with investing in such ventures over a period of time and eventually the online forums may become as ‘informationally efficient’ as the conventional secondary markets for securities.

Moreover, investors who invest a substantial amount in the company (say in excess of twenty-five percentage of the issue size) may be provided with special exit rights through a contractual arrangement. Such rights may include: (a) Put Option (an option to sell shares to the promoters on the happening of specified events or on the expiry of a specified time); (b) Initial Public Offering (the promoters could be required to initiate an initial public offer of the company’s shares, at the happening of which, the investors will have the option to offload their stake in the company through an offer for sale to the public; (c) Buy-back of Shares (the investors can tender their shares under a buy-back process initiated by the company); and (d) Liquidation / Winding up (an investor may have the company wound-up in case his desired exit opportunity is not given effect to).

Question 26

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 cybercrimes?

Proposal

The crowdfunding platforms should be required to comply with the Information Technology (Reasonable Security Practices and Procedures and Sensitive Personal Data or Information) Rules, 2011. In order to comply with the said rules, companies can either follow the international Standard IS/ISO/IEC 27001 on Information Technology - Security Techniques - Information Security Management System - Requirements, or set up a system of self-regulation with a standard of data protection that has been duly approved by the Central Government.

⁶⁹ When the markets are informationally efficient, the price of the stock is an unbiased estimate of its value, as a consequence of which one cannot consistently make returns over the average returns of the market. In other words, one cannot beat the market by knowing something about a stock, because the market price already reflects all available information in relation to that stock.

Rationale

Internet based crowdfunding platforms will deal with sensitive financial and personal information of their users on a daily basis. As such, it is of paramount importance that the IT policies and minimum standards of security are of a global standard, ensuring safety and confidentiality of sensitive information being shared online.

The Information Technology (Reasonable Security Practices and Procedures and Sensitive Personal Data or Information) Rules, 2011 (“**Rules**”) provide for a general legislative framework for the protection of sensitive information which will also apply to crowdfunding platforms. The Rules make it mandatory for the concerned company to comply with reasonable security practices and procedures.⁷⁰ Under these Rules, the company will be deemed to have complied with ‘reasonable security practices’ under two conditions - (i) if the company accepts the international Standard IS/ISO/IEC 27001 on “Information Technology - Security Techniques - Information Security Management System - Requirements” (ISO/IEC 27001)⁷¹, or (ii) if the company complies with the codes of best practices for data protection being followed by the industry association whose members are self-regulating, provided the standards are duly approved and notified by the Central Government⁷².

Therefore, under the law, crowdfunding platforms can either get certified under the ISO/IEC 27001 standard, or as an industry, establish new codes of best practices for data protection which can then be approved by the Central Government. A Government agency, the Standardisation Testing and Quality Certification Directorate under the Department of Electronics and Information Technology offers ISO/IEC 27001 certification services and it is easier to mandate the crowdfunding platforms to comply with the ISO/IEC 27001 standard. The alternate method is for the industry to set up a system of self-regulation with a standard of data protection that has been duly approved by the Central Government.

In case of the latter, the industry association will propose an industry standard of security and data protection to the Government. While ensuring the basic features of the ISO/IEC 27001 standard, the following areas should also be examined while instituting a new security standard specific to crowdfunding platforms:

Internal security: Every crowdfunding platform should have its own internal security, privacy and confidentiality policy that will conform to the guidelines prescribed by SEBI. This policy should be made public and the company should be liable for deviating from its stated policies in this regard. Internal access controls should be established to ensure that sensitive data is shared internally on a need-to-know basis. Strict controls over access to information are necessary to minimise the scope of cyber-crimes.

Online security: The guidelines should make it mandatory for crowdfunding platforms to invest resources in ensuring the security and robustness of their network infrastructure. The strength of their network should be tested through periodic penetration tests conducted by their own staff, as

⁷⁰ Information Technology (Reasonable Security Practices and Procedures and Sensitive Personal Data or Information) Rules, 2011, Rule 8(1).

⁷¹ *Ibid*, Rule 8(2).

⁷² *Ibid*, Rule 8(3).

well as qualified external experts. These tests should include brute force password cracking attacks, denial of service (“DoS”) and distributed denial of service (“DDoS”) attacks. In addition to these tests, the periodic review of security infrastructure should include search for backdoor traps in installed software and keeping network software updated. Further, encryption standards should be specified for communication of sensitive information between a web browser and the host server. Reports detailing the status of the above-mentioned periodic reviews of network infrastructure should be sent to SEBI or an agency specified by SEBI on a regular basis. These reports should also delineate the nature and effect of any cyber intrusion attempts and other forms of cyber-attacks on the online platform.

Sharing of information with third parties: In today’s day and age, online services often rely on third party software and services for providing their own services. For example, with the rise of inexpensive cloud storage services, most technology companies use third party cloud storage services as the back-end for their own services. This reliance between an internet company and other third party service providers is necessary to provide fast and inexpensive services worldwide. As sensitive financial and personal information will have to be shared with third parties by crowdfunding platforms, it is imperative that strict security standards be established for the flow of information between the company and third party online services and that these third party companies also conform to a basic standard of network security as set out in the guidelines.

SEBI may require that the crowdfunding platforms comply with the Information Technology (Reasonable Security Practices and Procedures and Sensitive Personal Data or Information) Rules, 2011. Whether to undertake ISO/IEC 27001 certification, or to independently establish a new industry standard, should be left to the discretion of industry as even in case of the latter, the Government will be free to reject the proposed industry standard if it falls below the ISO/IEC 27001 standard which shall serve as the benchmark. In either case, the minimum standard of ISO/IEC 27001 certification shall be followed, ensuring protection of sensitive data from cybercrimes.



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BETTER LAWS. BETTER GOVERNANCE

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