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EQUITY CROWDFUNDING - A COMPARATIVE ANALYSIS AMONG USA, CHINA AND INDIA'

ABSTRACT¹

Crowdfunding is one of the methods of raising finances for business ventures. Mostly seem to be availed by start-ups in India. The paper is essentially an attempt to look into the need for the regulation in this field, since we also notice crowdfunding in the pandemic. The idea is to initiate a thought of process with the introduction to such financing system followed by the case studies highlighting the emergence and existence of such regulations in the Chinese and the American economy. The objective seems to be satisfied when the case studies help us analyze the inefficiencies, associated risks and the awareness about the urgent need to regulate. A glimpse of application of Section 42 of The Indian Companies Act and The SEBI (Alternative Investments Funds) Regulations 2011 has been used to identify the current regime which monitors such financial undertakings. Since there has been a consultation paper to this effect by the SEBI the paper furthers the questions raised in the same and the author has identified certain issues which still should be considered by SEBI. Concluding constructively is an attempt to suggest certain measures to be communicated to the investors and to ignite an idea of how other alternative modes of financing could be less risky. We need to have a balance in start-up development and investor protection as both are equally a matter of concern.

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I. CROWDFUNDING

Crowdfunding is the use of small amount of moneys through a large number of people funding a particular project for a business through online web-based platforms.² The funders are motivated as they are connected with the start up having common values, visions or interests.³ Even Droff while mentioning Obama's speech points out how he believed that this will be a platform for the Americans to invest in start-ups they believe in. Syndication is one of the ways in which Chinese equity crowdfunding works, as "angels+ backers" model.⁴ The model ends up creating a limited partnership of the angel investor and the backers which further invest in the startup. The backers not really invest because of the goodwill of the angel⁵ but they rely on the due diligence results and the negotiated project valuation presentation by the angel. Direct investment, elimination of the process of first forming a separate entity and direct agreements through representatives are entered into and forming a joint stock company- there is a "investment cooperation agreement" wherein the campaigner is designated as the executing shareholder

It has been available in start-ups as they mitigate in their lack of conventional finance. Being an innovative and funding escalator, it may end up helping the start up to get funds from other sources as well. Even the JOBS Act as stated above was brought into with the same objective. The act has allowed the exemption of the registration process which was costly for the companies and to curb any fraud has also issued certain safeguards such as limit on the raising in a year, limiting the amount each investor can put and ensuring that all such funds are collected through a portal which always meet certain specified compliances. The act has also ensured that each investor should at least read the investor education component, assert the total liability and evaluate the risk with start-up companies. The platform of portals will ensure simplification of the search for the start-ups which will be in the need of funds and therefore the investors will be able to diversify their

² Kirby & Worner, Crowdfunding: An Infant Industry Growing Fast (Feb. 2014), IOSCO Staff Working Paper SWP3/2014, available at <http://www.iosco.org/research/pdf/swp/Crowd-funding-An-Infant-Industry-GrowingFast.pdf>. at pg. 8

³ Gerrit K.C. Ahlers et al., Signaling in Equity Crowdfunding (Oct. 2012) (unpublished manuscript), available at <http://ssrn.com/abstract=2161587>, at 8.

⁴ Shen, China Equity Crowdfunding Market Research Report 2016 is Issued; "Equity-for-Fee" Model is Popular Among Platforms, ZERo2JPO RESEARCH CENTER, Mar. 15, 2016, available at <http://en.pedaily.cn/Item.aspx?id=220799>.

⁵ See <https://angel.co/help/syndicates/syndicatenames>.

investments as the angels do. Obama also states such type of funding to be a get-rich-quick scheme, respectability to start-up entrepreneurs and the marvel or technologies.

II. EQUITY CROWDFUNDING IN CHINA: CURRENT PRACTICE AND IMPORTANT LEGAL ISSUES- BY JING LI⁶

Renrentou- member of SAC started in 2014, comparing the agreements, power of attorney and the limited partnership agreement equity funding do not really promise the investor with a suitable cash flow allowing them to share the ups and downs of the startup. Moreover only 75% of the net profits are kept for the campaigner and funders. Control rights are rather minimal. As through the power of attorney the managing rights being delegated to the campaigner is usually exercised in a minimal manner till they do not directly concern the interest of the financial returns as they also have to maintain the fund issuer prospects. Conclusion from the study is that the campaigner shall always keep the control and will run the business of the crowdfunding project.

Zhongtou8- created in 2014 a member of SAC as a professional investment manager. Agreements under this do not involve a new business entity being set up. Before putting it out for crowdfunding the campaigner will have due diligence done considering other factors such as internet, friendly industries, cultural communications, etc. It selects the potential lead investors who will make substantial investment into the project and is given an entitlement to a 10% carried interest and a priority access to the pool of projects.⁷ However although zhongtou8 is selecting potential leads but practically it is the parties that control the majority of the leads which raises concerns for the potential conflicts of interest. Same is the concern with respect to the post investment monitoring which may even create doubt on the quality of the crowdfunding

It is concluded that the investor qualification should be set low to let other crowds to participate for the benefit for the entrepreneurs and there should be a cap on how much each person could

⁶ Jing Li, Equity Crowdfunding in China: Current Practice and Important Legal Issues, 18 Asian Bus. Law. 59 (2016). The source of analysis in the paper is two crowdfunding portals in China namely Renrentou and Zhongou8. The former study found out that the investors' right to return were secured by the contracts and the latter study propounded to go beyond the contractual relationships and objects and found out that the projects were successful for the ones who were related to the founders of the portal, which was an indication of the conflicts of interests. From the study it is suggested that there should be a range of higher level of disclosures.

⁷ Lingtou jieshao [An Introduction of Leading Investors], ZHONGTOU8, <http://www.zhongtou8.cn/help/index/id/13>.

invest. Moreover the focus is to ensure effective disclosures which have better information to be used to make better and informed investment decisions.

III. THE SIREN CALL OF EQUITY CROWDFUNDING- by MICHAEL B. DORFF

The article is a reaction comment to the then recent Jumpstart Our Business Start Ups Act (JOBS) act⁸ allowing start-up companies to raise finance through the web in form of equity crowdfunding.⁹ The objective aimed was to create jobs from all such small businesses and the initiation of the investment opportunity for the middle class. Will it lead to fraud, no profits or return or can it be solved through any disclosure regulation was the concern of the critics. The paper after considering the angel investors, has pointed that they all will lose money. Strategies available to angel investors will not be the same for such funders. The part two of the paper gives a description of how such funding was prevented. He tries to channelize his worries practically through other possible outcomes and comes with the need of proper government rules to strike the balance between the investor costs and investor protection. It concluded that the equity crowdfunding must be abolished as most investors will lose money. Moreover the author has raised disappointment about the still persistent dilemma that if they have to protect the investors then they will have to make it too expensive for the portals to operate and the issuers to use the exemption and as a result retail crowdfunding would be even more difficult.

IV. CROWDFUNDING IN INDIA

According to Jing, main aim is to strike a balance between the mitigation of risks and the protection of investors vs. the supporting the funding as an innovation to fill the liquidity in startup financing. Dorff also puts forth the same dilemma for balancing the protection of investors from fraud and

⁸ Pub. L. No. 112-106, 126 Stat. 306 (2012).

⁹ John S. Wroldsen, The Social Network and the Crowdfund Act: Zuckerberg, Saverin, and Venture Capitalists'Dilution of the Crowd, 15 VAND. J. ENT. & TECH. L. 583, 593 (2013).

lowering investors' cost of fundraising. Even the Indian regulators as the US and Chinese construe need a balance between the investor protection and economic growth and development of the Indian economy through startups.

However, there are certain ways in which crowdfunding can happen in India. One through the private placement route as per Section 42 of The Companies Act 2013 and two FbC route under the SEBI(AIF) regulations 2012.

SEBI has worked on the following policy issues as considered in the consultation paper¹⁰ on crowdfunding in India. These policy questions were-

- a. The fundraising issuer- the company at its earlier stage, basically a startup which do not intend to raise more than 10cr in 12 months, not listed on any exchange, age of less than 48 months, not related to further financial ventures and should not be related in real estate. The custodians of the company shall not be prohibited from the SEBI, not a defaulter and should not be disqualified from appointment as a director¹¹ under the companies act 2013 and are "fit and proper"¹² under SEBI(intermediaries) regulation 2008. They are prohibited to use multiple crowdfunding platforms at the same time, making direct or indirect advertisements, no route other than SEBI recognized platform. It should raise a private placement offer letter and the disclosures required had to be done on an ongoing basis.
- b. The crowd- only the accredited investors are allowed to invest through this. Qualified Institutional Buyers¹³, companies with a minimum net worth of 20cr, High Net worth individuals, eligible retail investors and the ones who have an income of more than 10 lac rupees, filed ITR for the last three years, limiting their investment up to 60000 Rs and ensuring that they do not invest more than 10% of their net value.
- c. The platform – however it is advised to have a SEBI recognized platform but any eligibility criteria for such platform has not yet been released. It may be RSEs and depositories, technology based incubators and associations with networks of PEs or angel investors. As suggested by the Chinese study there was a need to ensure no conflict of interest, we have

¹⁰ https://www.sebi.gov.in/sebi_data/attachdocs/1403005615257.pdf

¹¹ Section 164(2), Companies Act 2013.

¹² Schedule II of the regulations.

¹³ Section 2(1)(zd) of the SEBI(ICDR) regulations 2018.

provisions such as owning a domain ID, fair and transparent process, procedure addressing conflicts, have a grievance redressal mechanism, have a screening committee performing Due Diligence.

Firstly, as the Chinese critic pointed out the issue that there will be no distinction of private and public issue, similarly the consultation paper has no regards to the distinction, as we can see the dilemma in the companies act. So Section 2(68)(iii)¹⁴ has prevented public to subscribe to the shares of the private companies whereas Section 42 limits of people who can subscribe to the shares up to 200 persons. Ironically crowdfunding has characteristics of both private and public funding. if the number of the funders under this type of investment will be more than 50 then it will be treated under private placement of shares as per Section 42(2)¹⁵ wherein if the number exceeding 50 excluding QIB¹⁶ and employees and irrespective of it being listed or unlisted, wanting to list or not will nevertheless be deemed to be a public offer and therefore will be dealt accordingly. Nowhere in the consultation paper has it been mentioned about the nature of the equity type of crowdfunding.

Another problem lies is the nature of the responsibility SEBI should be accountable for. Mere creating categories of people who can be investors is not going to solve the problem, however it will create problems for the other type of crowdfunding activities. It has not discussed any of the issues which were contemplated by the authors studying the US and the Chinese markets, basically what has been done is the elimination of risk and not the management of risks.

There is a need to look at the drawbacks of the other systems wherein the Balance has not been reached there is too much of investor protection. Financial interest of the portal in the issuer– the Chinese law do not work on this but the US law does see the need for a standard of Arm's length to ensure vanishing of conflict of interests. Appreciating how qualification required for becoming an investor has already been looked upon which is a big issue in the Chinese economy.

¹⁴ Section 2(68)(iii), The Companies Act, 2013

¹⁵ Indian companies Act 2013.

¹⁶ SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009.

Disclosure can be an efficient approach to deal with is the solution which the US researcher suggests. However, the other paper gives a critical view to disclosure. Such as adding warnings which will sway off the investors and the issuers will move to other alternate sources of funding. Moreover, such disclosure requirement although less extensive than the registration procedure will ultimately add sufficient expense when combined later with the compound liability will make the issuers deterred for using such source of financing. Furthermore, what if the start-up performs poorly then irrespective of the disclosures the first wave of the investors will be most likely prevented. It may further impoverish the choices of the equity crowdfunders. For this side of the drawback in the policy we have certain disclosure requirements. The companies are required to file a prospectus with the registrar of companies which have its own detailed disclosure requirements.

The other issue is a result of the implementation of the laws made which were standardization of contracts¹⁷, no active participation¹⁸, higher risks¹⁹, no due diligence opportunity²⁰, no secondary market²¹, the risk of dilution²², manipulation²³ and frauds²⁴. However, these are certainly looked

¹⁷ It only relies on the standardized contracts provided by the funding portal. Therefore, no bargaining for the key investment rights. Standardized contracts giving too much discretion to the portals leaving the investors under protected.

¹⁸ Observing the US situation it is described that there will be lack of active participation for such investors.

¹⁹ Droff compares that as angels as a class will however having a chance to diversify their investments will be less likely to diversify as the angels will do. Since all angel investors are going to be at play only those businesses which were not capable of getting an angel investor will end up having crowdfunding as finance which implies that anyways the risk is even much more higher in all such start-ups.

²⁰ No adequate pre investment screening and due diligence and moreover weak post investment support, the risk is higher than the angels and the venture capitalists, see; Simu guquan zhongchou rongzi guanli banfa (shixing) (zhengqiu yijian gao) [(Trail) Administrative Measures for Private Equity Crowdfunding (Draft for Comments)] (promulgated by Securities Association of China, Dec. 18. 2014), available at http://www.sac.net.cn/tzgg/201412/t20141218_113326.html.

²¹ C. Steven Bradford, *The New Federal Crowdfunding Exemption: Promise Unfulfilled*, 40 SEC. REG. L.J. 195, 196 (2012).

²² There is a high chance of the funder to result in dilution from further equity offers, which calls for even more investor protection. See; David Wallace, *R.I.P.-Top 10 Failed Social Media Sites*, SEARCH ENGINE J. (Jan. 25, 2013), <http://www.searchenginejournal.com/r-i-p-top-10-failed-social-media-sites/57554/>. The other paper acknowledges the same drawback, as the angels and venture capitalists being sources for further funding dilute the interest of the prior investors, so unless there is any protection against such dilution such funders may not reap the rewards of their risk taking. Dilution is one of the demotivating factors for the equity crowdfunders as angels and venture capitalist end up securing themselves by inserting for themselves protection into company's founding documents. See;

²³ Social networking, wherein people who are less experienced investors club their social biases and pervasive narratives to invest in the financial markets. For example, herding behavior.

²⁴ There is a risk of fraud and manipulation in the Chinese market model of angel +backers as they might end up following the angels blindly. See; Dong Yang, *The People's Funding of China: Legal Developments of Equity Crowdfunding Progress, Proposals, and Prospects*, 83 UNIVERSITY OF CINCINNATI LAW REVIEW 459-460

upon in the consultation paper but since it has not being implemented we do need to consider all such issues while forming a stringent law for crowdfunding.

V. CONCLUSION

For the Indian market such form of funding will be a huge gain for the Section 8 companies. Even art and culture related ventures are going to be most beneficial. There is a need for the SEBI to look upon crowdfunding since it has not issued any concrete guidelines after 2014 for the same. Thankfully there are no huge frauds at least for now on such platform but since no law in place there is a high probability. More can be an expectation to ensure through SEBI to communicate the middle-class investors to look at the following points before investing to platforms such as-

- a. Go through the platform of other fundraisers
- b. Checking the verification of badge
- c. Look at the documents
- d. Ask for an impact report
- e. Report mechanisms.

There is a specific issue with respect to the jurisdiction of MCA and SEBI for such type of funding issues which although has not been discussed in the paper but raises certain concerns for the time being.

Hope that since the government is striving hard to get investments from the foreign market for the economic growth and development of the startups, but there still remains the question of them why not letting the Indian middle class invests through models of crowdfunding. Is it their lethargy to not work on SEBI guidelines proposed in India since 2014 or their aversion to risk for not taking a further risk by proposing equity crowdfunding. As even the consultation paper discusses about an alternative to avoid crowdfunding in India through the introduction to various other funding mechanisms which are regulated by SEBI. They are-

- a. SME segment- a company having less than ten crore of post issue value capital can raise only raise money through this and till twenty five crore rupees has an option to this, else

(2014). Even in the US such crowdfunding has given an opportunity for the criminal to take advantage of the investor gullibility.

only through public issue through the main board. Exemptions such as drafting of offer document directly with the exchange and not the SEBI, minimum prospective allottees in 50, filing half yearly financial results instead of quarterly are given to such segments.²⁵

- b. Institutional trading platforms- apart from SME it includes start-up companies to raise equity without an IPO. But participation is restricted to only informed investors, not allowed to raise capital otherwise if listed under ITP, it is to provide impetus to the start-up companies and enhances the liquidity of such scripts under the AIFs²⁶
- c. Alternative investment funds- regulated by SEBI²⁷, has three types of funds such as one of the government consider it as socioeconomically desirable, other private equity and other hedge funds. It does not allow more than 1000 investors and the minimum net worth of the investor has to be 1cr rupees.

But smart is a man who takes risk, in my opinion had we not rely on FDI but such platforms, it will not only create jobs but let the government as well as the Indian middle-class showcase their ability to not always avoid the risk but to mitigate and diversify their risks. The problem with crowdfunding in India is not the issues it has been raising in other economies but the problem is even at this stage of ours, the 'to be' stagnant economy we are not considering to give such options to the public. The issues observed in the other economies can be a way we can learn from their mistake and strike a proper balance between the investor protection and startup development through our robust mechanism of SEBI.

My proposal should be to introduce the following for successful crowdfunding-

- a. Regular and proper disclosures to be maintained at the platforms.
- b. The platforms must be registered and to be treated at par as any other intermediary.
- c. A very transparent system or may be one to one communication platform should be opened to let the investors have a clear view about the start-up idea.
- d. There is a need of certain amendments to the companies act.

²⁵ Chapter XB of the Securities and Exchange Board of India (Issue Of Capital And Disclosure Requirements) Regulations 2009.

²⁶ SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 as Chapter XC

²⁷ SEBI (Alternative Investment Funds) Regulations, 2012

All we can hope for is a way forward to form better, concrete and inclusive guidelines for the betterment of the economy we are hardly living in.

