

Consultation Paper on Crowdfunding in India

1.0 Introduction

1.1 This consultation paper aims to provide a brief overview of the global scenario of crowdfunding including the various prevalent models under it, the associated benefits and risks, the regulatory approaches in different jurisdictions etc. The paper also covers the extant legal structure governing the fund raising for start ups and SMEs in India. The paper discusses legal and regulatory challenges in implementing the framework for Crowdfunding. This paper proposes framework for ushering in crowdfunding by giving access to capital market to provide an additional channel of early stage funding to Start-ups and SMEs and seeks to balance the same with investor protection. Through this consultation paper SEBI intends to invite comments and suggestions from industry and market participants regarding the different possible structures for crowdfunding within the existing legal framework and other associated issues.

1.2 The Consultation Paper has been put forward for discussion only and does not necessarily mean that a Crowdfunding Regulation would be introduced in the form as proposed in the consultation paper or in any other form.

2.0 What is Crowdfunding?

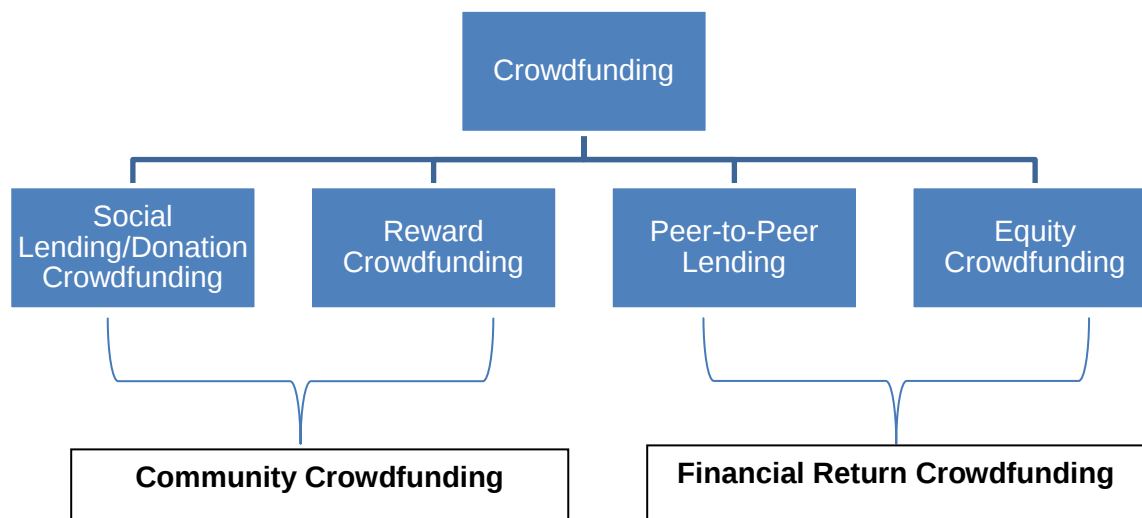
2.1 Crowdfunding is solicitation of funds (small amount) from multiple investors through a web-based platform or social networking site for a specific project, business venture or social cause.

2.2 *Crowd sourced funding is a means of raising money for a creative project (for instance, music, film, book publication), a benevolent or public-interest cause (for instance, a community based social or co-operative initiative) or a business venture, through small financial contributions from persons who may number in the hundreds or*

thousands. Those contributions are sought through an online crowd-funding platform, while the offer may also be promoted through social media.¹

3.0 Types of Crowd-Funding

3.1 As per IOSCO Staff Working Paper - Crowd-funding: An Infant Industry Growing Fast, 2014 ('**IOSCO Paper**'), Crowd-funding can be divided into four categories: donation crowdfunding, reward crowdfunding, peer-to-peer lending and equity crowdfunding.



Source: IOSCO Staff Working Paper - Crowd-funding: An Infant Industry Growing Fast , 2014

3.2 Donation Crowdfunding

3.2.1 Donation crowdfunding denotes solicitation of funds for social, artistic, philanthropic or other purpose, and not in exchange for anything of tangible value.

3.2.2 For example, In the US, Kickstarter, Indiegogo etc. are some of the platforms that support donation based crowdfunding.

¹ Crowd Based Equity Funding – Discussion Paper - Corporations and Markets Advisory Committee, Australia, September , 2013

3.3 Reward Crowdfunding

3.3.1 Reward crowdfunding refers to solicitation of funds, wherein investors receive some existing or future tangible reward (such as an existing or future consumer product or a membership rewards scheme) as consideration.

3.3.2 Most of the websites which support donation crowdfunding, also enable reward crowdfunding, e.g. Kickstarter, RocketHub etc.

3.4 Peer-to-Peer lending

3.4.1 In Peer-to-Peer lending, an online platform matches lenders/investors with borrowers/issuers in order to provide unsecured loans and the interest rate is set by the platform. Some Peer-to-Peer platforms arrange loans between individuals, while other platforms pool funds which are then lent to small and medium-sized businesses.

3.4.2 Some of the leading examples from the US are Lending Club, Prosper etc. and from UK are Zopa, Funding Circle etc.

3.4.3 A report by the Open Data Institute in July 2013 found that between October 2010 and May 2013 some 49,000 investors in the UK funded peer-to-peer loans worth more than £378m.²

3.4.4 Some of the platforms charge a fee based on the loan origination and have an incentive to push investors into larger loans which may not suit an investor's risk profile.

3.4.5 Though, Peer-to-peer lending did not appear to involve securities, loan/notes/contracts can be traded on a peer-to-peer platform or a secondary market. Thus, these loans may become securities, with the contract between the lender and the borrower being the security note.³

2 Crowd Based Equity Funding – Discussion Paper - Corporations and Markets Advisory Committee, Australia, September, 2013

3 IOSCO Staff Working Paper - Crowd-funding: An Infant Industry Growing Fast, 2014

3.4.6 In peer-to-peer lending, there is no investor protection by way of a compensation scheme to cover defaults in this market as there is with deposit guarantee schemes for bank deposits. Retail investors, who do not have the capacity to absorb defaults, may lose significant proportions of their investments, if there are any defaults.

3.4.7 As per IOSCO paper, in some Jurisdiction like Germany and Italy, peer-to-peer platforms are classified as banks (due to their credit intermediation function) and are therefore regulated as banks.

3.5 Equity Based Crowdfunding

3.5.1 In Equity Based Crowdfunding, in consideration of funds solicited from investors, Equity Shares of the Company are issued.

3.5.2 It refers to fund raising by a business, particularly early-stage funding, through offering equity interests in the business to investors online. Businesses seeking to raise capital through this mode typically advertise online through a crowdfunding platform website, which serves as an intermediary between investors and the start-up companies.

3.5.3 Traditionally, Start-ups are funded through private equity, angel investor or loan arrangements with a financial institution. Any offering of public equity takes place only after the product or business becomes commercially viable. However, in Equity based Crowdfunding solicitation is done at an earlier stage.

Some examples of equity crowdfunding platforms are Syndicate Room, Crowdcube and Seedrs.

3.5.4 In a few jurisdictions (like China), these platforms are restricted to offer this type of capital raising to sophisticated investors or to a limited number of individual investors. In China, an equity raising offer made to less than 200 individuals does not need to fulfil the public equity raising requirements.

4.0 Benefits of Crowdfunding

- i. Crowdfunding provides a much needed new mode of financing for start-ups and SME sector and increases flows of credit to SMEs and other users in the real economy.
- ii. Financial crisis (2008) resulted in failure of number of Banks and, consequently the Basel III Capital adequacy norms have been made applicable to Banks. As a result, Banks have become increasingly constrained in their ability to lend money to the ventures or start-ups which may have high risk element. Hence, there is a need for funding for SME through alternative sources.
- iii. SMEs are able to raise funds at lower cost of capital without undergoing through rigorous procedures in this mode.
- iv. Crowdfunding provides new investment avenue and provides a new product for portfolio diversification of Investors.
- v. It increases competition in a space traditionally dominated by a few providers (providing finance to Start-ups and SMEs).
- vi. The operators of a crowdfunding platform may engage in vetting or due diligence of projects to be included on their website, to maintain the reputation of the website.

5.0 Risks of Crowdfunding

5.1 Substitution of Institutional Risk by Retail Risk

5.1.1 Presently, the risk in financing Start-ups and SMEs is borne by the Venture Capital Funds (VCFs) and Private Equity (PE) Investors. In crowdfunding, these entities solicit investments in smaller sums from large number of investors. Hence, the risk taking by VCF/PE (informed investors) is substituted with retail investors, whose risk tolerance level may be very low. Retail investors may not be able to understand the risk in these investments and will be unable to bear the loss of investments.

5.1.2 This may be more dangerous, considering the fact that investments in SMEs and Start-up may involve high risk and low liquidity and are generally treated as aggressive and long term investments. VCF/PE Investors will be able to negotiate a better pricing

and some influence on management, which would be absent in the Crowdfunding Route, where smaller contributions are sought from multiple investors. Uninformed and unsophisticated investors (retail investors) may act with a 'herd mentality'.

5.2 Risk of default

5.2.1 There is no or less recourse to the investors against the issuer, in case of default or fraud. Funds are not directly solicited by the issuer and issuer also do not come out with any offer document. Funds are solicited by the platform and such platform may or may not conduct proper due diligence of the issuer. If a platform is being temporarily shut down, or closed permanently, no recourse is available to the investors.

5.2.2 There is no collateral (even in case of peer to peer lending), as in case of Corporate Bonds. Further, in peer to peer lending, there are no investor protection by way of a compensation scheme to cover defaults like deposit guarantee schemes for bank deposits.

5.2.3 Public funding is sought on the basis of future possibilities as against the clear evidence of a viable existing business model, which is needed under the existing regulations. Investments in companies without viable business model increase the risk of failure and loss to equity investors.

5.2.4 The risk of failure is further increased by the fact that the funding is potentially by participants who do not have the skills and experience needed to assess the risk before investing/lending, as compared to the VCF/PE Investors, banks or other financial institutions who provides funds under the traditional business model.

Eg: Bubble and Balm was a fair trade soap company, who were also the first company to raise funding for their start-up through the equity crowd-funding platform Crowdcube, based in the UK, in 2011. It raised £75,000 in return for 15 per cent of the company's equity from 82 investors, who contributed between £10 and £7,500 each. In July 2013 the business closed overnight, leaving no way of

*contacting the company or a way to recover losses. The investors lost 100% of their investment.*⁴

5.3 Risk of Fraud

5.3.1 There is possibility of genuine websites being used by fraudsters claiming to be promoters of projects or of false websites being established, simply to defraud the investors or to entice individuals to provide credit card details etc. Thus, there is a risk of misuse as well as cyber-security and/or identity theft.

5.4 Central role of the Internet:

5.4.1 Crowdfunding platform is an internet based market place for issuers to sell their own securities to raise capital. Thus the central role of the Internet and its wide reach would increase the number of persons potentially affected, which can be significantly greater than the traditional means of fundraising. Younger investors may get influenced simply because of its link to social media and the Internet.

5.4.2 Funds could be raised from investors residing at various countries without complying with requirement of local laws of various jurisdictions.

5.5 Systemic Risk:

- a) Due to the “individual” nature of crowdfunding, there is a possibility that investors may not practice good diversification principles.
- b) There may be no secondary market in which investors can sell their investments and exit and hence, there is a risk of illiquidity.
- c) There is also possibility of Money laundering.
- d) These platforms could expose other financial sectors to the risk of default, as occurred during the subprime mortgage crisis. If the rapid growth rate in peer-to-peer lending continues, these risks could become systemic.
- e) There are Cross-border implications, if the funds are solicited through internet, as there are disparities in Contract Act or securities law application in different jurisdictions.

⁴IOSCO Staff Working Paper - Crowd-funding: An Infant Industry Growing Fast , 2014

5.6 Information Asymmetry

- a) There is high chance of information asymmetry associated with these platforms, where one party invests/trades based on some information which is unknown to other set of investors. Since there is lack of hard information, there is too much reliance on soft information based on the social networking platforms in this model, which increases the risks.
- b) There is no monitoring of these platforms, as to which account the money goes.
- c) There is lack of transparency and reporting obligations on issuers including with respect to the use of funds raised.
- d) There is possibility of omission of information and misinformation providing distorted view of the issuer or the actual investment, which may result in over-estimation of the actual return. This may induce the investors to invest in a product that would not align with their risk tolerance.

5.7 Substitution of Existing Regulatory Framework

5.7.1 Peer to Peer Lending acts as a Bank by matching lenders/investors with borrowers/issuers, without complying with any of the rigid requirements of Banks.

5.7.2 The Disclosure and due diligence involved in Crowdfunding platform cannot be compared with existing framework of public offering through filing of Prospectus with adequate information, which is also subject to the scrutiny of the Regulators. Further, other public issue requirements for equity shares like to have minimum track record for the issuers, minimum promoters' contribution, lock in, and for debt securities like requirement to have trustees, rating by Credit rating agencies etc. may not be applicable in the crowdfunding platforms.

5.7.3 Further, even private placement requirements have been tightened in India recently i.e. requirement to have Private Placement Offer Letter, restriction on number of investors to whom it can be made, restrictions on mode of placements, etc. Crowdfunding Platforms may not adhere to any of the said requirements.

6.0 Regulatory framework for Crowdfunding in various Jurisdictions:

6.0.1 As of date, very few jurisdictions have come out with regulations for crowdfunding. Some jurisdictions are in the initial stages of introduction with concept papers for feedback of the industry.

6.0.2 Two areas that have seen rapid growth in recent years are Peer-to-Peer Lending and Equity Crowdfunding. Financial Reward (FR) crowd-funding globally has grown rapidly in the last 5 years, with data suggesting that the peer-to-peer lending market doubles each year. It accounts for approximately \$6.4 billion outstanding globally. Collectively, the US, UK and China make up 96% of the overall FR crowdfunding market, with USA accounting for 51%, China for 28% and UK for 17%.⁵.

6.1 Regulatory Practices

In Donation crowdfunding and Reward crowdfunding, only donations or grants are solicited and no financial return in the form of a yield or return on investment is expected by the donor/grantor. Hence, such funding mostly falls outside the purview of Securities market regulator. (In India, payment of donations are mainly governed by the provisions of Income Tax Act). Peer-to-Peer Lending, depending upon whether pure lending or any debt securities are issued, are regulated by Banking or Securities market regulator. Crowd Sourced Equity Funding are mostly regulated by Securities market regulator.

6.2 Regulation of Peer-to-Peer lending

6.2.1 Peer-to-Peer lending is also termed as 'direct consumer lending' or 'marketplace lending'. The Peer-to-Peer lending is approached differently by various regulators, treated as banking by some jurisdictions and as an intermediary in some others, while some jurisdictions like Israel and Japan have prohibited it altogether.

6.2.2 As per IOSCO Paper⁵, though the nature of regulations concerning Peer-to-Peer Lending varies with nations, these can be broadly divided into different categories.

⁵ 'Crowd-funding: An Infant Industry Growing Fast' Staff Working paper of IOSCO Research Department

Regulatory Regime	Description	Countries
Unregulated	In these jurisdictions either the regulation has classified peer-to-peer lending as an exempt market or there is a lack of definition in legislation	Brazil, China, Egypt, South Korea
Intermediary Regulation	This regulates peer-to-peer lending platforms as an intermediary. This usually requires registration of such platform as an intermediary, and other regulatory requirements depending on the jurisdiction.	Australia, Argentina, Brazil, New Zealand
Banking Regulations	This regulated peer-to-peer lending platforms as banks.	France, Germany, Italy
US Model	This is a two tier system. This requires the registration of peer-to-peer lending platforms with the SEC, as well as applying for a licence to conduct business on a state by state basis.	USA
Prohibited	Both peer-to-peer lending and equity crowd-funding are banned under legislation	Israel, Japan

6.3 Regulation of Equity Crowdfunding

In case of Equity Crowdfunding, most jurisdictions have enabled it as an exemption to general requirements regarding public solicitation through prospectus/offering memorandum. While in some jurisdictions such exemption is given only to offer made to “accredited/informed/wealthiest” investors, others exempts solicitation made through “Crowdfunding Platform” capping the amount that can be raised or the amount that can be invested by each investor.

6.4 Regulation of Crowdfunding in various Jurisdictions:

6.4.1 United States

Jumpstart Our Business Startups Act, 2012 or (JOBS Act) has already proposed a basic regulatory framework to regulate Crowdfunding Platforms.

Previously, in U.S. there was a ban on 'general solicitation' or 'general advertising' of investment in securities, other than a prospectus-based offer.

Title II of the JOBS Act deals with equity offers to accredited investors. Pursuant to SEC Rules under that Title, in effect from September 2013, US entrepreneurs may publicly advertise and market their company's investment opportunity, of whatever size, to 'accredited investors' (in effect, individuals with over \$1 million in liquid net worth or annual incomes over \$200,000), including through the Internet or social media, as well as through print, radio or television.

Title III of the JOBS Act deals with Crowd Sourced equity Funding (CSEF) offers to investors generally. It is intended to allow start-up and other companies to use online intermediaries to obtain modest amounts of capital. Title III of the Act, the crowdfunding provision, has not yet come into force.

Under this act, for a transaction to be qualified as a crowdfunding transaction, it must meet specified requirements, including the following:

- the amount raised not to exceed \$1 million in a 12-month period (this amount is to be adjusted for inflation at least every five years).
- individual investments in a 12-month period are limited to:
 - o the greater of \$2,000 or 5 percent of annual income or net worth, if annual income or net worth of the investor is less than \$100,000; and
 - o 10 percent of annual income or net worth (not to exceed an amount sold of \$100,000), if annual income or net worth of the investor is \$100,000 or more (these amounts are to be adjusted for inflation at least every five years); and

- transactions must be conducted through an intermediary that either is registered as a broker or is registered as a new type of entity called a “funding platform.”
- Crowdfunding requires the issuing company (emerging growth company) to file a disclosure document with SEC at least 21 days prior to first sale, and requires scaled financial disclosure, including audited financial statements for raises of over \$500,000.
- Annual reports must be filed with SEC by the issuer company which completes a crowdfunding round.
- Funding platforms (but not broker-dealers) cannot: offer investment advice or make recommendations to investors. They cannot solicit transactions for securities offered or displayed on its platform, or compensating employees or agents for doing so. They cannot hold or manage any investor funds or securities.

In the US, *Kickstarter* enabled creative individuals—musicians, filmmakers, writers—to fund their work, often with the only return being an advance copy or limited edition of a DVD or other art work, concert tickets, or a signed thank-you note.⁶

6.4.2 New Zealand

The recently enacted Financial Markets Conduct Act, 2013 (the Act) contains provisions designed to facilitate CSEF.

The new regulations in New Zealand enables companies to raise up to a maximum of \$ 2 Million from 20 investors in a year through crowdfunding without having to issue a prospectus. It covers both the varieties of crowdfunding: Equity Crowdfunding and Peer-to-Peer Lending.

The market regulator, Financial Markets Authority, has asked both, equity crowdfunding platforms and peer-to-peer lenders, to apply for a license to operate.

⁶ *Crowd Based Equity Funding – Discussion Paper - Corporations and Markets Advisory Committee, Australia, September , 2013*

6.4.3 Australia

The Corporations and Market Advisory Committee (Australian Government) recently came out with a Concept Paper on Crowdfunding and is currently in the process of framing rules for equity based crowdfunding.

The current regulations allow a startup to raise not more than \$ 20 Million or transfer equity to more than 20 people in any given 12 months. This system restricts this channel to a set of sophisticated investors. These rules are under revision.

6.4.4 Canada

Crowdfunding is divided into Non-Equity and Equity Crowdfunding platforms in Canada. Equity Crowdfunding involves the issuance of securities and consist of peer-to-peer (**P2P**) lending and equity transactions.

Canadian Securities Administrators (CSA), an umbrella organization for different provincial and territorial securities regulators in Canada, has published National Instrument (in 2014) involving prospectus exemptions that include the Offering Memorandum exemption (the OM exemption) which is used by registered dealers to sell securities on the internet to the public. The OM exemption is available in all jurisdictions in Canada, except Ontario, and has been in place for many years.

There are registration requirements for Crowd Sourced Equity Funding Platforms, including Integrity, proficiency and solvency requirements, and for the persons operating them.

Registration requirement addresses concerns relating to possible conflicts of interest and self-dealing by intermediaries and to avoid fraudulent offerings of securities to investors through the Internet.

6.4.5 United Kingdom

In March, 2014 Financial Conduct Authority (FCA) came out with regulations governing the crowdfunding in Britain. The new regime will be applicable to the firms operating loan-based crowdfunding platforms and investment-based crowdfunding platforms.

Loan-Based Crowdfunding Platforms: These include peer-to-peer lending platforms or peer-to-business lending platforms on which consumers can invest in loan agreements.

Investment-Based Crowdfunding Platforms: These include the platforms on which consumers can buy investments, such as equity or debt securities that are not listed or traded on a recognized exchange, or units in an unregulated collective investment scheme. In other words, these are 'non-readily realized securities'.

Under the new regulation, investment-based crowdfunding platforms are treated slightly differently to loan-based crowdfunding platforms by the FCA. The new regulations have become effective from April 1, 2014. As a result, the regulation of the consumer credit market has been transferred from the Office of Fair Trading to the FCA. This includes responsibility for regulating loan-based crowdfunding.

New Regulations:

Loan-Based Crowdfunding Platforms:

- The new regulations intend to safe guard the interests of the investors by ring fencing the investments from the platform's finances. Therefore in case anything happens to the platform, the investments would not be hurt. The platforms also need to have a contingency plan or a third party in place to ensure seamless operations.
- Platforms must also have capital reserves to cushion the effect of defaults. Each platform will need to hold £20,000 from October this year and £50,000 from April 2017.

- The new regulations also take a robust view on disclosures. The marketing of the products should not be misleading and all the risks should be adequately highlighted.
- Unlike savings or bank accounts, neither loan or investment-based crowdfunding is covered by the £85,000 Financial Services Compensation Scheme. Thus loan-based crowdfunding is still very much an investment, rather than savings product.
- Investors can cancel their agreement without any penalty within a cooling period of 14 days if the firm does not provide access to a secondary market.
- The new regulations provide access to the financial services ombudsman for all complaints.

How are the new Rules different?

Many established lending-based platforms are already regulated by FCA and therefore largely compliant to the new regulations. However, the regulations put a structure in place for the platforms to manage their risks properly and not promise some ludicrous return.

Investment-Based Crowdfunding Platforms:

Very similar rules apply to investment-based crowdfunding as loan-based - i.e. the marketing must be fair and not misleading, risks should be highlighted and systems must be in place to separate your money from theirs - and ensure there are adequate capital reserves.

The 14 day cooling off period and access to financial ombudsman also apply.

Aside from systems requirements, there are new rules on who is actually allowed to invest their money in crowdfunding. These include:

- retail clients who are advised,
- retail clients classified as corporate finance contacts or venture capital contacts,
- retail clients certified as sophisticated or high net worth, or
- retail clients who confirm that they will not invest more than 10 per cent of their net investible assets in these products.

So the onus is really on the investor to ensure they fall into one of the above brackets, rather than the platform. Investors must tick a box to confirm they fall into one of the above categories.

The investors must also pass an online appropriateness test to prove they are aware of the risks. October 1, 2014 is the deadline for the platforms to launch investor tests.

An investor can also reclassify herself as 'sophisticated' once he/she has made at least two investments in investment-based crowdfunding.

How are the new Rules different?

- The new regulations for investment-based crowdfunding make sure that investors don't get undue exposure and at the same time there is a scope for increasing exposures in incremental phase by following a learning curve.
- The definition of a 'sophisticated' investor is not just restricted to the net worth but also takes in consideration the experience and the confidence that an investor has in such investments.
- Disclosures by the investors play a very crucial role.

6.4.6 France

The old regulations in France allowed a company to raise up to \$ 1,40,000 for equity. This amount has been raised to \$ 14,00,000. But there is no maximum investment cap specified for a particular investor, which makes the investors decide on their risk appetite.

The new laws allows platforms to register as a crowdfunding investment advisor, which will enable platforms to get paid by companies as well as the investors.

Like US, France has also brought in the concept of accredited investors. Previously, the companies were only able to give the complete information (valuation, dates, percent of ownership, etc.) concerning their fundraising to 150 potential investors. The new rules have done away with that cap, allowing for an unlimited number of investors to pitch in cash.

The need for an external audit is done away, but there is a huge impetus on extensive disclosures by issuers both at the time of fund raising and periodically.

Companies will also be allowed to take loans from individuals for a total of up to €1 million, though the loan amount is capped at €1,000 per investor per company.

6.4.7 Japan

Financial Services Agency (FSA), Japan has promulgated an amendment in Financial Instruments and Exchange Act on May 23, 2014 to facilitate and promote, inter alia, Equity Crowdfunding in Japan.

The amendments pertinent to Crowdfunding are given as under:

I. Relaxation of entry requirements of Financial Instruments Business Operators (FIBO).

(FIBO: An entity allowed to engage in the activities of trading, intermediation, brokerage, undertaking in primary and secondary public offerings, and other businesses involving only the securities which they are authorized for.)

Revised Regulations:

- Relaxation of Entry Requirements
 - o Restrictions on the conduct of other businesses would not be imposed on crowdfunding platform operators that handle only 'small amounts' and the minimum capital required for registration would be reduced⁷.
 - o 'small amounts' mean that the total amount offered is less than 100 million yen and the amount of investment per person is 500,00 yen or less.
- Establishment of Rules to protect Investors
 - o To prevent fraudulent behavior, crowdfunding platform operators would be obligated to conduct checks on the businesses of the start-ups and to provide information of issuers, etc. appropriately through the Internet.

⁷ Type I FIBO: 50 million yen (current) reduced to 10 million yen, Type II FIBO: 10 million yen (current) reduced to 5 million yen

7.0 Indian Scenario

7.1. Existing Legal Framework

7.1.1 The provisions in the existing legal framework for raising funds by companies are regulated under Companies' Act 2013 and Securities Act i.e. SEBI Act, 1992, Securities Contracts (Regulation) Act, 1956, Depositories Act, 1996. Raising of pooled managed investment funds by various entities such as Alternative Investment Fund (AIF), Mutual Fund (MF) etc. is regulated under Securities Laws.

7.2. Public Issue of Securities by Companies

7.2.1 Companies making public issue of securities need to comply with public issue requirements prescribed in Companies Act, 2013 and Rules made thereunder, apart from the requirements of SEBI Regulations.

7.2.2 Companies Act requires a company proposing to make a public issue to make a listing application to recognized stock exchanges. It requires the issuing company to file a Prospectus with Registrar of Companies. Further, detailed disclosure requirements for Prospectus are also specified.

7.2.3 Under Section 24 of the Companies Act, 2013, the provisions relating to issue and transfer of securities by listed companies or those companies which intend to get their securities listed on any recognized stock exchange in India shall be administered by SEBI. Hence, SEBI regulates public issuance of securities and those private placements which are proposed to be listed on stock exchange(s).

7.2.4 SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 (ICDR) requires issuers making public issue of specified securities to comply with requirements prescribed there-in which includes appointment of merchant banker, registrar to issue, filing of draft offer document with SEBI, eligibility requirement such as track record, minimum promoter's contribution, lock-in requirements, requirement to have a monitoring agency, etc., apart from detailed disclosure requirements.

7.2.5 However, in case of debt securities, there is a simpler regime and the issuer need to comply with SEBI (Issue and Listing of Debt Securities) Regulations, 2008 (ILDS), which requires compliance with basic requirements like having a Debenture trustee, Credit Rating, disclosure requirements, etc.

Further, once securities are listed in a Recognized Stock Exchange, the issuer has to comply with the continuous listing requirements.

7.3. Private Placements of Securities by Companies

7.3.1 Taking into account the recent misuse of private placement route by some companies which issued huge number of debt securities to public under the garb of private placements, Companies Act, 2013 and Rules made thereunder, have put some restrictions on private placements, which was previously lightly regulated.

7.3.2 As per Chapter III - The Companies (Prospectus and Allotment of Securities) Rules, 2014 , in case of a private placement of securities, private placement offer or invitation **cannot be made to more than 200 persons in the aggregate in a financial year** (excluding Qualified Institutional Buyers and employees of the company being offered securities under a scheme of employees stock option).

7.3.3 Such offer can be made **only to such persons whose names are recorded by the company prior to the invitation** to subscribe, and that such persons shall receive the offer by name, and that a complete record of such offers shall be kept by the company and complete information about such offer shall be filed with the Registrar within a period of thirty days of circulation of relevant private placement offer letter.

7.3.4 All monies payable towards subscription of securities through private placement shall be paid through cheque or demand draft or other banking channels but not by cash. Further, rules require that the payment to be made for subscription to securities shall be made from the bank account of the person subscribing to such securities and the company shall keep a record of all such bank accounts. The company shall allot its

securities within sixty days from the date of receipt of the application money for private placement, else money has to be repaid to the investors.

7.3.5 Company offering securities through private placement **shall not release any public advertisements or utilize any media, marketing or distribution channels or agents to inform the public at large about such an offer.**

7.3.6 Ministry of Corporate Affairs has also notified Companies (Prospectus and Allotment of Securities) Rules, 2014. As per the said Rules, a private placement offer letter shall be accompanied by an application form serially numbered and addressed specifically to the person to whom the offer is made and no person other than the person so addressed in the application form shall be allowed to apply through such application form. The value of such offer or invitation per person shall be with an investment size of not less than Rs.20,000 of face value of the securities.

7.3.7 A return of allotment of securities shall be filed with Registrar of Companies within 30 days of allotment along with a complete list of all security holders containing the full name, address, Permanent Account Number and E-mail ID of such security holder.

7.3.8 Companies Act, 2013 mentions that any offer or invitation that is not in compliance with the provisions of Section 42 shall be treated as a public offer and all provisions of Companies Act, 2013, and the Securities Contracts (Regulation) Act, 1956 and the Securities and Exchange Board of India Act, 1992 shall be required to be complied with, including the above mentioned requirements.

7.3.9 However, as mentioned above, Companies Act, 2013 provides a window for making private placement offers to Qualified Institutional Buyers (QIBs) and the 'limit of 200' is not applicable to such QIBs. QIBs are the entities such as a MF, Foreign Portfolio Investor (FPI), AIF, Scheduled Commercial Bank, IRDA registered Insurance company etc. as defined in SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009.

7.4. Provisions regarding SME Funding

7.4.1 SEBI has taken various steps in the recent past to enable Start-ups and SME to raise funds through various routes such as SME Segment of Exchanges, Institutional Trading Platform (ITP), Category I- SME Fund under AIF Regulations. These channels are briefly defined in the following sections:

7.4.2 SME Segment

7.4.2.1 SEBI has specified framework for a SME segment (platform) on Recognized Stock Exchanges, where Small and Medium Enterprises (SME) can list their securities. A company which has its post-issue face value capital not exceeding ten crore rupees shall list only in SME platform. A company, which has its post issue face value capital more than ten crore rupees and upto twenty five crore rupees, has an option to list in SME platform. In case the post-issue face value capital exceeds Rupees twenty five crore rupees, the issuer should compulsorily list only on main board of the Stock Exchanges.

7.4.2.2 However, a listed issuer whose post-issue face value capital is less than twenty five crore rupees may migrate to SME platform if its shareholders approve such migration by passing a special resolution through postal ballot. An issuer listed on SME exchange proposing to issue further capital pursuant to which their post-issue face value capital may increase beyond Rs. 25 crore shall migrate to the main board, subject to obtaining in-principle approval of the main board before issue of such securities.

7.4.2.3 Various relaxations have been provided to SMEs listing on SME segment under SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009. Some of them are:

- Draft Offer document may be filed directly with the exchange and not necessarily with SEBI.
- Eligibility criteria for an issuer under Regulation 26 is not applicable to companies listing under SME segment.

- Minimum application value of Rs.5000-7000 is not applicable (min. application value shall not be less than Rs. one lakh per application).
- Minimum number of prospective allottees is fifty (instead of 1,000 in Main board).

7.4.2.4 Similarly, relaxations have also been provided with respect to the continuous listing requirements for Companies listed in SMEs:

- Requirement to file half yearly financial results instead of quarterly
- Exemption from publishing financial results in newspaper
- SME companies may send abridged annual report to their shareholders. However, the same need to be displayed on the website of the exchange and company.

7.4.2.5 Apart from the above, there is a compulsory market making requirement for companies listed on SME segment for a minimum period of three years from the date of listing to ensure liquidity in the market.

7.4.2.6 SME Segments were launched on BSE and NSE on December 14, 2012 and September 18, 2012 respectively. There are 60 SMEs listed on the BSE SME Exchange and 5 SMEs listed on the NSE SME Exchange (Emerge) as on June 11, 2014.

7.4.3 Institutional Trading Platform (ITP)

7.4.3.1 SEBI has permitted listing of Small and Medium Enterprises (SME), including start-up companies, on the SME exchange Institutional Trading Platform (ITP), without being required to make an initial public offer. The main features of the ITP Platform following are:

- Only such SMEs which do not have their securities listed on any recognized stock exchange are permitted to list their specified securities exclusively on the ITP.
- The listing process of ITP does not involve an IPO, or private placement or any issue of securities.

- While such companies are listed on the platform, they are not permitted to raise capital.
- Since the trading lot has been mandated as 10 lakh, participation in this platform is restricted to informed investors.
- The companies listed in ITP are SMEs and start-up companies which get visibility by listing in the stock exchanges, without any public issue of their securities.
- The regulatory framework for ITP also envisages that the SMEs listed in this platform will mandatorily exit the platform if (a) a period of 10 years have elapsed since the company was listed in the ITP (b) the paid-up capital of the company is more than twenty five crore rupees (c) the revenue of the company is more than three hundred crore rupees (d) company reaches market capitalization of more than five hundred crore rupees.

7.4.3.2 This platform is merely meant to provide the initial impetus for such SMEs rather than a sustained listing over a long term horizon.

7.4.3.3 In addition to the visibility to SMEs, this framework also provides a trading platform for the scrips of Start-up Companies held by Alternative Investment Funds (AIFs), VCFs etc. and enhances the liquidity in such scrips, which in-turn provide enabling environment for SME and start-up enterprises to flourish.

BSE launched its ITP on February 11, 2014. There are 6 companies listed on ITP of BSE. NSE launched its ITP on October 28, 2013 and there is 1 company listed on it as on June 11, 2014.

7.5. Provisions related to Alternative Investment Funds:

7.5.1 SEBI (Venture Capital Funds) Regulations (“VCF Regulations”) were framed in 1996 to encourage funding by entrepreneurs’ early-stage companies in India. However, since registration of VCF was not mandatory under VCF Regulations, all players in the alternative funds industry were not registered with SEBI. Hence, it was felt that there was a regulatory gap which needed to be addressed. Further, SEBI Board had

approved the proposal for a clear regulatory framework for privately pooled investment vehicles under AIF framework to inter-alia pave way for increased investment in start-ups, SMEs, etc. and also provide for a mechanism to monitor and assess systemic risks and risks to financial market stability posed by the activities of some funds such as Hedge funds.

7.5.2 Considering the same, SEBI notified the framework for registering and regulating Alternative Investment Funds (AIF) through SEBI (Alternative Investment Funds) Regulations, 2012 on May 21, 2012.

7.5.3 These Regulations cover all privately pooled investment vehicles in India raising funds from Indian or foreign investors for investing in accordance with a defined investment policy for the benefit of its investors. However, Mutual Funds, Collective Investment Schemes, Family Trusts, Employee Welfare trusts, Securitization trusts, any other funds regulated by other regulators, etc. are exempted from the ambit of the AIF Regulations.

7.5.4 These regulations seek to cover the funds broadly under 3 categories.

- Category I – which includes Venture Capital Funds, SME Funds, Social Venture Funds, Infrastructure Fund, etc. (which invests in sectors or areas which the government or regulators may consider as socially or economically desirable);
- Category II – which includes private equity funds or debt funds (which does not undertake leverage or borrowing other than to meet day-to-day operational requirements) and
- Category III – which includes Hedge Funds - (employ leverage including through investment in derivatives)

7.5.5 As per the said Regulations, AIF should be prohibited by its trust deed/memorandum and articles of association/partnership deed from making an invitation to the public to subscribe to its securities. AIF shall not accept from an investor an investment of value less than Rs. 1 Crore and no scheme of the AIF shall have more

than 1,000 investors. Further, each scheme of the AIF shall have a minimum corpus of Rs. 20 crore. Further, the manager or sponsor shall have a continuing interest in the AIF of certain percentage of the corpus.

7.5.6 Category I AIFs are further categorized in 4 sub-categories: (i) Venture Capital Funds (ii) Social Venture Funds, (iii) SME Funds, (iv) Infrastructure Funds.

i. Social Venture Funds:

An AIF which invests primarily in securities or units of social ventures and which satisfies social performance norms laid down by the fund and whose investors may agree to receive restricted or muted returns may get itself registered as a Social Venture Fund under SEBI (Alternative Investment Funds) Regulations, 2012. It can accept investment which is not less than one crore and such investor may accept muted returns. Such funds are also entitled to accept grants, provided that utilization of such grants shall be restricted to social ventures. Further, the amount of grants that may be accepted by the fund from any person shall not be less than Rs. 25 Lakhs and no profits or gains shall accrue to the provider of such grants.

There are 3 Social Venture Funds registered with SEBI with a corpus of Rs. 820-900 Crores as on June 11, 2014.

ii. SME Funds:

An investment fund which invests primarily in unlisted securities of investee companies which are SMEs or securities of those SMEs which are listed or proposed to be listed on a SME exchange or SME segment of an exchange may get itself registered as an SME Fund. Such funds:

- shall invest at least 75% of the investible funds in unlisted securities or partnership interest of venture capital undertakings or investee companies which are SMEs or in companies listed or proposed to be listed on SME exchange or SME segment of an exchange
- may enter into an agreement with merchant banker to subscribe to the unsubscribed portion of the issue or to receive or deliver securities in the process

of market making under Chapter XB of the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009

There are 5 SME funds registered with SEBI with corpus in the range of Rs. 1,625 - 2,125 Crores as on June 11, 2014.

iii. Angel Funds:

Under SEBI (Alternative Investment Funds) Regulations, 2012, a sub-category has been created under Category I – Venture Capital Funds called “Angel Funds” vide amendment dated September 16, 2013. Such funds can raise funds from angel investors and make investments in start-ups/early stage companies.

In order to ensure that investment by such angel funds is genuine 'angel investment' in India, it is prescribed that the investee companies:

- a. are incorporated in India and are not more than 3 years old; and
- b. have a turnover not exceeding Rs 25 crore; and
- c. are unlisted, and
- d. are not promoted, sponsored or related to an Industrial Group whose group turnover is in excess of Rs. 300 crore, and
- e. has no family connection with the investors proposing to invest in the company.

Investment in an investee company by an angel fund shall not be less than Rs. 50 lakhs and more than Rs. 5 crore. Such conditions are expected to ensure that the investments are genuine investments in start-ups/ early stage companies in India.

Minimum Corpus of an Angel Fund shall be Rs.10 Crores. Minimum investment from each investor shall be Rs. 25 Lakhs. As Angel investments are highly risky investments, necessary restrictions are imposed on the eligibility of the investors in order to ensure that only investors who have prior experience/ adequate awareness of such investments and who have sufficient capital invest in such funds. Reduced mandatory minimum sponsor/manager contribution is made applicable to Angel Funds comparing to other AIFs, i.e. 2.5% of the corpus/ Rs. 50 lakhs, whichever is lesser.

There is 1 Angel Fund registered with SEBI as on June 11, 2014.

8.0 Is Crowdfunding really needed ?

8.1 As mentioned earlier, the 2008 financial crisis resulted in failure of number of Banks and, consequently, the new capital adequacy regulations for banks, such as Basel III were implemented. As a result, credit providers have become increasingly constrained in their ability to lend money to the real economy.

8.2 IOSCO Paper states that the amount of bank loans made in Western Europe and the USA dropped significantly at the beginning of the crisis. While there have been some signs of recovery in the US (although the growth rate is still below pre-crisis levels), in Western Europe the growth rate in loans to the non-financial corporate sector has been negative, especially to SMEs in the EU. In this funding vacuum, peer-to-peer lending and other Crowdfunding Platforms are growing in popularity, as bank liquidity is reduced and new regulatory requirements make obtaining loans for small and medium enterprises and individuals difficult.

8.3 In India, during the last few years, the IPO market has not been very active. Though, SEBI, has been at the forefront in facilitating fund raising by SMEs through measures like SME segment in Stock Exchanges, Category I- SME funds under AIF, Institutional Trading Platform, etc., still there is need to encourage innovative way of fund raising to provide an impetus to genuine SMEs/Start-ups and to explore other alternative models of fund raising with appropriate framework in consonance with retail investor protection.

8.4 Since the "Crowdfunding" phenomenon is gaining its popularity, its importance cannot be ignored. To regulate crowdfunding, it is very important to take note that while it is necessary to ensure that Start-ups/SMEs could raise funds at ease, it is equally important to ensure that no systemic risks are created wherein retail investors are lured by some unscrupulous players by substituting the existing framework, which has been developed over a period of time through experience and observation. Hence, there is

necessity to strike a proper balance between investor protection and the role equity markets can play in supporting economic development and growth.

8.5 While some regulators are criticized by media from “taking the crowd out of crowdfunding”,⁸ there are also media reports explaining the risks in the model and stating that regulators who are today denounced for their intervention will then be castigated for their neglect.⁹

8.6 IOSCO Paper states that *“A risk posed by moving to regulate a previously exempt sector is the perceived rubber stamping of the industry through regulation, creating credibility in the peer-to-peer lending and equity crowd-funding markets.*

This could attract less experienced investors to these markets who may not understand the risks involved in these types of investment.

8.7 Therefore it would be appropriate for regulators to take appropriate stand in this regard and send out a message to the various stakeholders recognizing this emerging route of funding. India, so far, does not face a significant exposure to crowdfunding but given that this mode of fund raising is growing at a scorching pace, it is important that regulators keep an open eye and a vigilant attitude.

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 ?*

⁸<http://www.theguardian.com/technology/2014/mar/06/crowdfunding-regulator-10-percent-rule>

⁹<http://www.johnkay.com/2014/03/25/regulators-will-get-the-blame-for-the-stupidity-of-crowds>

9.0 Proposal for Crowdfunding in India

9.0.1 SEBI has provided various frameworks for raising of funds by startups, SMEs etc. as specified in the paragraph 7. In addition to the available frameworks, SEBI seeks to provide fresh avenues for startups and SMEs set up by young entrepreneurs and technology professionals to raise early stage funding through internet based platforms, potentially more efficiently and cost effectively than through public issue or private placement offering.

9.0.2 Crowdfunding is an innovative way to provide modest amount of funding to young entrepreneurs and technology professionals needing early stage or seed capital for startup companies which may spur entrepreneurship and ultimately assist in boosting the growth of real economy.

9.0.3 A company raising funds through online crowdfunding platforms or websites offers equity or debt interests in its business to investors who make small contributions, through a crowdfunding platform or social media. In most of the cases funding is sought online on the basis of future projections rather than a viable business model in operation which increases the risk of failures and therefore loss to the investors.

9.0.4 If the costs associated with regulatory provisions for investor protection are excessive, crowdfunding may not become a viable capital raising method. At the same time investors would be concerned about the risks of crowdfunding and may not be prepared to invest if there are no adequate safeguards in place. Therefore the proposal seeks to strike a balance between retail investor protection and capital market access to such ventures by providing adequate investor safeguard without creating too many entry barriers or significant regulatory burdens on the issuers.

9.0.5 Pure Donation Based Crowdfunding (where issuers directly seek donation from the grantors), Reward Based Crowdfunding (where issuers directly offers rewards like movie tickets, new computer game, download of a book etc.) and Peer-to-Peer lending do not fall within the regulatory purview of SEBI, as they do not generally involve

issuance of securities for financial return, and may require authorization from other regulators. For example, Peer-to-Peer lending may fall under the purview of RBI.

9.0.6 Taking into account various provisions under the Indian law and crowdfunding framework in other jurisdictions, this proposal seeks to explore the possibilities of having Security Based Crowdfunding framework in India within the existing legal framework.

9.0.7 Crowdfunding is intended to facilitate raising of modest amount by startups and SMEs for early stage funding and it is not necessary or appropriate to allow certain complex or hybrid products. Under the Security Based Crowdfunding, the possible routes which are being explored are as follows:

1. Equity based Crowdfunding (EbC)
2. Debt based Crowdfunding (DbC)
3. Fund based Crowdfunding (FbC)

9.0.8 In all the approaches, the Crowdfunding Platform plays a central role where investors can meet promising start up companies. The web based crowdfunding platform will facilitate raising of capital through its website from investors who have access to such platform. The first 2 routes are primarily based on the Private Placement route as defined under Section 42, Companies Act 2013. The FbC route is primarily modeled on SEBI (AIF) Regulations, 2012.

9.0.9 Before dealing with these routes it is important that the following are established:

- the investors that are allowed to invest through the crowdfunding platforms,
- the types of entities that are allowed to raise funds through this channel and the disclosure requirements,
- the types of entities that are allowed to set up internet based Crowdfunding Platforms to enable online solicitation from such investors,

and the different associated aspects.

9.1 Who can be the Investor?

9.1.1 Various jurisdictions have imposed different restrictions on investments and categories of investors who are allowed to invest in companies which are displayed on such internet based crowdfunding websites or platforms, such as:

Jurisdiction	Limitations on Investment under Crowdfunding
USA	In a 12 month period, investors are allowed to invest • \$2,000 or 5 percent of their annual income or net worth, whichever is greater, if both their annual income and net worth are less than \$100,000. • 10 percent of their annual income or net worth, whichever is greater, if either their annual income or net worth is equal to or more than \$100,000.
UK	• No limit for investors advised by professionals, linked to corporate finance or venture capital firms, or those certified as sophisticated or high net worth. • Not more than 10% of assets - excluding homes and pensions, for other investors.
Australia	One of the option proposed is that the investor needs to be sophisticated i.e. have assets of worth at least \$ 2.5 million or have a gross income of at least \$ 250,000 for each of the last 2 financial years.
France	€1,000 per campaign
Canada	A maximum of \$2,500 in a single investment and \$10,000 per year

9.1.2 It is necessary that the investors who seek to invest in crowdfunding understand the inherent risks involved in the speculative nature of start-up companies and illiquid nature of their securities and can bear the loss of the entire investment.

9.1.3 In Indian scenario, considering the necessity to provide alternative funding sources to Start-ups and at the same time to ensure that retail investors are not made to bear

the risks of Start-up ventures, it is proposed to permit only **Accredited Investors** to participate in crowdfunding.

9.1.4 The Accredited Investors:

9.1.4.1 The proposed accredited investors who may be allowed to invest through crowdfunding platforms are as under:

- Qualified Institutional Buyers (QIBs) as defined in SEBI (Issue of Capital and Disclosure Requirements) regulations, 2009 as amended from time to time,
- Companies incorporated under the Companies Act of India, with a minimum net worth¹⁰ of Rs. 20 Crore,
- High Net Worth Individuals (HNIs) with a minimum net worth Rs. 2 Crores or more (excluding the value of the primary residence or any loan secured on such property), and
- Eligible Retail Investors (ERIs):
 - o who receive investment advice from an Investment Adviser, or
 - o who avail services of a Portfolio manager, or
 - o who have passed an Appropriateness Test (may be conducted by an institution accredited by NISM or the crowdfunding platforms),**and**
 - o who have a minimum annual gross income of Rs. 10 Lacs,
 - o who have filed Income Tax return for at least last 3 financial years,
 - o who certify that they will not invest more than Rs. 60,000 in an issue through crowdfunding platform,
 - o who certify that they will not invest more than 10% of their net worth through crowdfunding. (Net worth excludes the value of the primary residence or any loan secured on such property).

9.1.4.2 Thus those retail investors who have knowledge, experience or have access to investment advice and have resources to cope with the losses on their investments in a

¹⁰ Net Worth is calculated as the aggregate value of paid up equity capital plus free reserves (excluding reserves created out of revaluation) reduced by the aggregate value of accumulated losses and deferred expenditure not written off, including miscellaneous expenses not written off.

start up, are eligible to invest as ERI in crowdfunding and come within the category of accredited investors.

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.

9.1.5 Investment Limits:

9.1.5.1 Chapter III - The Companies (Prospectus and Allotment of Securities) Rules, 2014 specifies that in case of a private placement of securities the offer or invitation to subscribe shall not be made to more than 200 investors in a financial year. Any offer or invitation made to QIBs or to employees of the company under a scheme of employees stock option shall not be considered while calculating the limit of 200 persons.

Therefore, EbC and DbC shall allow private placement offers through internet based crowdfunding platforms to any number of QIBs and a maximum of 200 HNIs and ERIs combined.

9.1.5.2 In some jurisdictions, e.g.in Italy professional investors must own at least 5% of the equity in a crowdfunded venture. The apparent intention is to give some form of comfort to retail investors that the issuer is genuine as one or more sophisticated investors have chosen to invest. It is therefore proposed that QIBs, Companies and HNIs should be required to own at least a certain percentage in every issue through EbC and DbC.

9.1.5.3 Chapter III - The Companies (Prospectus and Allotment of Securities) Rules, 2014 specifies that in case of a private placement of securities, **the minimum offer value per person must be at least Rs. 20,000 of the face value of the securities.** In view of the above, we propose that:

- A QIB is required to purchase at least 5 times of the minimum offer value per person as specified in the aforementioned rule. **Collectively all the QIBs shall hold a minimum of 5% of the securities issued.**
- A Company is required to purchase at least 4 times of the minimum offer value per person as specified in the aforementioned rule.
- A HNI is required to purchase at least 3 times the minimum offer value per person.
- An ERI is required to purchase at least the minimum offer value per person. The maximum investment by an ERI in an issue shall not exceed Rs. 60,000. The total of all investments in crowdfunding for an eligible retail investor in a year should not exceed 10% of its net worth.

***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.*

***Question 4:** Is the limit of investors upto 200 besides QIBs or employees of the company under a scheme of employees 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 upto 1,000 investors, excluding QIBs or employees of the company under a scheme of employees stock option?*

9.1.6 Investment Conditions:

- The ERIs and HNIs must sign a '**Risk Acknowledgement**' that they understand the risk of illiquid nature of investment and potential loss of entire investment, and that they can bear the loss.
- The issue has to be in Demat form thus all the accredited investors need to hold a demat account.
- The payment has to be made through a cheque or a demand draft or another banking channel. Payment by Cash and Credit Cards shall not be accepted.
- The ERIs must be an Indian citizen / NRI.
- ERIs must fulfill the eligibility requirements as specified in the paragraph 9.1.4.1.

- Investments by foreign investors shall, however, be subject to guidelines as may be specified by RBI and government of India from time to time.

Question 5: *Are the Investment Conditions mentioned in the paragraph 9.1.6 enough to warn and guard investors regarding the risky nature of crowdfunding? Specify changes, if any, along with the rationale.*

9.2 Who can raise funds from Crowdfunding Platform and Limitations on capital raised?

9.2.1 Crowdfunding is intended to solve the funding problems of early stage startups and SMEs. The existing various sources of funding through capital markets for startups and SMEs in India have been summarized in paragraph 7.

9.2.2 As crowdfunding shall entail substitution or relaxation of requirements of prospectus or listing etc. various jurisdictions have imposed different set of limitations on the amount allowed to be raised through online crowdfunding platforms and the conditions to be satisfied by the issuing companies. Some of these are listed as under:

Jurisdiction	Limitation on capital Raised
USA	\$1,000,000 in a period of 12 months
UK	€2.5 million in a period of 12 months
New Zealand	NZ\$2 million from 20 investors in any 12 month period
Australia	Not more than \$2 million or transfer equity to more than 20 people in a 12 month period
France	€1m (£827,951) per campaign per year
Canada	\$1.5 million over one year

9.2.3 Some jurisdictions have also imposed restrictions on the nature of companies which can raise capital from such crowdfunding platforms, e.g. in Italy crowdfunding is restricted only to innovative startups. To be innovative a firm must be recognized as

such by the Chamber of Commerce and to be startup a firm can be no more than 48 months in existence.

9.2.4 Crowdfunding can provide an alternative source of capital for startups and SMEs that either have limited access to capital or have exhausted other available sources of capital. It is, therefore, proposed that the additional channel of crowdfunding platform to raise modest amount of funds is allowed to be accessed by early stage startup or SME which is an unlisted public company incorporated in India, under EbC or DbC routes as mentioned in paragraph 9.4, provided it is:

- a company intending to raise capital not exceeding Rs. 10 Crores in a period of 12 months. Companies which intend to make issue more than size of Rs.10 Crores may raise funds by complying with the provisions of SEBI (ICDR) Regulations and list them on a SME Platform or main board of a recognized stock exchange,
- a company which is not promoted, sponsored or related to an industrial group which has a turnover in excess of Rs. 25 Crores or has an established business,
- a company which is not listed on any exchange,
- a company which is not more than 48 months old,
- a company which proposes to engage in non-financing ventures, i.e. funds raised through the crowdfunding platform will not be further used for providing loans or investments in other entities, and
- a company which is not engaged in real estate and activities which are not permitted under industrial policy of Government of India.

9.2.5 Further, to ensure only genuine entities raise funds through this mode:

- The issuing company, its directors, promoters or associates have not been prohibited from accessing or operating in the capital markets or restrained from buying, selling or dealing in securities under any order or direction passed by the SEBI.
- The issuing company, its directors, promoters or associates are not mentioned as a 'defaulter' or a 'wilful defaulter' by RBI or CIBIL.
- The director(s) or promoter(s) are not disqualified to be appointed as director(s) under the Companies Act 2013.

- The issuing company, its directors, promoters or associates are 'fit and proper' persons as specified under the Schedule II of the SEBI (Intermediaries) Regulations, 2008.

9.2.6 In addition to above, the issuers must also comply with the following:

- In a given period of 12 months, Issuers shall not use multiple crowdfunding platforms to raise funds.
- Issuers shall not directly or indirectly advertise their offering to public in general or solicit investments from the public.
- Issuer shall compulsorily route all crowdfunding issues through a SEBI recognized Crowdfunding Platform.
- Issuers shall not directly or indirectly incentivize or compensate any person to promote its offering.
- Issuers shall provide provisions for oversubscription. This may include maximum oversubscription amount to be retained, which should not exceed 25% of the actual issue size; intended usage of the oversubscribed amount. The total amount retained, including the actual issue size and oversubscription, shall not exceed the limit of Rs. 10 Crores.

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 issuers? Specify changes, if any, along with the rationale.*

9.3 Disclosure Requirements on Issuer

9.3.1 It is proposed that Crowdfunding follow a disclosure based regime. It is very important that the companies seeking to raise funds through crowdfunding disclose true and factual information to facilitate investors in an informed decision making. The disclosures are required (i) when an issuer approaches the crowdfunding platform with the intention of raising funds from the accredited investors registered with the platform, and (ii) at regular intervals on an ongoing basis.

9.3.2 Though different jurisdictions have specified different set of disclosures for the issuers, the basic spirit behind this is to enable the investors to make an informed decision regarding their investments and to keep a track of the growth of their investments on a continuing basis. The disclosure requirements in different jurisdictions are as follows:

Jurisdiction	Required disclosures
USA	• The name, legal status, physical address and Web site address of the issuer; • The names of the directors and officers (and any persons occupying a similar status or performing a similar function), and each person holding more than 20 percent of the shares of the issuer; • a description of the business of the issuer and the anticipated business plan of the issuer; • a description of the financial condition of the issuer⁸³; • a description of the stated purpose and intended use of the proceeds of the offering sought by the issuer with respect to the target offering amount; • statement on excess investment; • description on other offerings, related party transactions and financial condition; • the target offering amount, the deadline to reach the target offering amount and regular updates regarding the progress of the issuer in meeting the target offering amount; • intermediary identification and compensation; • the price to the public of the securities or the method for determining the price; and • a description of the ownership and capital structure of the issuer. • In addition, Section 4A(b)(1)(I) specifies that the Commission may require additional disclosures for the protection of investors and in the public interest.

UK	Investors should be presented with information that is "fair, clear and not misleading" when deciding whether or not to make an investment. No specific disclosures mandated by the regulator.
New Zealand	Issuers making Crowd Sourced Equity Funding(CSEF) offers through licensed CSEF intermediaries will be exempt from the normal requirements to register a product disclosure document.
France	A document with information concerning the company, its activities and its financial situation.
Canada	• Detailed business plan • Disclosure of the issuer's cash with third party confirmation if the issuer has not incurred any expenditures and its only asset is cash; or • Annual financial statements if the issuer has incurred expenditures; or • Audited annual financial statements if the issuer has raised more than \$500,000 under the crowdfunding prospectus exemption or any other prospectus exemption since its formation and has expended more than \$150,000 since that time.

9.3.3 Though the disclosures may not be as elaborate as IPO disclosures, which would increase the cost of compliance, some basic details of the company need to be provided. Therefore it is proposed that, a company intending to raise funds through crowdfunding platform submit an **Private Placement Offer Letter** to the Crowdfunding Portal, which inter alia may contain the following:

- i. Name of the company & Registered office address
- ii. A description of the current/new venture for which the funds are being raised (Anticipated Business Plan)
- iii. Issue Size and specified target offering amount and intended usage of funds
- iv. A description on the valuation of securities offered
- v. Past history of funding, if any
- vi. History of any prior refusal from any Crowdfunding Platform

- vii. A description of financial condition of the company including Audited financial statements of 1 year, if any (Balance sheet, Profit and Loss Account, Cash Flow Statements)
- viii. Price of securities offered and the rights and liabilities attaching to the securities
- ix. Ownership details and capital structure
- x. Details regarding Board, Management and Group entities, persons with a shareholding of 20% or more, etc.,
- xi. Principal risks to the issuer's business
- xii. Grievance redressal and Dispute resolution mechanism, such as arbitration mechanism
- xiii. Such other information as SEBI may specify

9.3.4 The Private Placement Offer Letter submitted by the issuer shall be circulated online only to those selected accredited investors who are registered with the crowdfunding platform and have made a commitment, not numbering more than 200, and excluding QIBs.

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.*

9.3.5 Though future projections are not allowed in offer document of a public issue, but in crowdfunding, owing to the lack of any meaningful business history or financial track record, decision making is significantly based on the future projections made by the issuer. So it becomes important that a realistic view into the future growth path of the issuer is provided to the prospective investors. These projections should be based on some trusted third party research and realistic assumptions.

Question 8: *Due to the lack of history and track record, it is important that the 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?

9.3.6 The issuing companies shall also be required to submit information on an ongoing basis. It is proposed that the issuing companies submit biannual disclosures to the Crowdfunding Platform, which inter alia may contain the following:

- i. Audited financial statements (Balance sheet, Profit & Loss statement, Cash flow statement etc.)
- ii. Utilization of funds raised in accordance to the object of the issue as specified at the time of the issue
- iii. A detailed view of the current state of business and the progress made since last disclosure
- iv. Any other funding raised since the last disclosure
- v. Any penalty, pending litigation or regulatory action against the company or promoter(s) or director(s)

9.3.7 Such ongoing disclosures shall be displayed by the platform on its website and will be available to accredited investors who are registered with such platform.

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?

9.4 Who can set up a Crowdfunding Platform?

9.4.1 It is necessary that crowdfunding platforms are not established or not used to facilitate fund raising by fraudulent entities. It is therefore important to specify integrity, experience and solvency requirements applicable to crowdfunding platform owner and the key persons associated with it. Therefore it is proposed that any online offering or issue or sale through the internet can be made only through a SEBI recognized crowdfunding platform.

9.4.2 If it is intended to develop a framework for Crowdfunding Platform, the criteria for eligibility or recognition need to be specified.

9.4.3 The entities who can set up a crowdfunding platform or website and their roles and responsibilities in different jurisdictions are as follows:

Jurisdiction	Roles and Responsibilities of Crowdfunding Platform
USA	If the online platform just lists an entrepreneur's or company's pitch, uses a third party to manage the transfer of both cash and stock, and offers general support services that don't fall into these categories of activities, it can register as a crowdfund investment portal. If it conducts any of these activities, it must register as a full broker-dealer. It has the following responsibilities: • directors, officers or partners (or any person occupying a similar status or performing a similar function) are prohibited from having any financial interest in an issuer using its services • required to take steps to reduce the risk of fraud by obtaining a background and securities enforcement regulatory history check on each officer, director, and person holding more than 20 percent of the outstanding equity of every issuer whose securities are offered by such intermediary • Intermediary and its associated persons prohibited from accepting an investment commitment unless the investor has opened an account with the intermediary and the intermediary has obtained from the investor consent to electronic delivery of materials • Intermediary required to deliver to the investors educational materials at the time of account opening • Intermediary required to disclose its compensation structure to the investor • Intermediary required to make issuers' information available at least 21 days prior to the issue • Intermediary to ensure that an investor's investment limit is not breached before it makes an investment • Intermediary to provide communication channels on its website for

	investors to connect amongst themselves as well as for an investor to connect to an issuer • Intermediary to ensure that all proceeds are only provided to the issuer when the aggregate capital raised from all investors is equal to or greater than a target offering amount, in case it is a broker. In case of funding portal, since it cannot receive funds, it would direct the funds to a qualified third party like bank, which then makes the transfer to the issuer once the proceeds equal or exceed the target amount • Funding portals required to maintain a fidelity bond as a contingency fund
UK	Crowdfunding platforms will be able to make direct offers to retail clients for a period of 12 months so long as the investor signs a Restricted Investor Statement. Crowdfunding platforms therefore need to ensure that they (a) include the name of the firm; (b) provide accurate information on the firm and not emphasize potential benefits of the investment without also giving a fair indication of the risks; (c) present the information in an easily understandable way; and (d) not disguise or hide any important statements or warnings. The FCA does not prescribe the level of due diligence which needs to be undertaken by crowdfunding platforms to assess the benefits and risks involved with each particular investment.
New Zealand	• The provider has fair, orderly, and transparent systems and procedures for providing the service: • The service is designed primarily for offers by persons other than the provider and its associated persons: • The provider has an adequate policy for identifying and managing the risk of fraud by issuers using the service (the anti-fraud policy) that, at a minimum—

	(i) checks, against publicly available and readily accessible information, the identity of the issuer and information provided by the issuer relating to the identity and character of its directors and senior managers; and (ii) excludes an issuer from using the service if the provider— (A) is not satisfied as to the identity of the issuer or of the issuer's directors and senior managers; or (B) has reason to believe that any of the issuer's directors or senior managers are not of good character; or (C) has reason to believe that the issuer is not likely to comply with the obligations imposed on it under the service • The provider has adequate disclosure arrangements to give investors, or to enable investors to readily obtain, timely and understandable information to assist investors to decide whether to acquire the shares (for example, through initial disclosure, or question and answer forums, or other information that is made available) • The provider has an adequate policy (a fair dealing policy) for excluding an issuer from using the service if the provider has information (for example, from checks or assessments it carries out (if any)) that gives it reason to believe that the issuer, in relation to any dealing in shares using the service, has— (i) engaged in conduct that is misleading or deceptive or likely to mislead or deceive; or (ii) made a false or misleading representation in contravention of section 22 of the Act; or (iii) made an unsubstantiated representation in contravention of section 23 of the Act:
--	--

	• The provider has adequate systems and procedures for implementing the anti-fraud policy and the fair dealing policy: • The provider has adequate systems and procedures for ensuring that each issuer does not raise more than \$2 million in any 12-month period under the service: • The provider has adequate systems and procedures for handling conflicts between the commercial interests of the provider (or of its associated persons) and the need for the provider to have fair, orderly, and transparent systems and procedures for providing the service. • If a broking service is to be provided by the provider in the course of providing the service, the provider is, or will be, registered under the Financial Service Providers (Registration and Dispute Resolution) Act 2008 for the broking service on and from commencing to provide the broking service.
Australia	• The website operator needs to demonstrate that it has sufficient resources (including financial, technological and human resources) and adequate other arrangements (including arrangements for handling of conflicts of interest involving the licensee) to ensure that, to the extent that it is reasonably practicable to do so, the market a fair, orderly and transparent. • In case, a CSEF (Crowd Sourced Equity Funding) website is promoter of a company seeking funds through that website, it can call for additional disclosures like details of any benefits to that promoter. • Advertising restrictions on the CSEF website.
France	They are supposed to provide the following services: • Non-guaranteed placement • Order receipt-transmission on behalf of third parties (ORT) • Order execution on behalf of third parties

	• Operation of a multilateral trading facility • Investment advice
Canada	Portals must comply with general registrant requirements applicable to EMDs (with certain exceptions), including minimum capital, insurance, regulatory reporting, record-keeping and record-retention requirements. Portals will be required to: • conduct background checks on issuers, directors, officers, promoters and control persons, • understand the general structure, features and risks of a security offered, • review the information presented by the issuer on the portal's website to confirm that the information adequately sets out the general features and structure of the security, issuer-specific risks, parties involved, any identified conflicts of interest, and the intended use of funds, • deny access to an issuer if it has reason to believe that the issuer or its offering is fraudulent, and • provide investor education materials in plain language and obtain a signed risk acknowledgement form from investors

9.4.4 Recognition of Crowdfunding Platform

9.4.4.1 It is proposed that the entities who fall in any of the following classes be allowed to set up a crowdfunding platform.

9.4.4.2 Class I Entities:

- Recognized Stock Exchanges with nationwide terminal presence (RSEs)
- SEBI registered Depositories

9.4.4.3 In addition to the entities mentioned above, it is proposed that the another class of entities with relevant experience and domain knowledge be allowed to launch

crowdfunding platforms to ensure a healthy competition in the market, provided they satisfy the requirements specified by SEBI.

9.4.4.4 Class II Entities:

- Technology Business Incubators(TBIs)
 - o promoted by Central Government or any State Government through bodies such as NSTEDB (National Science & Technology Entrepreneurship Development Board) under Department of Science & Technology
 - o functioning as a society registered under societies act of 1860/or as a non-profit making section 8 company,
 - o having at least 5 years of experience,
 - o having a minimum net worth of Rs. 10 Crores
 - o should have attained self-sufficiency and,
 - o should display only those companies which share a common focus thrust areas as the TBI

9.4.4.5 A joint venture of a Class I entity and a Class II entity is also acceptable for setting up a Crowdfunding Platform as this would bring the best of both classes.

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 a 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?*

Question 11: *Any suggestions on some other possible entities which can be included in Class II with a tentative list of qualifying criteria?*

9.4.4.6 To enable Fund based Crowdfunding (FbC), it is proposed that the new class of *Crowd Fund* AIFs be allowed to be displayed on the platforms launched by RSEs and depositories. In addition to these platforms, a dedicated class of platform owners is

proposed to enable FbC launching crowdfunding platforms provided they satisfy the requirements specified by SEBI.

9.4.4.7 Class III Entities:

- Associations and Networks of PE or Angel Investors
 - o with a track record of a minimum of 3 years
 - o with a minimum member strength of 100 active members from the relevant industry
 - o which are registered as Section 8 companies under Companies Act 2013 with a paid up share capital of Rs. 2 Crores

9.4.4.8 Thus the platforms launched by Class I & Class III Entities can enable the FbC.

Question 12: *Any suggestions on some other possible candidates which can be included in Class III for the purpose of providing platform for FbC? Also specify their tentative qualifying criteria?*

9.4.4.8 To prevent fraudulent offering of securities via the internet, it is proposed to provide that no entity can raise funds through crowdfunding without channeling their issues through a recognized Crowdfunding Platform, subject to the approval of Screening Committee.

9.4.5 Requirements on Crowdfunding Platform:

Taking into consideration the risky nature of securities offered, the Crowdfunding platforms must play the role of a gatekeeper and take reasonable measures to reduce the risk of frauds. This requires adequate capital, technological and human resources to carry out the business in a complying manner. Thus it is proposed that the obligations of such platforms shall be as under:

- to conduct screening and basic due diligence of the business of the start up. However, no amount of due diligence can provide any form of guarantee of the commercial success.
- to conduct background and regulatory checks on the issuers, whole time directors, promoters, shareholders holding more than 20% of equity shares in the company
- review the information presented by the issuer on the portal's website to confirm that the information adequately sets out the general features and structure of the security, issuer-specific risks, parties involved, any identified conflicts of interest, and the intended use of funds
- to conduct due diligence of investors such as net worth requirement and KYC requirement, if any, while maintaining the privacy of the investors
- deny access to an issuer if it has reason to believe that the issuer or its offering is fraudulent
- maintain a record of all the issues brought by the companies and subsequently the disclosures of the issuing companies and make it easily accessible to the investors
- collect and transmit information to SEBI as may be called for

Question 13: *Any suggestions on some additional or reduced requirements on Crowdfunding Platforms?*

9.4.6 Further, to ensure a seamless operation and avoid any conflict of interest a Crowdfunding Platform shall also be required to satisfy the following conditions:

- Platform needs to own the Domain ID/website/URL and mention the same in the application for recognition with SEBI and should have adequate systems and procedures to manage the daily operations as well as the emergency situations.
- Platform needs to have adequate human, technology and risk management capabilities
- Platform needs to have fair, orderly and transparent processes
- Platform needs to have procedure to address possible conflicts which may arise between issuers and the platform
- Fund raising by subsidiaries/associates or other entities related to the Platform Owners shall not be allowed

- An elaborate contingency/termination plan need to be formulated with minimum impact on the investors, to ensure a seamless operation in the event of closure or financial distress in the crowdfunding platform
- Crowdfunding platforms shall not offer investment advice, solicit, manage funds or securities, incentivize employees for such sale of securities displayed on the platform or make recommendations to investors.
- Only accredited investors registered with a crowdfunding platform can invest through that crowdfunding platform. Only Indian start-up companies or SMEs or *Crowd Funds* can raise funds through these crowdfunding platforms.
- Platform shall provide a Grievance Redressal mechanism for the investors as well as the issuers
- The task of due diligence of the issuing companies is very crucial to differentiate a genuine issuer from a fraud. The due diligence, among other things, will involve track record of the Promoters, Directors, Key Managerial Personnel, business carried on by the company, proposed business plans, Opportunities, Strategies, Litigations, etc.
- Apart from the basic due diligence, it is important that the platform puts in place some sort of filtering mechanism to differentiate between the quality of ideas and business plans. For this purpose, it is proposed that every crowdfunding platform will have a '**Screening Committee**' with a variety of experience from different domains and sectors.

9.4.6.1 It is proposed that the **Screening Committee** of a Crowdfunding Platform may have a strength of a minimum of 10 persons, which may have follow the following composition:

- at least 40% of the committee should be composed of professional with expertise in mentoring of startups and early stage ventures,
- at least 30% of the committee should be composed of professionals with experience in banking or capital markets,

- not more than 30% of the committee should be composed of persons of high caliber and qualifications which are nominated by the owner of the crowdfunding portal, but not on its payrolls.

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.*

Question 15: *Any suggestions on the role and responsibility of the screening committee and its composition etc.?*

9.4.7 Along with the companies raising fund by crowdfunding platform, the investors also need to be subjected to a moderate level of due diligence. This is to make sure that investors, particularly ERIs, are accredited and that they invest in accordance to the net worth conditions specified by SEBI. The task of due diligence of investors in crowdfunding could be given to the platform or some third parties which can be SEBI registered intermediaries like brokers, depository participants (DP), Investment Advisers, Portfolio Managers etc. ERIs and HNIs may be required to submit, among other things, a net worth certificate from a Chartered Accountant to Stock Broker /Investment Adviser/Portfolio Manager and also make a declaration or sign a 'Risk Acknowledgement' regarding the understanding of risks in their investments.

9.4.8 Crowdfunding Platforms may charge a nominal fee from the company seeking funds through the platform and the accredited investors looking for a good investment opportunity in the companies which shall be displayed on the website only after a comprehensive due diligence and screening.

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?*

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?*

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?*

9.5 Equity based Crowdfunding (EbC)

9.5.1 This route, as the name suggests, enables the issuers to raise upto Rs. 10 Crores online by issuing equity shares through a recognized crowdfunding platform and offering equity stake in their business to the accredited investors who are registered with the platform.

9.5.2 A company desirous of raising funds by EbC route through a crowdfunding platform may do so after it duly satisfies the due diligence and screening criteria set by the platform.

9.5.3 These issues shall be further subject to the following conditions:

- No single investor shall hold more than 25% stake in a company.
- The promoter(s) shall be required to maintain a minimum of 5% equity stake in the company for at least 3 years.

9.5.4 The issuers shall comply with the requirements specified in paragraph 9.2 and follow the procedure as specified in paragraph 9.8. The Private Placement Offer Letter will contain, inter alia, the disclosures as mentioned in paragraph 9.3.

9.5.5 The investors who invest in equity issues through EbC shall have rights of a equity shareholder as given in the Companies Act.

Question 19: *Any suggestions on the requirements in EbC to make it more transparent and investor friendly?*

9.6 Debt based Crowdfunding (DbC)

9.6.1 This route, as the name suggests, enables the issuers to raise upto Rs. 10 Crores online by issuing debentures or debt securities through a recognized crowdfunding platform to the accredited investors who are registered with the platform.

9.6.2 A company desirous of issuing debt securities by DbC route through a crowdfunding platform may do so after it duly satisfies the due diligence and screening criteria set by the platform and fulfills requirements as specified in paragraph 9.2.

9.6.3 These issues shall be further subject to the following conditions:

- The debt securities issued should comply with requirements specified under Companies Act or rules made thereunder applicable to debentures or bonds.
- The issuer shall appoint a debenture trustee to hold the assets on behalf of the investors.
- The issuer shall need to create a Debenture Redemption Reserve (DRR) of 25% of the value of the debentures.

9.6.4 The issuers shall follow the procedure as specified in paragraph 9.8. The Private Placement Offer Letter in DbC shall contain, inter alia, the disclosures as mentioned in paragraph 9.3 and a summarized term sheet as specified in the SEBI (Issue and Listing of Debt Securities) Regulations, 2008.

9.6.5 The debentures holders shall have rights as given under the Companies Act.

Question 20: *Any suggestions on the requirements in DbC to make it more transparent and investor friendly?*

Question 21: *Is there any need to prescribe the limit on the leverage a company can take through DbC?*

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?*

9.7 Fund based Crowdfunding (FbC)

9.7.1 Under this route, the funds of the accredited investors registered with a recognized platform will be collected online through the platform and pooled under the AIF to invest in shares or debt securities in crowdfunded ventures which are displayed on a recognized crowdfunding platform.

9.7.2 For this purpose, it is proposed to provide a separate class of funds under Category I AIFs to offer Fund based Crowdfunding as Category I AIF- *Crowd Funds*. The minimum and maximum corpus of such funds would be Rs. 10 Crores and Rs. 25 Crores respectively.

9.7.3 As per the SEBI (AIF) Regulations, 2012, such funds will be able to solicit funds online from a maximum of 1,000 accredited investors. The requirement of the minimum investment of Rs. 1 Crore by every investor for an AIF is also proposed to be relaxed for this new class and brought to Rs. 25 Lacs. Under the proposal, funds can be solicited online from upto 1,000 accredited investors registered with a platform by displaying *Crowd Funds* on the crowdfunding platforms set up by class I or III entities as specified in paragraph 9.4.4.

9.7.4 All the accredited investors viz. QIBs, Companies, HNIs and ERIs will be able to invest in these funds. These pooled monies will be then invested by *Crowd Fund* AIFs into start ups and SMEs displayed on a recognized crowdfunding platform under the terms or objectives of the scheme. The sponsor or manager need to maintain a

continuing interest of at least 2.5% of the corpus in the form of investment in the fund and such interest shall not be through the waiver of management fees.

9.7.5 This new class of Category I AIF-*Crowd Funds*, can also solicit funds online through crowdfunding platforms from the registered accredited investors, for deploying them further into donation based crowdfunding. *Thus Crowd Funds may also invest in those companies displayed on the crowdfunding platforms which are incorporated as not-for-profit entities or social enterprises set up as Section 8 companies under Companies Act 2013, for charitable or community benefit or other public interest projects, with investors focusing more on altruistic reasons or general benefits, rather than any expectation of financial return to them.*

9.7.6 Further for accepting donation from the registered accredited investors, the minimum per capita investment can be set at Rs. 50,000. The grantor of donation shall not be entitled to any dividend or profit or gain.

9.7.7 These Category I AIF *Crowd Funds* shall register with SEBI under the SEBI (AIF) Regulations and the application shall be made in the format as specified in the First Schedule to the said regulation under Form A. The disclosures in the Placement Memorandum of the *Crowd Funds* shall be similar to Category I AIF- VCFs. The ongoing disclosures and valuation requirements shall also be similar to the VCFs. The disclosures are mainly related to disclosures on fees and charges, management of conflicts of interest, investments and leverage, a prudent spread of risk and other safeguards.

9.7.8 The *Crowd Funds* can, post registration with SEBI, get displayed on any Crowdfunding Platform set up by either Class I or Class III entities, to raise funds from a maximum of 1000 accredited investors (including QIBs, Companies, HNIs and ERIs) registered with the platform through issue of placement memorandum. The *Crowd Funds* may not be required to be subjected to the scrutiny of the Screening Committee of the platform. The *Crowd Funds* can channel the funds raised from its investors

through the platform into various companies which are displayed on the crowdfunding platform. Units of such funds may be issued only in dematerialized form.

9.7.9 In contrast to EbC where the accredited investors directly hold equity of issues and are shareholders of the company and therefore have legal ownership, in FbC the investments of registered accredited investors are pooled and routed online through a Crowd Fund. The fund holds the equity in its name on behalf of the investors who are issued units of the fund rather than equity of the issuer, and thus have only beneficial ownership in the equity of the company.

9.7.10 FbC addresses several regulatory issues like the restriction on the number of offers made in private placement, minimum investment of Rs. 20,000 worth of face value of securities by every investor etc. It also transfers the duty of investment decision making from ERIs and HNIs, who are not well versed with different investment strategies, to the fund managers, who are experts in this type of investment analysis.

9.7.11 The requirement on ERIs to be consulted by a SEBI registered Investment Adviser or Portfolio Manager may not be applicable for investment through FbC.

Question 23: *Any suggestions on the requirements in FbC to make it more transparent and investor friendly?*

9.8 Procedure for offering through a Crowdfunding Platform

9.8.1 There is restriction on public offering other than a prospectus based offer and mandatory listing except for private placement of securities. Therefore it has been proposed that the offer can be made through a web based recognized crowdfunding platform only to accredited investors who have been given access to the platform.

9.8.2 A step-wise illustrative procedure is given as under:

- An issuer, satisfying the requirements as specified in paragraph 9.2 and interested in raising funds, gets displayed on a recognized crowdfunding platform by submitting requisite documents and undergoing due diligence and screening by the platform.
- The crowdfunding platform also maintains a list of accredited investors who have been given access to the platform to invest in the companies displayed on it. The accredited investors are allowed to register only after examination of KYC compliances and fulfillment of other requirements like net worth, appropriateness test, signing of Risk Acknowledgement etc. as mentioned in paragraph 9.1. Post registration, these accredited investors are given a Login ID and password to access the platform.
- Post screening by the Screening Committee of the crowdfunding platform, the companies interested in raising funds through the platform can put up a notice containing the brief of their business plan on the platform along with the funds required.
- This notice will be subjected to an open discussion on a forum or public board, like a chat room or chat board, provided by the platform, amongst the interested accredited investors and the issuer in which the proposed business plan will be analyzed and critiqued from different perspectives. This feature is provided to gauge the interest of the accredited investors and support an informed decision making by the prospective investors.
- The notice is intended to draw the attention of accredited investors registered with the platform and not an invitation to subscription. After perusing the plan and discussing it, the interested accredited investors can make a commitment or pledge to the company about the funds they intend to invest.
- Once adequate demand is gauged, the issuer may make the formal offer for subscription to those who have made commitment, not numbering more than 200 HNIs, ERIs and Companies collectively, and any number of QIBs, with the detailed online Private Placement Offer Letter, which inter alia may contain the disclosures mentioned in paragraph 9.7. This shall amount to an invitation or offer for subscription and shall be in compliance with the Section 42 of the

Companies Act, 2013 and other rules and regulations pertaining to private placement of securities.

- Pursuant to perusing the Private Placement Offer Letter, the accredited investors may choose to invest in the company or may decide to withdraw their commitment.
- The subscription amount shall be collected from the accredited investors who choose to invest pursuant to perusal of Private Placement Offer Letter of the issuer and kept in a separate bank account. The crowdfund platform owner or a reputed designated third party shall open an escrow account with a Scheduled Commercial Bank to hold the subscription funds of the investors.
- The issue shall remain open for a maximum period of 15 days.
- The crowdfunding issue will be considered successful only if it is able to achieve a minimum pre-specified threshold, expressed in terms of percentage of original issue size as mentioned in the Private Placement Offer Letter. This threshold shall never fall below 50%. The subscription amount shall be transferred to the issuer by the platform owner or the designated third party, only if the threshold is achieved.
- The issuer shall allot the securities to the accredited investors who have subscribed to the issue within 15 days from the date of receipt of the subscription money. In case it fails to do so, it shall refund the entire sum to the subscribers within 15 days from the date of completion of 15 days. In case the issuer fails to refund the money within the aforesaid period, it shall be liable to refund that money with interest at the rate of 12% per annum from the expiry of fifteenth day of securities allotment.
- The issuer shall file a return with RoC as required under Companies Act 2013.
- In case of FbC, the procedure as mentioned in paragraph 9.7 and particularly in 9.7.8, shall be applicable.

Question 24: Any suggestion to simplify the procedure as specified in paragraph 9.8 within the existing legal framework?

9.9 Secondary Market

9.9.1 Crowdfunding is intended to facilitate capital raising through online medium by startups and SMEs and not for the resale of securities. There is no requirement of listing for trading and no listing obligation on the issuer. Crowdfunding platforms only allow an issuer to sell its own securities to raise capital and seldom provide a secondary market for such securities. Therefore many jurisdictions have imposed restriction on a secondary market of securities issued through crowdfunding.

9.9.2 However different jurisdictions have prescribed provisions for providing some exit to the securities holders of crowdfunded ventures as given under:

Jurisdiction	Provisions for Secondary Market
USA	Securities issued in crowdfunding may not be transferred by the purchaser for one year after the date of purchase, except when transferred: (1) To the issuer of the securities; (2) to an accredited investor; (3) as part of an offering registered with the Commission; or (4) to a family member of the purchaser or the equivalent, or in connection with certain events, including death or divorce of the purchaser, or other similar circumstances, in the discretion of the Commission.
UK	After purchasing unlisted equity in a company, even if it remains a going-concern, investors will usually find there is no, or only a limited, secondary market for their investments. Consumers investing in such equity need to understand that they will probably have to wait until an event occurs, such as the sale of the company, a management buy-out or a flotation, before getting a return. Consumers should realize that, in the event of their death, ownership of these investments will probably need to be transferred to their beneficiaries.
New Zealand	This matter has not yet been clarified. Requested for public comments.
Australia	This matter has not yet been clarified. Requested for public comments.
Canada	• Securities of a reporting issuer are subject to a four-month hold period (subject to certain other conditions being met). • Securities of a non-reporting issuer are subject to an indefinite hold

	period and can only be resold under a prospectus exemption or under a prospectus.
--	---

9.9.3 In the Indian scenario also, it is difficult to provide a secondary market trading framework for the companies displayed on a crowdfunding platform, as then it would be treated as a Stock Exchange. Hence, companies displayed on Crowdfunding Platforms will not be treated as “Listed Companies” and there will be no secondary market liquidity in such scrips and investors should be made aware about such risks before investing in such companies.

9.9.4 The securities issued in crowdfunding by the issuer can be transferred by the investors as under:

- to the issuer of the security in accordance with the provisions of Companies Act 2013 and the rules made thereunder, pertaining to the buyback of securities by unlisted public limited companies,
- to another accredited investor registered with the platform,
- to a family member or relative or friend of the accredited investor or the equivalent.

9.9.5 The promoter(s), however, shall be required to maintain a minimum of 5% equity stake in the company for at least three years from the date of the issue.

9.9.6 The investor may get exit only when there is sale of the company, a management buyout or a floatation of IPO or listing of company on a recognized stock exchange in SME segment or main board.

9.9.7 If there is any shareholder agreement between promoters of the issuing company and any AIF giving rights to such shareholders to sell their shares to the promoters etc., same shall be disclosed to all the accredited investors.

Question 25: *Any suggestion on additional avenues of exit or liquidity of securities in crowdfunding?*

9.10 Protection from Cybercrimes

9.10.1 Crowdfunding Platform/Website is the center point of interaction between the companies and the prospective investors. Moreover it will also function as the repository of all the information and disclosures provided by the companies periodically. It occupies a very crucial position in the entire infrastructure. Therefore it needs to be secure and safe from all types of cyber-attacks.

9.10.2 To protect the Crowdfunding platform from hacking/identity theft, etc., the necessary steps need to be taken by the owners of the Crowdfunding Platform.

9.10.3 To provide communication security over the Internet, the crowdfunding platforms should be layered over Transport Layer Security (TLS)/ Secure Sockets Layer (SSL). Platform owner should ensure safety, secrecy, integrity and retrievability of the data. The platform owner shall have a adequate back-up, and Disaster management and recovery and restoration plans.

9.10.4 It is desirable that platform owners draft a security policy which shall, then, be put in public for comments and analysis. There shall be regular audits by reputed external auditors who is CISA (Certified Information Systems Auditor) or otherwise appropriately qualified that the security measures taken by the Platform Owners are adequate and meet the requirements and that risk management systems are in place to identify and mitigate the risks arising out of the regular operations.

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 cyber crimes?*

9.11 Tax Treatment

Taxation of funds raised through crowdfunding shall be in accordance with the current tax provisions applicable to the unlisted companies raising funds through equity or debt or an AIF.

***Question 27:** Crowdfunding is intended to perform the role of an alternate funding option for entrepreneurs and investment option for investors in unlisted companies or Crowd Funds. With this view, what kind of taxation treatment would be suitable for the different stakeholders involved?*

10.0 Role of SEBI

10.1 SEBI has been established with a triple mandate of protecting the investors' interests along with developing and regulating the Indian securities market. These are the guiding principles behind our policies and regulations. Therefore, to enable the small issuers to raise funds and facilitate the investors in an informed decision making, appropriate safeguards and disclosures are proposed to be put in place.

10.2 SEBI's role in crowdfunding, which is proposed to provide a cost effective and efficient method of fund raising, will mainly be limited to:

- recognition of the Crowdfunding Portals
- oversight and regulation of the Crowdfunding market in India
- playing no role in vetting of the Private Placement Offer letter of the issuing companies
- issuance of guidelines/circular regarding information required to be disclosed in Private Placement Offer Letter or on an ongoing basis or requirements of due diligence and screening or any other matter
- conduct of periodic inspections or audits of Crowdfunding Platforms and enforcement of Crowdfunding Regulations

11.0 Cost and Benefit Analysis of the Proposal

11.1 The proposed structure for crowdfunding will provide an enabling framework. Crowdfunding may provide an alternative source of capital for entrepreneurs that either have limited access to capital or have exhausted other available sources of capital. This also saves the entrepreneur from a lot of effort required in obtaining capital and allows him/her to focus on the business.

11.2 One of the objectives of the regulations is to reduce the costs involved in raising funds for entrepreneurs. Under the existing regulations, an issuer is required to pay underwriter fees, legal and accounting fees, registrar and transfer agent fees, merchant banker fees, marketing & advertising fees or distribution commissions and other fees some of which may not be applicable in crowdfunding.

11.3 Crowdfunding facilitates such entrepreneurs in raising funds without incurring too much of the costs by doing away with the requirement of appointing a merchant banker, marketing & advertising expenses and book building etc. Further, there shall be no listing requirements and no prospectus needs be filed with SEBI. However, a company seeking display in recognized crowdfunding platform may be required to pay fees to such platform, which is expected to be substantially lower in comparison to the current issue expenditure. The fees to a platform may be dependent on various factors like number of platforms in the market, number of companies seeking display at such crowdfunding platforms etc.

11.4 Crowdfunding not only helps the issuers to raise money but also serves as a way of advertising for these companies. It helps in increasing their visibility which can directly or indirectly lead to the growth in their businesses. Crowdfunding is expected to spur entrepreneurship and benefit the entire economy.

11.5 Crowdfunding also enables investors to make relatively modest investments across a range of opportunities with relatively low transaction costs and obtain equity positions in companies that may eventually prove to be successful and profitable, which they are not able to do under the current regulations. Platforms may also charge a nominal fee to its registered accredited investors for carrying out their due diligence.

Platforms may also be required to pay some fee for recognition. Consultation process may assist in crystallizing such charges for the new framework.

12.0 Public comments:

12.1. Public comments and suggestions are solicited on the consultation paper. It does not necessarily imply that all or any of the comments will be invariably accepted for formulation of regulation. Interested persons may send their comments by e-mail to Mr. Aditya Sarda (adityas@sebi.gov.in) or Mr. Ankit Goel (ankitg@sebi.gov.in) on or before **July 16, 2014**.

12.2 Comments and suggestions should be given in the following format:

Name of Entity / Person / Intermediary			
Question No./ Suggestion on Paragraph No.	Proposal / Suggested Changes	Rationale	

Issued on: **June 17, 2014**.

Disclaimer: References to various jurisdictions in this document have been based on the regulations/guidelines/consultation papers, etc. of the respective country regulators and news articles/websites and other secondary sources. The references in no way indicate validation of any country regulations on the subject. The purpose of the said references is only to provide the reader a better picture of the global scenario with respect to crowdfunding. This paper should not be construed as a legal advice. Though utmost care has been taken in the preparation of the paper, SEBI takes no responsibility for the accuracy or validity of the information provided.

Annexure-1

Consolidated List of all Questions

Question No.	Question
Q1	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 ?
Q2	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.
Q3	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.
Q4	Is the limit of investors upto 200 besides QIBs or employees of the company under a scheme of employees 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 upto 1,000 investors, excluding QIBs or employees of the company under a scheme of employees stock option?
Q5	Are the Investment Conditions mentioned in the paragraph 9.1.6 enough to warn and guard investors regarding the risky nature of crowdfunding? Specify changes, if any, along with the rationale.
Q6	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 issuers? Specify changes, if any, along with the rationale.
Q7	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.
Q8	Due to the lack of history and track record, it is important that the 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?
Q9	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?
Q10	While Class I entities are already under SEBI's purview and have a successful track record in managing issues and securities, Class II entities have a 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?
Q11	Any suggestions on some other possible entities which can be included in Class II with a tentative list of qualifying criteria?

Q12	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?
Q13	Any suggestions on some additional or reduced requirements on Crowdfunding Platforms?
Q14	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.
Q15	Any suggestions on the role and responsibility of the screening committee and its composition etc.?
Q16	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?
Q17	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?
Q18	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?
Q19	Any suggestions on the requirements in EbC to make it more transparent and investor friendly?
Q20	Any suggestions on the requirements in DbC to make it more transparent and investor friendly?
Q21	Is there any need to prescribe the limit on the leverage a company can take through DbC?
Q22	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?
Q23	Any suggestions on the requirements in FbC to make it more transparent and investor friendly?
Q24	Any suggestion to simplify the procedure as specified in paragraph 9.8 within the existing legal framework?
Q25	Any suggestion on additional avenues of exit or liquidity of securities in crowdfunding?
Q26	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 cyber crimes?
Q27	Crowdfunding is intended to perform the role of an alternate funding option for entrepreneurs and investment option for investors in unlisted companies or Crowd Funds. With this view, what kind of taxation treatment would be suitable for the different stakeholders involved?