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EXPLICATION ON THE CONCEPT OF CROWDFUNDING IN THE INDIAN LEGAL SYSTEM

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Abstract

For new businesses, raising the capital has always been a herculean task. They mostly rely on venture capital, loans, self-financing etc. for initial funding. Crowdfunding is the other mechanism apart from these; although less discussed in India. The article delves deep regarding the concept of crowdfunding. In this research we will discuss crowdfunding, its various forms particularly the reward-based, donation-based, equity-based and debt-based crowdfunding. Moreover, the process of crowdfunding has also been explained in this work. In India, as such there are not sufficient laws to regulate crowdfunding and therefore the author is primarily relying on the consultation papers of Securities and Exchange Board of India ['SEBI'] and Reserve Bank of India ['RBI']. Further, a reading of these consultation papers would indicate that there is no clarity as to who has the authority to issue directions in case of crowdfunding, as there is an overlapping of jurisdictions between the RBI and the SEBI. In this research, the various obligations that SEBI has imposed on the issuers of the securities as well as on the platform owners have also been discussed. This specifically consists of the disclosure requirement on the part of entrepreneurs. The qualifications for an investor to take part in the crowdfunding process have also been elaborated upon. This is followed by the analysis of the recommendations made by SEBI. The paper follows a multi-disciplinary approach referring to the relationship of crowdfunding with elections, Intellectual Property regime. The section of analysis is followed by the suggestion where the author has suggested for the introduction

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of Sharia Crowdfunding in India with a suitable reason for such a suggestion. To sum up the discussion, a suitable conclusion has been provided by the author at the end.

Keywords: *Crowdfunding, Securities and Exchange Board of India, Islamic Finance, Reserve Bank of India, Shariah Crowdfunding.*

I. Introduction

Business is the art of extracting money from another man's pocket without resorting to viole –

Max Amsterdam

India is becoming one of the major destinations of upcoming startups.[1] It has joined the league of countries like the United States, China etc. who have a plethora of successful startups.[2] This is evident from the number of entrepreneurs along with the diversity of ideas they are pitching on platforms like 'Shark Tank'.[3] The success of the business depends upon its ability to get money from others. But before that, to even start a business, money as capital is indispensable. How well a businessman can convince the investors to invest their money in his project is really crucial. However, with the increasing competition, it is getting really difficult to raise money to set up a business. The situation of entrepreneurs from humble backgrounds is even more precarious. Nonetheless, the rapid advancement in technology and raising awareness on microfinance has brought a sigh of relief for these people. Today, crowdfunding has become one of the most familiar ways of raising finance with the entrepreneurs having limited sources of raising capital. The concept of crowdfunding assumed significance after the 2008 economic depression,[4] thereby leading to the implementation of Basel norms resulting in restraints on the banks giving loans.[5] Due

1 Surendra Singh, *India has 50k-plus startups providing 2L jobs, country emerging as world's preferred startup destination: Minister*, The Times Of India, Feb 20, 2022, 08:11AM, https://timesofindia.indiatimes.com/india/india-has-50k-plus-startups-providing-2l-jobs-country-emerging-as-worlds-preferred-startup-destination-minister/articleshow/89695900.cms

2 John Sarkar, *India becomes third largest startup ecosystem in the world*, Sep 3, 2021, 10:31AM, https://timesofindia.indiatimes.com/business/india-business/india-becomes-third-largest-startup-ecosystem-in-the-world/articleshow/85871428.cms

3 *EMPOWERING INDIA'S STARTUP CULTURE: MEET THE SHARKS*, ENSPIRE, https://www.bloomboxkjsc e.com/media/pdfs/enspire-march-22.pdf.

4 The World Bank, *Crowdfunding's Potential for the Developing World*, 2013/01/01 AM, https://documents1.worldbank.org/curated/en/409841468327411701/pdf/840000WP0Box380crowdfunding0study00.pdf.

5 James J Williamson, *the jobs act and middle-income investors: why it doesn't go far enough,* Vol. 122 No. 7, The Yale Law Journal

to this the businesses, especially the new startups started facing difficulty in getting finance because they had very limited resources to back the loans they required. This led to the emergence of crowdfunding as an alternative source of funding across the world.

II. Crowdfunding

Crowdfunding is the collection of funds from multiple investors through a web-based platform or a social networking site for a specific project, business venture or a social cause.[6] In the process of crowdfunding, generally there are three parties involved i.e., the investor, the entrepreneur and the platform owner.[7] The entrepreneur comes up with the business idea for which he requires the funding. He collaborates with the platform owner which does the screening of the idea and makes all the arrangements. The campaigning is done for the idea in order to make the people aware of the business venture. The people invest their money in the project and the platform owner collects the money on behalf of the entrepreneur. After deducting his fees, the platform owner transfers the funds to the entrepreneurs. The profits made by the entrepreneur by using those funds are then divided among the general public which had initially invested.[8]

III. Types of Crowdfunding

In normal parlance, there are four types of crowdfunding which exist i.e., the reward-based crowdfunding, donation-based crowdfunding, equity-based crowdfunding and debt-based crowdfunding.[9] Donation based and reward-based crowdfunding are not very complex in nature, hence allowed in most of the countries. But the problem arises in the case of equity and debt-based crowdfunding which are convoluted and lie within the ambit of more than one regulatory authority.

1. Reward based Crowdfunding-

In reward-based crowdfunding, a tangible reward is given in return of the investment made by the investors. The reward can be some present or future tangible consideration.

6 Mario D' Ambrosio, *Crowdfunding and Venture Capital: Substitutes and Complements?* Vol. 20 No.1. The Journal of Private Equity,

7 Eric R. Smith, *Keeping current: crowdfunding: the real thing is almost here*, Vol. 1, No. 1, Business Law Today

8 SEBI, *Consultation paper on crowdfunding in India, Jan 7, 2014, https://www.sebi.gov.in/sebi_data/attachdocs/1389083605384.pdf*

9 *Id.*

2. Donation based Crowdfunding-

The donation-based crowdfunding is the sort of charity where the public or the donor donates the money without expecting anything in return.[10] Section 80-G of Income Tax Act governs the donation-based crowdfunding, where the donor gets exemptions from tax deductions. The only catch here is that it does not provide any exemption, if the amount of ₹ 2000 or more is donated in cash.[11] Apart from this, Section 66-A of Information Technology Act used to regulate this crowdfunding model, where the parties involved in the transaction were barred from making any kind of misrepresentation or fraudulent commitments.[12] But now this provision has no applicability, as it has been struck down by the judiciary.[13]

3. Debt based Crowdfunding-

The debt-based crowdfunding is about raising unsecured loans through an online platform where the lenders meet the buyers. The debt-based crowdfunding as of now is not regulated by any law in India. Recently, RBI has launched a consultation paper which is the only authority providing directions on it.[14] RBI has assumed the role of regulatory authority for peer-to-peer lending due to the fact that Section 45S of RBI Act[15] prohibits any acceptance of deposits by a firm or a firm or an unincorporated association of individuals, if the business they are doing falls within the functions of a financial institution under Section 45-I.[16] The function of accepting the deposits from the lenders and providing it to the borrowers indicates towards the activities of a financial institution.[17] RBI is in favor of bringing the platforms under the definition of NBFCs under Section 45 I(f)(iii), thereby making regulations under Section 45JA and 45L.

4. Equity based Crowdfunding-

10 Karina Sigar, *Fret no more: inapplicability of crowdfunding concerns in the internet age and the jobs act's safeguards,* Vol. 64, No. 2. Administrative Law Review,

11 Income Tax Act, 1961, No. 43 of 1961, Acts of Parliament, §80-G (India).

12 The Information Technology Act, 2000, No. 21 of 2000, Acts of Parliament, §66-A (India).

13 Shreya Singh v. Union of India, (2015) 5 SCC 1 (India).

14 RBI,*Consultation paper on peer to peer lending*, April 2016, https://rbidocs.rbi.org.in/rdocs/content/pdfs/CPERR280416.pdf

15 RBI Act, 1934, No. 2 of 1934, Acts of Parliament, §45 (India).

16 *supra* note 8.

17 *Id.*

In equity-based crowdfunding, equity shares of the company are issued in return of the amount invested by the investors.[18] With regards to the equity-based crowdfunding, there is no law in place in India to regulate it apart from a consultation paper of SEBI. This form of crowdfunding is technical because of the fact that it incidentally falls under the purview of Companies Act, 2013, SEBI (Securities Contract Regulations Act), 1956.

IV. Relevant Rules of Consultation Paper of Sebi

The private companies raise their funds through private placement.[19] The rules maintain that private placement of securities cannot be made more than to 200 persons in a financial year excluding the qualified institutional buyers and employees of the company, offered the securities under the scheme of employees stock option.[20] At the same time, the law is clear that if any condition of the private placement is violated the same shall be deemed to be a public offer.[21] But the companies under the garb of raising funds through crowdfunding were actually exceeding this numerical threshold of 200. Therefore, SEBI came up with the proposal to put a limit of 200 on this. Further, SEBI realized that in absence of Initial Public Offer (IPO), there is a need to protect the retail investors who have limited access to the information pertaining to the company. Therefore, SEBI has proposed that only the Accredited Investors should be allowed to participate in crowdfunding. For this purpose, SEBI has provided certain qualifications of an accredited investor including qualified institutional buyers (QIBs) as defined in relevant SEBI regulations,[22] companies incorporated under the Companies Act with a minimum net worth of ₹ 20 Crore, high net worth individuals (HNIs) with a minimum net worth ₹ 2 Crores or more, Eligible Retail Investors (ERIs) who receive investment advice from an Investment Adviser, or who avail services of a Portfolio manager etc.[23] The SEBI has also proposed that a QIB shall hold a minimum of 5% securities issued, whereas a company is required to purchase at least 4 times of the minimum of the offer value per person, HNI is required to purchase at least 3 times the minimum offer value per person, ERI is required to purchase at least the minimum offer value per person where the maximum investment by an ERI in an issue shall

18 G. Usha, *Crowd funding for startups in India*, IOSR Journal of Business and Management.

19 Companies Act, 2013, No. 18 of 2013, Acts of Parliament, §23 (India) [hereinafter Companies Act, 2013]

20 Securities and Exchange Board of India Share Capital and Debenture Companies (Prospectus and Allotment of Securities) Rules, 2014, Gazette of India, pt. II sec. 3, (April 1, 2014).

21 Companies Act, 2013, *supra* note 14, §42.

22 Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009, Gazette of India, pt. III sec. 4, §2(zd), (August 26, 2009).

23 *supra* note 8.

not exceed ₹ 60,000.[24] At the same time, the SEBI has also suggested that only companies with certain specifications should be allowed to go for crowdfunding. These specifications include a company intending to raise a capital not exceeding ₹ 10 Crores in a period of 12 months, a company not sponsored by any company having the turnover more than ₹ 25 crores, a company which is not listed on any stock exchange and is not more than 48 months old etc.[25]

V. Disclosure Requirements on Issuer

The SEBI has advocated for the disclosure by the issuers in order to maintain the transparency. For this, the issuers are expected to submit a private placement offer letter to the crowdfunding portal which will contain the particulars like name of the company with the registered office address, description of the valuation of the securities offered, the specified target offering amount and the intended usage of the funds, past history of funding, ownership details and capital structure, rights and liabilities attaching to the securities etc. At the same time, SEBI has also stressed upon the fact that the crowdfunding platforms also play a vital role in the whole process and therefore, there is a need for prescribing the essentialities of a crowdfunding platform as well. For this, SEBI has suggested that an entity has to be recognized as a crowdfunding platform before making any online offering. It is for this purpose that the SEBI has allowed the recognized stock exchanges with a nationwide terminal presence or through SEBI registered depositories to function as a crowdfunding platform. While the other class of entities which SEBI has recommended consists of those having relevant experience and domain knowledge. The technology business incubators promoted by the central or state government having a minimum experience of 5 years with a minimum net worth of ₹ 10 crore etc. are the requirements of an entity falling under this category. SEBI has also imposed certain obligations on the platforms to prevent any kind of fraudulent and deception in the whole process of crowdfunding. This includes conducting due diligence of the startup, checking the background to ensure whole time directors, promoters, shareholders holding more than 20% of equity shares in the company, completing the KYC formalities, keeping a record of all the issues by the companies and the disclosure at a later stage etc.[26] SEBI has also proposed a 'screening committee' which will be a filtering mechanism in the platforms. These screening committees are required to have a minimum strength of 10 persons, with a minimum 40% comprising of the professionals having expertise in startups, at least 30% composing of banking experts and the remaining

24 *Id.*

25 *Id.*

26 *supra* note 8.

can be persons of huge caliber which are the nominees of the owner of the crowdfunding portal.[27]

VI. Procedure of Raising Funds Through Crowdfunding

An entrepreneur interested in raising funds has to fulfil the disclosure requirements as mentioned above. He is also required to submit the relevant documents to get them displayed on the platform. Meanwhile, the crowdfunding platforms do the necessary KYC formalities and other ancillary documentation like signing of risk acknowledgment, net worth etc. The accredited investors are offered a login id and password to access the platform; which is followed by the screening committee doing screening of companies before calling for investments. The segment of open discussion between the accredited investor and the issuer in a boardroom plays an important role in taking an informed decision by prospective investors. At the end, it is upon the investors to invest in the company or not.

In the next stage, the private placement offer letter is provided to the investors in compliance with Section 42.[28] If the investors decide to invest the amount, the collected amount is kept in a separate account. The issue shall be kept open for a period of 15 days, where the minimum subscription has to be met. This minimum subscription is required to be mentioned in the offer letter. It is pertinent to point out here that this subscription can never be less than 50%. The securities are required to be allotted to the investors within 15 days, if subscription is more than this aforementioned limit. In case of failure, money is to be returned by the company within the next 15 days, otherwise an interest at the rate of 12% per annum is charged on the same.

SEBI has also deliberated upon the fact whether these platforms can act as a secondary trading market. As per the consultation paper, there cannot be any secondary market in case of crowdfunding platforms otherwise it would be treated as a stock exchange. But still the investors can transfer the securities to the issuers of the securities or to other accredited investors, or to a family member of an accredited investor. At the same time, an investor may also get an exit when there is a sale of the company or a management buyout or issuance of IPO or the company gets listed on a recognized stock exchange.

27 *Id.*

28 Companies Act, 2013, *supra* note 14, §42.

VII. Analysis

1. Crowdfunding Platform: A Stock Exchange?

Stock Exchange is referred as[29]-

a) *a body of individuals, whether incorporated or not, constituted before corporatization and demutualization under sections 4A and 4B, or*

b) *a body corporate incorporated under the Companies Act, 1956 whether under a scheme of corporatization and demutualization or otherwise,*

for the purpose of assisting, regulating or controlling the business of buying, selling or dealing in the securities. In its consultation paper, SEBI was in favor of regulating the crowdfunding platforms, specifically in case of equity-based crowdfunding as there is actual exchange of securities of taking place.[30] However, when SEBI pondered upon the question of considering platforms as a secondary exchange market, it dropped the idea as it was not a stock exchange.

SEBI has the power to administer in the case of listed public companies and in the case of those public companies which intend to get their securities listed on a recognized stock exchange in India.[31] In the present case, the question arises as to how SEBI can regulate the affairs of crowdfunding platforms, if they are not stock exchanges in the humble opinion of SEBI. This is a moot question which still requires an answer.

2. Is Consultation Paper Binding?

The entire discussion in this research is based upon the consultation paper of SEBI. SEBI has proposed a variety of guidelines in its consultation paper. But now the question arises as to whether that consultation paper is binding? A consultation paper as the name suggests is a mere document put in the public domain for academic discussions.[32] Therefore, these guidelines proposed are merely some discussion points which are not even final. Also, this consultation paper was introduced by SEBI in 2014 but till now there are no proper laws and guidelines introduced by the Parliament or SEBI. This has created a puzzling situation as there is confusion among the players of the crowdfunding market whether to follow it

29 Securities Contracts (Regulation) Act, 1956

30 *supra* note 8.

31 Sahara India Real Estate Corporation Limited & Ors. v. SEBI, (Civil Appeal No. 9813 and 9833 of 2011).

32 Law Commission of India, *Consultation paper on Sedition*, 30 Aug 2018, https://lawcommissionofindia.nic.in/reports/CP-on-Sedition.pdf

or not.

3. 'Politics in Crowdfunding' And 'Crowdfunding in Politics'

There was a time, when the political parties and the candidates contesting the elections used to approach the corporate houses for the donations to contest the elections. The easy access you have to these companies, the more there will be chances for your success. But now, it appears that the situations have changed. With the advancement in technology, candidates are looking for alternative sources of funding for the elections which are cheap and easy to access. Crowdfunding seems to suit this requirement of the candidates. It is cheap as not much cost is involved and because there is an involvement of people at large, the funds can be raised comfortably. In the Karnataka assembly elections, the candidates resorted to crowdfunding, specifically donation-based crowdfunding for raising the amounts.[33] But what if the debt-based crowdfunding and equity-based crowdfunding takes the place of donation-based crowdfunding. As discussed above, SEBI and RBI have imposed certain disclosure obligations on the entrepreneurs and the platform owners in case of debt and equity-based crowdfunding. However, by virtue of the Representation of People Act, the political parties are exempted from disclosing the details of the amount they have received.[34] As such this problem has not arisen so far, but anticipating the popularity crowdfunding is enjoying, the solutions to these relevant questions are required to be looked for.

4. Disclosure Norms Threaten the IP Of Crowdfunding

As discussed above, the crowdfunding requires disclosure pertaining to the scheme of crowdfunding along with the other details. In today's world of advanced technology, new technologies are coming up which requires further funding and financial assistance for further research. For this, they often rely upon the various models of crowdfunding. However, the disclosure norms may raise issues with respect to the intellectual property such as in trademarks, patents etc. Taking the case of patent, section 3 of the Patent Act[35] requires certain qualifications to be fulfilled before granting a patent on any application. This includes novelty, inventive steps and commercial utilization. Novelty here requires that the idea on which the patent is requested should be new in nature. It means that it should not have existed beforehand. For this, the patent office considers every piece of information associated with that patent application in the public domain. If the information

33 K.C. Deepika, *Citizens lend me your note and money,* https://www.thehindu.com/news/national/karnatak a/citizens-lend-me-your-vote-and-money/article23732472.ece. (Last visited May 21, 2021 10.30 AM)

34 The Representation of People Act, 1951, §29C,

35 The Patents Act, 1970, §3,

on that application is already available in the public domain, it loses its novelty. Hence, resulting in the rejection of the patent application. Further, such disclosure may also lead to some competitor coming up and copying that idea. The solution to this problem is present in the Patent Act itself i.e. the concept of '***provisional specification***' and '***priority date***'.[36]

A. Priority Date-

The date of first filing of a patent application is called the priority date. In the patent system of first to file, this date becomes important and if there are two patents/ patent applications with same/substantially similar subject matter, the earlier priority date patent application/patent survives the other.

B. Provisional Specification-

The Patent Act allows for two kinds of specifications/disclosures i.e. provisional specification and complete specification. When the invention is conceived but not fully developed, providing a complete specification is not practically possible and hence they introduced the option of a provisional specification. A provisional specification is required to give only the key novelty and inventive aspect of the invention in an abridged form and may not have claims provided.

Therefore, before going for raising funds through crowdfunding a provisional specification can be filed on a priority date and after complete development of the idea complete specification can be filed. So, even if any third person files an application for the patent of the same subject matter, he will not get the patent. Moreover, filing a provisional specification will also prevent the novelty of your project getting killed.

VIII. Conclusion

The unique value of crowdfunding is not money, it's community[37]

- Ethan Mollick

The basic essence of Crowdfunding is the involvement of the community. It has received the popularity which it enjoys today; because the entrepreneurs who do not have any contact with the influential people can raise the money for their ventures. It is a settled principle that a thing which becomes stagnant soon loses its value. Consumable water, if it remains

36 The Patent Act, 1970, §11,

37 Ethan Mollick, *The Uniques Value of Crowdfunding is not Money-It's Community*, https://hbr. org/2016/04/the-unique-value-of-crowdfunding-is-not-money-its-community (Last visited April 21,2016)

stagnant for a period, loses its utility. Similarly, a broad vision with regards to the law is required. Law is dynamic in nature in which changes take place frequently. A sincere attempt should be made to accommodate those changes in the existing framework of laws. Further, an interdisciplinary study is required to be made on crowdfunding along with various other laws including the IP laws as discussed in this paper.

In India, there is an inherent problem in the administrative and legal framework. To be specific, this problem is to control everything. India's *100^{h} ranking out of 190 countries* in the **index of ease of doing business** is a paramount example of this.[38] The suggestions that SEBI has provided are so repressive that it will take away the basic essence of the concept and it is a mere red-tapism. SEBI expects the issuers of the securities to prepare a private placement offer letter along with a research conducted by a third party, showing the future prospects of the company's growth. An entrepreneur who does not have any financial resources, isn't it unreasonable to expect him to do these burdensome tasks? Not only this SEBI and the RBI are having parallel jurisdiction in crowdfunding. Can't there be a single regulatory body for crowdfunding matters? In the concluding remarks, the author would like to suggest that there is a serious requirement of Minimum government and maximum governance.

IX. Suggestion

The Introduction of Shariah Crowdfunding in India. India consists of a large number of people from Muslim community, who lead their lives as per the principles of sharia law. Sharia law provides its directions in a number of areas of a person including the way of doing business. It prohibits any kind of returns on gambling *(Maysir)*.[39] It also prohibits charging on interests (*Riba*) on debts as it is considered as exploitative and unjust gain.[40] Further, the purpose for which the funds are being raised should be 'halal' i.e. allowed by sharia. Therefore, things such as wine, pork etc. cannot be funded. As discussed in the aforementioned paragraphs, the debt-based crowdfunding which is the most commonly used form of crowdfunding; is totally based upon charging of interest. Due to this, many

38 Nisha Ranjan, *View: structural reforms are needed to scale up World Bank's ease of doing business ranking*, https://economictimes.indiatimes.com/news/economy/policy/view-structural-reforms-are-needed-to-scaleup-world-banks-ease-of-doing-business-ranking/articleshow/64034653.cms. (Last visited May 21, 2021 10.30 AM)

39 Alfred Kammer, *Islamic Finance: Opportunities, Challenges and Policy Options*, International Monetary Fund staff discussion note, April 2015, https://www.imf.org/external/pubs/ft/sdn/2015/sdn1505.pdf.

40 Abayomi A. Alawode, *Islamic Finance*, The World Bank, March 31, 2015, https://www.worldbank.org/en/topic/financialsector/brief/islamic-finance

entrepreneurs from Muslim community hesitate in using crowdfunding to raise the funds for their venture as it is deemed against Islam. This also results in their exclusion from the mainstream business.

Sachar Committee Report of 2006 on Social, Economic and Educational Status of Muslims

Bank Credit (Amount Outstanding) (%)

	Muslims	**Other Minorities**	**Others**
Pvt. Sector Banks	6.6	7.9	85.5
PSU Banks	4.6	6.3	89.1

The solution to this problem lies in the sharia crowdfunding. A Sharia-compliant crowdfunding is a form which takes place on an online portal, where people finance other businesses on a sharia compliant basis for the purpose of gaining a financial return over a pre-determined period of time.[41] In this form of crowdfunding, the returns on the amount invested are in the form of profits and not in any form of interest.[42] Thus, it is not against the principles of Islam.

Therefore, it has become indispensable to introduce sharia crowdfunding in order to ensure their financial inclusion in the society. Sharia crowdfunding has become a very popular concept in Arab countries and measures should be taken to promote it in India as well. However, the problem is RBI is not in favor of introducing Islamic banking in India as it feels that "*wider and equal opportunities*" are available to all citizens to access banking facilities.

41 *Consultation Paper*, Kingdom of Bahrain, https://www.cbb.gov.bh/assets/Consultations/Consultation-Shariah-compliant%20Financing%20based%20Crowdfunding.pdf.

42 *Leveraging Islamic Finance for SMEs*, Joint WB-IsDB G20 Islamic Finance Policy Paper, http://g20.org.tr/wp-content/uploads/2015/09/Leveraging-Islamic-Finance-for-SMEs.pdf.