Intra Legem

MYTH: THREE'S A CROWD

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Whoever said three's a crowd surely got it wrong here! In fact, the apt idiom here is, "more the merrier"!

Gone are the days of shouting orders and instructions on the trading floors and gone are the days of computerized stock exchanges. Here comes the internet at the speed of 5G. When we can fill our wardrobe and groceries online, why not manage our portfolios too, while we are at it!

India is an ever evolving market. While the dust was settling on FDI (foreign direct investment), the e-commerce sector took India by storm. It is true that while there may be one Flipkart, there may be many flopkarts too. But the fact remains that e-commerce has made its mark and is here to stay. Will crowdfunding too gain such popularity and take India by storm? Will we forget how to trade on the stock exchanges and buy and sell stocks with just a click on our mobile?

Crowdfunding, as its name suggests, is nothing more than a group of investors congregating and funding a project, but not on the floor of the stock exchange or through a roadshow but via the internet.

Startup investing and fundraising is moving from the boardroom to the deal room (online) as new laws for equity crowdfunding come into effect across various jurisdictions. Prior to this, traditional fundraising has been a fractured process that takes place across hundreds of private emails, calls and in person pitch meetings. But now, early stage venture capital is being disrupted and moving online in a more public way. Alongside this, tens of thousands of startups are opting to use the web and equity crowdfunding to find, pitch and close investors.

The crowdfunding model is fueled by three types of actors: the project initiator who proposes the idea and/or project to be funded; individuals or groups who support the idea; and a moderating organisation (the "**platform**") that brings the parties together to launch the idea.

The earliest recorded use of the word "crowdfunding" was by Michael Sullivan in fundavlog in August 2006, a failed attempt at creating an incubator for videoblog-related projects and events including a simple funding functionality.

Crowdfunding as a concept pre-dates the internet and projects like the Statue of Liberty raised funds from a large number of donors.

Crowdfunding is all the rage right now. A 2013 report by the World Bank projected that the global crowdfunding market could surpass US$96 billion a year by 2025. Let's be honest: crowdfunding is exciting. Consumers enjoy unprecedented influence. For an entrepreneur, it almost seems too good to be true: Simply put your idea out there for the world to see and let the money roll in.

So, why crowdfunding? There are many advantages of crowdfunding. It is the biggest global funding resource, which brings a large group of believers and avid supporters for the business. The risk is shared among many investors, thereby putting less financial pressure on just a few

individuals. It cuts out banks, venture capitalists and professional investors to create a business funding process. Last, but not the least, it gives you the possibility to engage with your with your believers even before the business launches.

The return on investment from equity crowdfunding can be enormous. While most startups may not achieve the return on investment of the magnitude of Facebook or Dropbox, a long-term investment of five (5) to eight (8) years in the right startup could produce higher returns than any other asset.

Needless to add, there are risks and disadvantages of crowdfunding. The first risk involves the possibility of a large number of likely non-sophisticated investors in an early-stage company, which has a high chance of failure making it an added complication. Because of the low cost of capital and the relative ease with which entrepreneurs may access and engage with crowdfunding portals, crowdfunding has been used by many startup companies to raise smaller amounts of money for their initial stage. Startup companies have an inherent risk of failure. Failure statistics universally show that over 50% of newly founded firms will fail during their first five years.

To add to the above risk, there is no or less recourse to the investors against the issuer, in case of default or fraud. Neither are the funds directly solicited by the issuer nor does the issuer issue 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 temporarily shuts down, or is closed permanently, no recourse is available to the investors.

New access and transparency created by online models opens doors for discovering new investment opportunities in private securities. With the right information, research and processes to protect investors and evaluate the cases, this can lead to a new paradigm where investors are not limited to their own local community, but can access information from around the world.

Is crowdfunding recognised and permitted mode of fund raise? The use of crowd sourced funding for the purpose of raising funds for business development has become increasingly popular in a number of foreign jurisdictions. A number of commentators are of the view that crowdfunding is one of the biggest financial changes in history due to the fact that it changes the way money is exchanged. It is an attractive option for start-up companies wishing to raise both working capital for their businesses and consumer product awareness. In April 2012, a revolutionary avenue of capital formation for small businesses was created when President Obama signed The JOBS (Jumpstart Our Business Startups) Act into law and equity crowdfunding in the United States was born. The United Kingdom has introduced two forms of platforms, one loan based crowdfunding platform and the other investment based crowdfunding platform. Japan also acknowledges equity based crowdfunding platform.

New Zealand allows intermediary service providers, such as crowdfunding portals, to be licensed. While New Zealand limits the amount raised to NZ$2 million, there are no upper limits on investment, nor is there a distinction between sophisticated and retail investors, making New Zealand one of the most crowdfunding-friendly jurisdictions.

Is crowdfunding recognised in India? Recognised yes, regulated no! The Securities & Exchange Board of India recognises that crowdfunding, if regulated appropriately, can provide an excellent funding alternative for early-stage ventures and cash-strapped small businesses. However, given its vulnerability to "regulatory arbitrage" and fraud, the regulatory framework needs to strike the right balance between protection of investors and promotion of entrepreneurship.

In June 2014, the Securities and Exchange Board of India ("**SEBI**") issued a "Consultation Paper on Crowdfunding in India" ("**Consultation Paper**"), which discusses legal and regulatory challenges in implementing the framework for crowdfunding. The Consultation Paper proposes a framework for ushering in crowdfunding by giving access to capital market to provide an additional channel of early stage funding to startups and SMEs and seeks to balance the same with investor protection.

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, SEBI proposed to permit only accredited investors to participate in crowdfunding and the sale be made through a SEBI recognized crowdfunding platform.

However, the Consultation Paper misses discussion on cross-border crowdfunding. Many countries have passed regulations, which fall into two categories. The first, the US model, which creates an exemption, i.e. allow small companies to access public funds. Countries that fall into this category include Australia, Italy, Japan, New Zealand and Singapore. The second includes countries that do not offer an exemption, such as India, Hong Kong and Malaysia.

Taxation is an important issue which cannot be ignored. While the Consultation Paper does not detail the tax implications, it does clarify that taxation of funds raised through crowdfunding will be in accordance with the current tax provisions applicable to unlisted companies raising funds through equity or debt or an AIF.

While the regulations and restrictions are necessary to regulate crowdfunding in India, the limited class of investors will expect an outcome out of their investment. This is a setback to creative works and social causes which do not give return on investments. The technical start-ups will benefit the most from this new class of analyze-before-investing. Earlier, most crowdfunding was through small donations from individuals who invested because a friend had recommended or they felt for the project. The emotional vibes in investment will take a backseat as the accredited investors will evaluate the project and its potential before investing. A QIB will prefer to stay away from investing in a project where the risk element involved is higher and, therefore, there are chances of investment not being returned.

In June of 2015, SEBI decided not to bring out any regulations for crowd funding as of now. SEBI is currently in the midst of evolving guidelines for funding arrangements for startup entrepreneurs and aiming to give a strong boost to

India's already buzzing start-up space. On June 23, 2015, SEBI made it easier for entrepreneur-driven new companies to list on stock exchange platforms with easier listing, shareholding and disclosure norms. The new rules intend to attract start-ups to list in the country, rather than looking for funds from a foreign bourse.

So, will crowdfunding die a natural death in India? Not at all. Crowdfunding, although not regulated in India, will nevertheless flourish. Even though SEBI may have introduced easier listing, shareholding and disclosure norms for start-ups, the fact remains that the risk appetite and quality of investors is much more advanced with investors overseas than in India. Since the crowdfunding platform in India will not be regulated, the risk to the investor will be far more than when a start-up company proposes to list on the stock exchange platform and allow itself to be regulated by the stock exchanges.

While listing on Indian stock exchanges will ensure a wide array of investors and compliance with the listing agreements and stock exchange norms, crowdfunding will ensure that the company receives funds not only from investors across the globe but also from investors who feel for the project.

In India, crowdfunding may happen in two ways. The first may be an Indian company seeking funds from non-resident investors and the second, a company set up outside India seeking funds from investors around the world, including India. Given the nature of both crowdfunding and the global reach of the Internet, it is possible that Indian investors may be involved in crowdfunding activities in other jurisdictions.

The reach of the internet and the crowdfunding platform has made access to funds a lot easier. An Indian company may set up an overseas company in a crowdfunding-friendly jurisdiction, and then seek funds from investors around the world. On the other hand, if an Indian retail investor, who was not able to participate in the equity of the Indian company, can now invest through the crowdfunding platform. The funds received by the overseas company may then be invested in the Indian company.

The traditional boundaries of corporate finance are breaking down. It is time to shed older notions of corporate finance within the frameworks of political confines and instead address the issue of the world being better connected, even within the realm of corporate finance.

While we wait for listing of start-up companies on the Indian stock exchanges and the herd mentality to take over, Indian entrepreneurs will continue to raise funds on the crowdfunding platform and grow their business. Whether one or both the platforms will be successful or whether one platform will overtake the other; only time will tell.

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