

Article

Crowd funding – evolution and management



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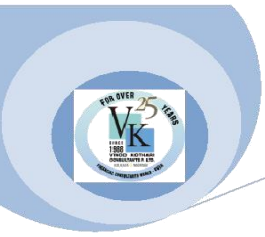
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Introduction

With globalization and technological interface increasing by the day, the next logical innovation in the internet platform is financial intermediation.

Virtual presence allows facilitating financial intermediation connecting the haves with the have nots. Globally the phenomena is common, where virtual platforms have been set up to bring together lenders and borrowers increasing access to funds globally and making the geographical limitations for lending/ borrowing relation redundant.

This has prompted the regulators in India such as Securities and Exchange Board of India (SEBI) to introduce regulations pertaining to crowd funding. In June 2014, SEBI released a discussion paper on crowd funding¹. Under the crowd funding concept, lenders aggregate to meet the funding requirements of a borrower. It is like consortium lending proposition by banks but undertaken by individuals and through a virtual interface.

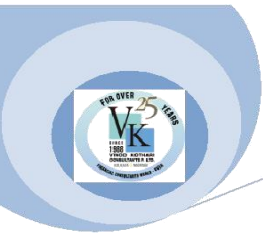
This write-up covers the basic understanding of crowd funding along with its regulatory regime in the international jurisdictions and in India.

What is Crowd funding

Crowd funding is the solicitation of funds (usually small amount) from several investors through online platform or social networking site for a particular project, business venture or a social cause. Raising of funds could be for any creative project (for example, music, film, book publication), benevolent or public-interest cause (for instance, a community based social or co-operative initiative) or a business undertaking, through small financial contributions from persons who may be in hundreds or thousands. These contributions are sought through a web-based crowd-funding platform or the offer may also be promoted through social media.

Based on online concept, crowd funding is an altogether a new impression in the minds of the investors as well as for the business venturer, who possibly otherwise would have found it difficult to seek funds for their project or some other social purpose.

¹ http://www.sebi.gov.in/cms/sebi_data/attachdocs/1403005615257.pdf

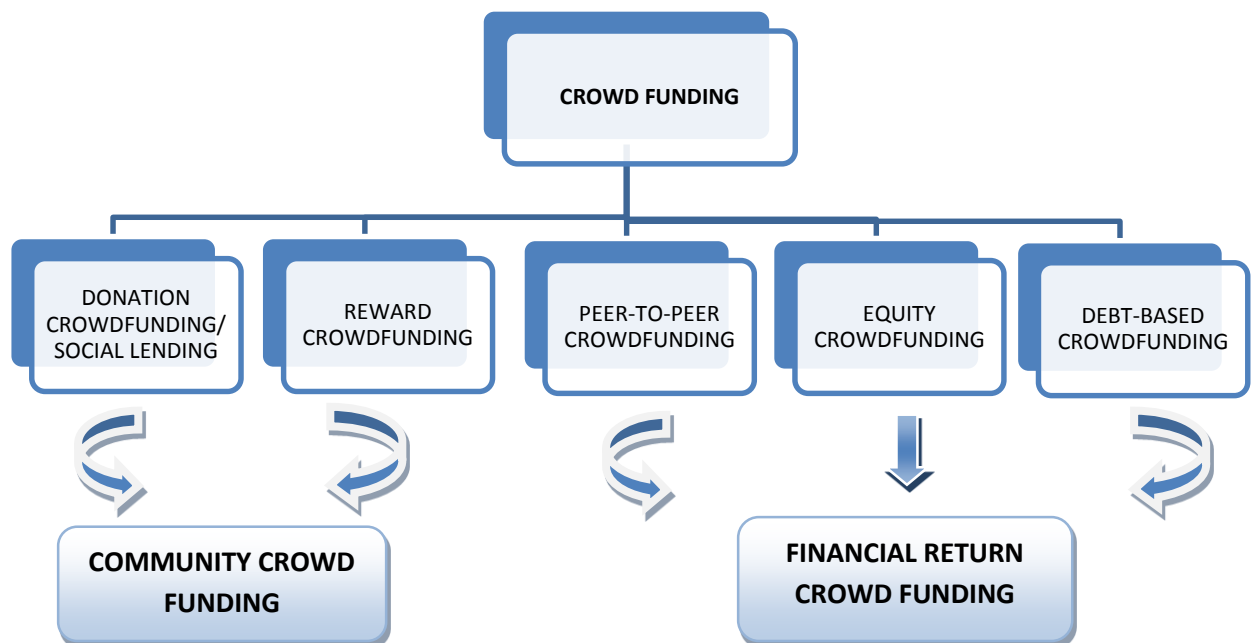


Types of Crowd funding

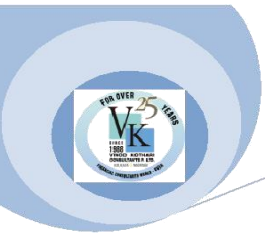
As per IOSCO Staff Working Paper- *Crowd-funding: An Infant Industry Growing Fast, 2014*², crowd-funding can be divided into four categories:

- a. donation crowdfunding,
- b. reward crowdfunding,
- c. peer-to-peer lending and
- d. equity crowdfunding

However the first two can be grouped under **community** crowd funding while the latter two can be grouped under **Financial Return** crowd funding. Apart from the categories mentioned in the IOSCO consultation paper, there is a fifth category of crowd funding that has been in existence in various countries, debt-based crowd funding. The diagram below illustrates the various categories of crowd funding prevalent globally.



² <http://www.iosco.org/research/pdf/swp/Crowd-funding-An-Infant-Industry-Growing-Fast.pdf>



Donation Crowd funding

It refers to collection of funds for artistic, philanthropic, social and other similar purposes without giving any tangible value in return. For instance a crowd funding platform like Fund Dreams India and Bluebells Community.

Reward Crowd funding

Under reward crowd funding funds are solicited and investors receive some existing or future tangible reward as consideration. (For instance an existing or future consumer product or a membership reward scheme)

Peer-To-Peer Crowd funding

Under this type an online platform is used to make the lenders meet the borrowers to provide unsecured loans. The interest rate is also set by the online platform. Some platforms charge fees based on the loan origination and therefore have an incentive to push investors into larger loans which may be unsuitable for the investor's risk profile.

Equity Crowd funding

Equity based crowd funding involves issuing equity shares to the investors for their contribution to the company. It basically involves raising funds by the entity, particularly early- stage funding , by offering interest in the business to investors online.

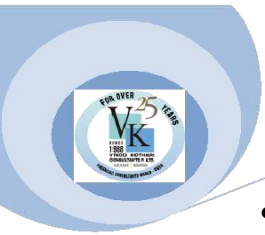
Debt-Based Crowd funding

This type of crowd funding exercise involves issuing debt securities to the investors for their investment in the company and includes funding required by the company at a later stage.

Benefits/ Advantages of Crowd funding

Despite the various categories, there are generic benefits to crowd funding as enumerated below:

- Crowd funding serves as a new investment avenue and provides a new product for portfolio diversification of investors.



- Start-ups and Small and Medium scale Enterprises (SMEs) will be able to raise funds at a lower cost of capital without undergoing rigorous and complex procedures under this mode.
- It also provides a much needed new mode of financing for start-ups and SME sector and thereby increasing the flow of credit to SMEs and other users in the real economy.
- Banks have become increasingly constrained in their lending to the ventures or start-ups which may have high risk element. Hence, there is a need for funding for SMEs through alternative sources.
- The operators of crowd funding platform may exercise vetting or due diligence of projects to be included on their websites, to maintain the goodwill of the online platform.

Risks in Crowd funding

Crowd funding involves various types of exposures or risks for the investors as well as for the financial market such as substitution of institutional risk by retail risk, default risk, risk of fraud, risk due to the central role of internet, and others which have been briefly discussed below.

Substitution of Institutional Risk by Retail Risk

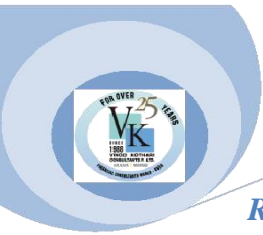
In crowd funding, SMEs and Start-ups ask for funds in small amounts from large number of investors whose risk tolerance may be very low; hence risk taking by informed investors (Venture Capital Funds and Private Equity Investors) is substituted by retail investors. This indeed turns out to be more dangerous, since investing in SMEs and Start-ups may be generally considered as aggressive and long term investments. Ignorant and unsophisticated investors (retail investors) may act with a '**herd mentality**'.

Default Risk

Chances of default is quite high since the issuer does not come out with any offer document and the funds are indirectly solicited by the issuer through a web platform. In case such a platform shuts down suddenly there is no or less recourse available to the investors against the issuer. Investing in companies without viable business model increases the risk of failure and loss to equity investors.

Risk of Fraud

Crowd funding always carries with itself a potential risk of defrauding the investors in the absence of any viable business model, since there is a possibility of genuine online platforms being used by fraudsters claiming to be owners of business projects.



Role of the Internet

Due to the wide coverage and reach of internet, the number of persons getting potentially affected by false projects is significantly greater than in traditional means of raising funds. People might get influenced to invest through online platforms, especially the young generation, because of its link to the social media and the internet.

Systematic Risk

The systematic risk falling in the path of investors may be due to the “individual” nature of crowd funding which leads to poor diversification principles, risk of illiquidity due to absence of secondary market, cross-border implications due to the difference existing in the law structure of different jurisdictions, possibility of money laundering.

Information Irregularity

The investors deal on the basis of soft information which may be unknown to other group of investors. There is lack of core information on which one can rely upon to take informed investment decision. Lack of regular monitoring of the platforms is not done. There is also lack of transparency and reporting obligations on issuers. Possibility of misinformation and omission of facts leads to provide a distorted view to the investors which may not go along with the risk tolerance of the investor.

Swap of Existing Regulatory Framework

The requirements of the regulatory framework for public offer, private placement, issue of debt securities (like filing of prospectus, lock-in period, credit rating, etc) cannot be compared with the disclosure framework and due diligence involved in crowd funding ; as the latter may be outside the purview of the said regulations. Hence, the risk element involved gets intensified.

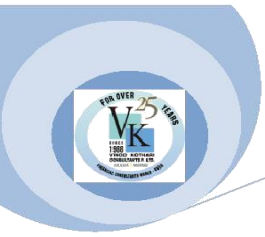
Regulatory Framework

International Scenario

Jurisdiction	Regulatory Framework
<u>United States</u>	Jumpstart Our Business Start-ups Act, 2012 or (JOBS Act) has already proposed a basic regulatory framework to regulate crowd funding platforms. Title III of the JOBS Act deals with Crowd Sourced equity Funding (CSEF). 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 crowd funding provision, has not yet come into force.



<p><u>New Zealand</u></p>	<p>The Financial Markets Conduct Act, 2013 (the Act) contains provisions designed to facilitate CSEF.</p> <p>The new regulations in New Zealand enables companies to raise up to a maximum of \$ 2 Million from 20 investors in a year through crowd funding without having to issue a prospectus. It covers both the equity crowd funding and peer-to-peer Lending.</p>
<p><u>Australia</u></p>	<p>The Corporations and Market Advisory Committee (Australian Government) recently came out with a Concept Paper on Crowd funding and is currently in the process of framing rules for equity based crowd funding.</p> <p>The current regulations does not allow a start-up to raise 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 currently under revision.</p>
<p><u>Canada</u></p>	<p>Crowd funding is divided into Non-Equity and Equity Crowd funding platforms in Canada. Equity Crowd funding involves the issuance of securities and consist of peer-to-peer (P2P) lending and equity transactions.</p> <p>There are registration requirements for Crowd Sourced Equity Funding Platforms, including Integrity, proficiency and solvency requirements, and for the persons operating them.</p>
<p><u>United Kingdom</u></p>	<p>In March, 2014 Financial Conduct Authority (FCA) came out with regulations governing the crowd funding in Britain. The new regime will be applicable to the firms operating loan-based crowd funding platforms and investment-based crowd funding platforms.</p>
<p><u>France</u></p>	<p>The new law allow platforms to register as a crowd funding investment advisor, which will enable platforms to get paid by companies as well as the investors.</p> <p>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.</p>
<p><u>Japan</u></p>	<p>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 Crowd funding in Japan.</p> <p>The amendments pertaining to Crowd funding include relaxation of entry requirements of Financial Instruments Business Operators (FIBO) and establishment of rules to protect investors.</p>



Indian Scenario

The provisions in the existing legal framework for raising funds by companies are regulated by Companies' Act 2013, 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 by Securities Laws. As of now the regulatory bodies have not yet laid down the provisions to regulate and standardize the crowd funding exercise in India, although the same is in progress and soon we will have a set of rules to account for fair and transparent mobilization and solicitation of funds raised through this web-based funding.

Pure donation based crowd funding (where issuers directly seek donation from the grantors), reward based crowd funding (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.

Mr. Raghuram Rajan, Governor of Reserve Bank of India, on August 21, 2015 raised concerns over the working of crowd funding, he said, ***“One of my worries about crowd funding is when it works, it's good, but when you have to recover (the important questions are) who recovers and how does it happen especially in an environment where enforcement is difficult³.”***

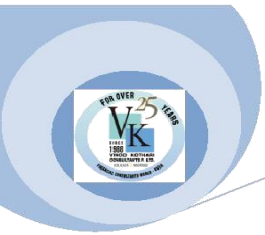
Mr. R Gandhi, Deputy Governor of Reserve Bank of India on August 23, 2015 said finance sector watchdogs are closely watching emerging instruments like bit coins and crowd funding, as they are seeking to operate in a "regulatory free" environment⁴.

However, the regulators are worried about the process in which crowd-funding is conducted. In case of investments from venture capitalists (VCs) and private equity (PE), it remains protected because of their influence on the company's management and board, but that kind of protection is absent in crowd-funding where retail investors participate.

In case of defaults or frauds, retail investors have no protection because of lack of documentation. If the website through which funds are raised closes down suddenly, then there is no way the money can be recovered. Some common crowd-funding platforms in India are TheHot-Start.com, Indiegogo.com and wishberry.in.

³ http://articles.economicstimes.indiatimes.com/2015-08-21/news/65706123_1_retail-investors-crowd-funding-venture-capitalists

⁴ <http://profit.ndtv.com/news/forex/article-rbi-warns-of-perils-of-bitcoins-crowdfunding-1210999>



Who can be the Investor

International Scenario

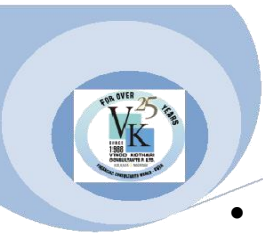
There has been various restrictions imposed on investments and the categories of investors who are allowed to invest in companies and these restrictions are displayed on internet based crowd funding websites or platforms of various jurisdictions, such as:

Jurisdiction	Limitation on Investment under Crowd funding
USA	<p>In a 12 month period, investors are allowed to invest</p> <ul style="list-style-type: none">• \$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	<ul style="list-style-type: none">• 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	<p>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.</p>
France	€1,000 per campaign
Canada	A maximum of \$2,500 in a single investment and \$10,000 per year

Indian Scenario

Under the Indian framework, considering the requirement to provide alternative funding sources to start-ups and at the same time safeguarding the interests of the retail investors, it is proposed to permit only ‘**Accredited Investors**’ to partake in crowd funding.

The proposed list of accredited investors who might be allowed to invest through crowd funding 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 worth of 20 crores.
- 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)
- Eligible Retail Investors (ERIs):
 - who receive investment advice from an Investment Adviser, or
 - who avail services of a Portfolio manager, or
 - who have passed an Appropriateness Test (may be conducted by an institution accredited by NISM or the crowd funding platforms),
and
 - who have a minimum annual gross income of Rs.10 lacs,
 - who have filed Income Tax return for at least last 3 financial years,
 - who certify that they will not invest more than Rs.60,000 in an issue through crowd funding platform,
 - who certify that they will not invest more than 10% of their net worth through crowd funding. (net worth excludes the value of the primary residence or any loan secured on such property).

Therefore, those retail investors are eligible to invest as ERI and are included in the category of accredited investors who have familiarity, experience and have access to investment advice and also have a backing to cope up with losses on their investment.

Eligibility for setting up Crowd funding Platforms

It is very important to lay down a set of conditions for those who propose to set up crowd funding platforms and for those who are running it, since the very medium of pooling funds is through these platforms.

International Scenario

In various international jurisdictions the roles and responsibilities of the entities who can set up a crowd funding platform or a website is briefly presented below:

Jurisdiction	Role and Responsibility of the Crowd funding Platform
<u>USA</u>	Merely listing an entrepreneur or using third party to manage the transfer will not suffice; one needs to register as a crowd fund investment portal or a full broker-dealer.



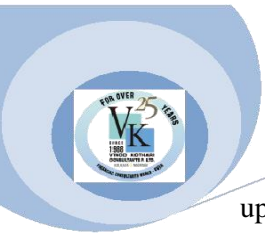
	<p>It has the following responsibilities:</p> <ul style="list-style-type: none">• Conduct regulatory check on each officer, director, and person holding more than 20 percent of the outstanding equity of every issuer whose securities are offered by such intermediary.• Intermediary required to deliver to the investors educational materials at the time of account opening, disclose 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.• Funding portals required to maintain a fidelity bond as a contingency fund.
<p><u>UK</u></p>	<p>Crowd funding 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.</p> <p>Crowd funding platforms therefore need to ensure that they</p> <ul style="list-style-type: none">(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. <p>The FCA does not prescribe the level of due diligence which needs to be undertaken by crowd funding platforms to assess the benefits and risks involved with each particular investment.</p>
<p><u>New Zealand</u></p>	<ul style="list-style-type: none">• 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)• The provider has adequate disclosure arrangements, fair dealing policy, proper implementation policy, adequate systems to resolve conflicts• 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.
<u>Australia</u>	<ul style="list-style-type: none">• 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.
<u>France</u>	They are supposed to provide the following services: <ul style="list-style-type: none">• 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
<u>Canada</u>	<p>Crowd funding portals must fulfil some requirements with respect to minimum capital, insurance regulatory reporting, record- keeping and retention requirements, etc.</p> <p>They are required to conduct background checks on the issuer and related persons, review the information given by the issuer, deny access to fraudulent issuers and provide investor education.</p>

Indian Scenario

In India as the regulatory framework for crowd funding is still a *work-in-progress* by the law makers; the eligibility criteria for setting up of crowd funding portals and platforms is not yet laid down. But considering the significance of these portals in the whole exercise of crowd funding it is proposed that any online offering or issue or sale through the internet can be made only through a SEBI recognized crowd funding platform. It is important to note that these platforms are not set



up or used to facilitate fund raising by fraudulent entities therefore, it is necessary to line down the specific requirements with respect to experience, solvency and integrity of these platforms.

Presently in India there are few crowd funding platforms to cater different needs of the people including social, commercial and charitable objectives- like Funds Dream India⁵, Start51⁶, Ketto⁷, Catapoolt⁸, Bluebell Community⁹ in addition to those named above.

Conclusion

Although crowd funding is an interesting and attractive source for the raising funds the only loophole is the absence of a uniform set of legislation for smooth functioning of the same. The regulatory strings will keep the investor safe and at the same time will help the fund seeker to raise funds with ease and with the confidence of the investor which will prove to be fruitful for both the parties in the long run.

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⁵ <http://www.funddreamsindia.com/>

⁶ <http://www.start51.com/>

⁷ <https://www.ketto.org/>

⁸ <http://www.catapoolt.com/>

⁹ <https://www.bitgiving.com/project/eventorganisation/id/MTE4NQ>