THE CONTINUING CONUNDRUM OF CROWDFUNDING GOING THE WAY OF PRIVATE PLACEMENT: ANALYSIS AND WAY FORWARD

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ABSTRACT

With the rapid rise of startups and the entrepreneurial ecosystem in the country, crowdfunding has gained significant traction as an alternative means of raising capital. Online platforms facilitating equity-based crowdfunding (EBC) have emerged, allowing startups to connect with retail investors, offering them an alternative to traditional venture capital or private equity funding. However, EBC has faced regulatory challenges, as seen in the cases of Septanove Technologies and Anbronica Technologies, where the Registrar of Companies (RoC) penalized these startups for breaching Section 42 of the Companies Act, 2013 by offering securities to more than 200 persons through their crowdfunding platforms. This paper will focus on the urgent need for a clear regulatory framework to legitimize EBC as a viable funding source for startups and small and medium enterprises (SMEs) in India. It will also provide a comparative analysis of international jurisdictions, suggesting reforms that India can adopt to support its growing startup ecosystem while ensuring investor protection.

Keywords: Private Placement, Crowdfunding, Public Placement, Equity Based Crowdfunding (EBC), Startups, Small and Medium Enterprises (SME), Securities and Exchange Board of India (SEBI), and Registrar of Companies (ROC).

1. Introduction

Every startup begins its journey with founders or a group of individuals who typically bootstrap or self-finance the company to initiate its operations. This initial phase, known as the pre-seed stage, keeps the organization private. As the company grows and solidifies its business strategy, it attracts various funding opportunities during the seed stage, involving sources like incubators, government support, and angel investors, collectively referred to as early-stage investments. Subsequently, as the business expands and legitimizes itself, it enters a series-type funding process, beginning with Series A and progressing as needed. This phase involves the participation of venture capital and private equity firms, leading to increased valuations with each round of investment[1].

In recent years, along with private equity and venture capital investments, Crowdfunding as a source of finance is increasingly gaining traction.[2] The Securities and Exchange Board of India ("SEBI") defines crowdfunding as "solicitation of funds (small amounts) from multiple investors through a web-based platform or social networking site for a specified project, business venture or social cause".[3] Therefore, as a result, this has led to the emergence of online technology platforms that connect businesses with retail investors to facilitate investments, particularly early-stage equity funding, known as 'equity-based crowdfunding' ("**EBC**"). These platforms offer startups an alternative to traditional venture capital or private equity funding and at the same time offer retail investors an alternative form of investment opportunity.[4]

Crowdfund is an "umbrella term used to describe an increasingly widespread form of fundraising, typically via the internet"[5]. Therefore, they can be typically classified into four following models based on what investors are promised in return to their contributions-

1. The Donation Model- In this model investors transfer money to the receivers without

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[1] Joel Cacciotti, *From Pre Seed to IPO: Startup Funding Explained,* Antler(May 4, 2023). https://www.antler.co/academy/startup-funding-stages

[2] Alexandra Mora-Cruz, *Crowdfunding platforms: a systematic literature review and a bibliometric analysis,* 19 IEMJ 1257 (2023).

[3] Consultation Paper on Crowdfunding in India, 2014, Securities and Exchange Board of India, 2.1 (June 14, 2014).

[4] Anand Shah, *Private Placement over a Public Platform- A Conundrum,* AZB and Partners (December 12, 2023) https://www.azbpartners.com/bank/private-placement-over-a-public-platform-a-conundrum/

[5] Douglas J Cummings, *Crowdfunding Fundamental Cases, Facts and Insights* (chapter 1, Academic Press, 2020).

any expectation of any kind of subsequent return on the sum transferred. As the name suggests, it is usually in the form of donations for charitable purposes.

2. The Reward Model- This model provides investors with something as a reward in return for their contribution, but it doesn't mean interest or a share in the company's profits. The reward can be minor, like a keychain or having the investor's name featured in the credits of a film. They do not offer any yields on investment.

3. Peer to Peer Lending Model- In this model, the investor transfers money to the recipient as a loan and expects it to be repaid in a certain period of time along with an interest. The online platform acts as an intermediary between the borrower and the lender.

4. Equity Based Crowdfunding Model- In this model, investors are promised a share in the profits or return in the business in exchange for their investments. Therefore, an equity stake of sorts is given to the investor, proportionate to the amount invested.[6]

This paper will only focus on the last model, ie. The Equity Based Crowdfunding (EBC) model, which has recently come under the scanner of heavy regulatory scrutiny in India for being violative of private placement norms under Section 42 of the Companies Act, 2013[7].

2. Existing legal regime for fundraising by startups (private limited companies)

a. Section 42 of Companies Act, 2013

Section 42 of Companies Act, 2013, read with Rule 14 of the Companies (Prospectus and Allotment of Securities) Rules, 2014, provides that private placement is "*any offer or invitation to subscribe or issue of securities to a select group of persons by a company (other than by way of public offer) through private placement offer-cum-application*".[8] It shall only be made to a select group of individuals, identified by the Board of Directors, which shall not be more than a total of 200 persons in a financial year. It also provides that no company making a private offer shall release a public advertisement or utilize media platforms to inform the public at large about the offer.

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[6] Thaya Brook Knight, Huiwen Leo and Adrian A. Ohmer, *A Very Quiet Revolution: A Primer On Securities Crowdfunding And Title III Of The Jobs Act* 2 MBELR 135 (2015).
[7] The Companies Act, No. 18 of 2013, §42 (Ind).
[8] Companies (Prospectus and Allotment of Securities) Rules 2014, Gazette of India, Rule 14 (March 27, 2014).

The 2013 case of *Sahara India Real Estate Corporation Ltd. & Ors. v. Securities Exchange Board of India & Anr* stands as a landmark judgment in the evolving jurisprudence surrounding private placement regulations in India. It involved two unlisted companies of the Sahara Group, Sahara India Real Estate Corporation Limited (SIRECL) and Sahara Housing Investment Corporation Limited (SHICL), which sought to raise funds through optional fully convertible debentures (OFCD) on a private placement basis. The issue arose when the group, via its agents and branch offices, offered OFCDs to over 30 million individuals. The Sahara Group contended that this did not constitute a public offering, as the OFCDs were made available exclusively to those affiliated with the Sahara Group of Companies, which they referred to as 'The Sahara Parivar'. Additionally, they argued that since they were unlisted companies, they would remain so even after the private placement.[9]

The Supreme Court held that the proviso to Section 67(3) of the erstwhile Companies Act, 1956, clearly stated that any offer made to 50 persons or more would be deemed to be a public offer and outside the preview of Section 67(3) of the 1956 Act.[10]The court observed that "*the proviso under section 67(3) of the Companies Act 1957 made the position clear, that any ofer/ invitation made by public company to 50 or more persons was bound to be considered as having made to the public. since OFCDs were issued to persons far in excess to 50, it was sought to be concluded thst the stance adopted by SIRECL and SHICL to the effect, that the offer of OFCDs was by the way of private placement was not acceptable*."[11]

As a direct result of the Sahara case, Section 42 was inserted into the Companies Act, 2013, in order to create a clear set of frameworks as to what constituted private placement and what did not. The explanation to Section 42(2) clearly states that "if any unlisted company makes an offer to more than 200 persons in a financial year, or allots securities to more than 50 persons, it would be deemed to be a public offer".

b. SEBI (Alternate Investment Funds) Regulations, 2012

Alternative Investment Fund ("AIF") is a fund established in India which is "a privately pooled investment vehicle which collects funds from investors, whether Indian or foreign, for investing it in accordance with a defined investment policy for the benefit of its investors".

[9] Sahara India Real Estate Corpn. Ltd. v. SEBI, (2013) 1 SCC 1 (Ind.)
[10] The Companies Act, No. 18 of 2013, §67(3) (Ind.)
[11] Sahara India Real Estate Corpn. Ltd. v. SEBI, (2013) 1 SCC 1 (Ind.)

These funds must be prohibited by its memorandum and articles from making any investment to public to subscribe to its securities. Moreover, no AIF shall accept any investment of value less than 1Cr and the number of investors should not exceed 1000 persons.[12]

3. Recent cases of scrutiny on crowdfunding platforms

In the matter of *Solargridx Ventures Private Limited*, the company introduced a Community Stock Option Plan (CSOP), which it offered to the general public via an online crowdfunding platform called Tyke. The investors were promised rewards based on the company's future valuation. In its ruling, the Ministry of Corporate Affairs (MCA) determined that these CSOPs were, in essence, derivatives—financial instruments whose value is derived from the price of an underlying asset. Since the value of these CSOPs was directly tied to the company's valuation, they were classified as 'securities' under Section 2(h) of the Securities Contracts (Regulation) Act, 1956.[13]

As a result, the MCA penalized Solargridx Ventures for violating Section 42 of the Companies Act, 2013. The company breached the private placement limit by offering securities to more than 200 people in a financial year and using media platforms to publicly advertise the securities issue. Additionally, the MCA found that Solargridx had violated Section 42(6) by failing to allocate the community options to investors within 60 days of receiving subscription payments. Consequently, the MCA ordered the company to refund all subscription amounts, with interest, to investors who had not received their securities.[14]

In another recent case of *Anbronica Technologies Private Limited*, the MCA imposed penalties on the company for using Tyke to unlawfully raise capital through Compulsory Convertible Debentures (CCDs). The Ministry observed that Tyke acted as more than just a media platform for unlisted companies to generate interest in their securities. It facilitated capital raising, provided end-to-end services, and violated Section 42(7) of the Companies Act, 2013, which governs private placements. The MCA concluded that these actions were in direct

[12] SEBI (Alternative Investment Funds) Regulations 2012, Gazette of India, Reg. 2(b) (May 21, 2012).
[13] Ministry of Corporate Affairs, Govt. of India, Adjudication Order of Penalties u/s 42 of the Companies Act, 2013 in the matter of Solargridx Ventures Private Limited (2023), https://www.mca.gov.in/bin/dms/getdocument?mds=sBM4VDe93G9p85DW%252BDkfvA%253D%253D&type=open
[14] Id.

contravention of the private placement rules.[15]

In the case of *Planify Capital Limited*, the company operated as a fundraising platform for startups by selling shares of unlisted companies through its website, Planify Platform. The scheme involved first offering shares to a related entity, Planify Enterprises Private Limited, which then down-sold these shares to retail investors via the Planify Platform. The MCA penalized Planify Capital for creating a complex transaction structure designed to circumvent Section 42 of the Companies Act, 2013. The Ministry found that shares were offered to a large group of investors, exceeding the 200-person limit set by the Act. Furthermore, the company failed to allocate equity shares to investors within the timeframe mandated by Section 42(8). The MCA concluded that the real intention was to offer securities to the general public, using Planify Enterprises as a facade to bypass legal restrictions.[16]

Therefore, based on the analysis of the aforementioned MCA orders, the following key issues arise when startups use online crowdfunding platforms for private placement:

a. Violation of private placement threshold- Section 42 of Companies Act, 2013, read with Rule 14 of the Companies (Prospectus and Allotment of Securities) Rules, 2014 clearly states that private placement offer shall not be made to more than 200 persons in a financial year. Crowdfunding by their very nature attracts a wide range of investors, potentially exceeding this limit.

b. Interpretation of public advertisement- Section 42(7) prohibits companies from using public advertisements to solicit investments during private placements, yet the law does not explicitly define what constitutes a "public advertisement." This leaves room for interpretation, especially when startups use digital platforms, websites, or social media to raise awareness about their offerings. Therefore, it is unclear whether the use of third-party platforms like Tyke or Planify constitutes public advertisement.

c. Lack of Regulatory Clarity: The ambiguity surrounding the regulatory treatment of crowdfunding platforms—whether they are mere intermediaries or active participants

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[15] Ministry of Corporate Affairs, Govt. of India, Adjudication order of Penalties u/s 42(10) of the Companies Act, 2013 in the matter of Anbronica Technologies Private Limited (2023), https://www.mca.gov.in/bin/dms/getdocument?mds=I4whIqT0vI2s3pZZHS8PiQ%253D%253D&type=open

[16] Ministry of Corporate Affairs, Govt. of India, Adjudication order of Penalties u/s 42(10) of the Companies Act, 2013 in the matter of Planify Capital Limited (2024), https://www.mca.gov.in/bin/dms/getdocument?mds=w64wOhzIOIxovd9hmbPqKw%253D%253D&type=open

in raising capital—creates uncertainty for both startups and investors, increasing the likelihood of non-compliance with securities and private placement laws.

4. SEBI's skepticism of Crowdfunding

In its Consultation Paper on Crowdfunding in India published in June 2014, the Securities and Exchange Board of India (SEBI) identified four significant risks associated with the practice of crowdfunding in the country. Firstly, the substitution of institutional risk with retail risk. Currently, the risks associated with financing startups and SMEs are predominantly borne by institutional investors like Venture Capital Funds or Private Equity investors. However, if crowdfunding is permitted in India, this risk would shift to retail investors, whose risk tolerance is generally lower. Since financing startups inherently involves high risks, retail investors may not be fully aware of or prepared for such risks, which could be dangerous.

Secondly, there is a high risk of default and fraud in financing early-stage businesses. Retail investors, in such cases, may lack any effective recourse against the issuer. Additionally, crowdfunding platforms may not always conduct thorough due diligence on companies before offering their securities to the public. This opens the door for fraudulent activities, including the creation of fake websites by fly-by-night operators looking to deceive investors.

Thirdly, the creation of illiquidity due to the absence of a secondary market: Unlike public listed shares that are freely traded on stock exchanges, securities on crowdfunding platforms are not tradable, leading to illiquidity. Investors may find themselves unable to exit their investments at will, which is a significant drawback compared to the liquidity offered by traditional stock exchanges.

Lastly, the presence of information asymmetry between two buyers of the same security. There is a risk of information asymmetry when one investor may make decisions based on information that is not available to others. This lack of transparency and disclosure obligations from issuers can lead to unequal access to information. Furthermore, retail investors often lack the experience needed to properly analyze available information, increasing the risk of making poorly informed investment decisions.[17]

[17] Consultation Paper on Crowdfunding in India, 2014, Securities and Exchange Board of India, 5.0 (June 14, 2014).

In August 2016, SEBI issued a press release cautioning investors against investing through unauthorized crowdfunding platforms that facilitated fundraising in ways similar to stock exchanges but without SEBI's recognition. These platforms were found to be in violation of the Securities Contracts (Regulation) Act, 1956, and the Companies Act, 2013, by offering private placements to the public at large. SEBI emphasized that investments made through these platforms would not be covered under its investor protection mechanisms, and investors would not have access to dispute resolution or grievance redressal processes typically available on recognized exchanges. This cautionary note highlighted the legal risks associated with such unauthorized platforms and urged investors to engage only with SEBI-recognized entities to ensure compliance and protection.[18]

5. Crowdfunding as a vital tool for a growing economy like India

While concerns around the legality and risks associated with crowdfunding have been raised, it is important to recognize the immense potential this model holds for a developing economy like India. With a rapidly expanding pool of retail investors, crowdfunding can serve as a powerful tool to channel capital into startups and small-to-medium enterprises (SMEs), which are essential drivers of innovation and job creation.

India is witnessing unprecedented growth in retail investment, fueled by increased financial literacy, access to digital platforms, and an expanding middle class[19]. Crowdfunding offers retail investors a chance to participate in early-stage ventures, creating opportunities to diversify their investment portfolios beyond traditional assets like stocks and mutual funds. In this context, equity-based crowdfunding can democratize finance, allowing individual investors to support innovative ideas, emerging businesses, and disruptive technologies that might otherwise struggle to secure funding through conventional channels. Furthermore, as the retail investor base grows, their collective influence can help shape a more dynamic capital market that supports local enterprises and fosters grassroots economic development.

6. Cross-Jurisdictional analysis

Equity crowdfunding has emerged as a pivotal tool for startups and SMEs to raise capital,

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[18] Ambika Chopra, *SEBI issues warning against crowdfunding platforms in India: Calls them unauthorized, Unregulated and Illegal, I*nc42, Sept. 10, 2016.

[19] A Ksheerasagar, *What's driving increased retail participation in Indian stock market,* The Mint, May 16,2024.

especially in developed nations like the UK, USA, and Germany, where comprehensive regulatory frameworks govern the process. These countries have successfully established clear, structured laws that not only protect investors but also promote innovation and business growth. In contrast, India's regulatory landscape is still in its early stages, presenting challenges to the legitimization and expansion of equity-based crowdfunding. By conducting a cross-jurisdictional analysis of these regulations, India can adopt global best practices to develop a robust legal framework that balances investor protection with entrepreneurial development.

a. United Kingdom

The United Kingdom (UK) is recognized for having "*the world's most developed equity crowdfunding industry*."[20] In the wake of the 2008 financial crisis, small businesses faced increasing difficulty in securing financing, which led to the rise of equity-based crowdfunding as an alternative capital-raising method. The UK seized this opportunity by supporting its crowdfunding market, bringing lending platforms under the jurisdiction of the Financial Conduct Authority (FCA). This regulatory oversight fostered the growth of numerous crowdfunding platforms that began thoroughly vetting client companies to build strong reputations and gain customer trust. These regulations were formalized under the Financial Services and Markets Act 2000, which is regularly updated to adapt to the evolving crowdfunding landscape.[21] Furthermore, the Seed Enterprise Investment Scheme (SEIS) and the Enterprise Investment Scheme (EIS), which offer tax incentives to individuals investing in equity crowdfunding for early-stage businesses, have significantly contributed to the growth of the industry.[22]

b. Germany

Germany introduced its first crowdfunding regulation in 2015 through the Small Investor Protection Act, which aimed to establish a structured legal framework for equity-based crowdfunding with a focus on safeguarding small investors. The Act introduced specific regulations for crowdfunding platforms that facilitate private placement and company financing through online channels. To mitigate risks for individual investors, it imposed limits on the amount one can invest in a single issuer, determined by the investor's financial capacity.

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[20] Nathan Rose, *How the World Regulates Equity Crowdfunding,* The Regulatory Review, June 26, 2019.
[21] Charlotte Hill, *An Introduction to Crowdfunding Part 1,* TaylorWessing, April 22, 2021.
[22] Nathan Rose, *supra* note 20.

For example, if an investor has freely available assets of at least €100,000, they are permitted to invest up to €10,000 in a single issuer.

Additionally, platforms are required to provide clear and comprehensive information about the investment opportunities they offer, including details on the risks associated with such investments. This ensures that investors are well-informed before making any financial commitments. The Federal Financial Supervisory Authority (BaFin) is responsible for overseeing compliance with these regulations, ensuring platforms operate within legal parameters and uphold investor protection standards. Therefore, the Small Investor Protection Act represents a major step in structuring Germany's equity crowdfunding landscape, balancing the promotion of innovative financing methods with the need for essential investor protections.[23]

c. United States of America

In 2012, the United States Congress enacted the Jumpstart Our Business Startups Act (JOBS Act) to legitimize 'Crowd Sourced Equity Funding' (CSEF) in the country. This Act exempts certain fundraising activities from mandatory registration and prospectus requirements for the sale or offering of securities. A two-tier mechanism is established under the Act. First, issuers seeking exemption under the JOBS Act can only raise up to a specified amount, as determined by the government at that time, within a 12-month period. Second, investors wishing to participate in crowdfunding are limited to investing up to 5% of their annual income or $2,000, whichever is greater in case the net worth of the investor is below $100,000 and 10% of the annual incime if the net worth of the investor is $100,000 or more.

Further, the JOBS Act also provides comprehensive disclosure requirements that must be filed by the issuing company with the Securities and Exchange Commission (SEC). It also provides that all transactions must be conducted by a registered intermediary called as "funding platform" that is prohibited from making any investment advice or investment recommendations in its website.[24]

Therefore, the regulatory frameworks in the UK, Germany, and the USA have played a pivotal

[23] Lars Hornuf, Lars Klohn, Tobias Schilling, *The Regulation of Crowdfunding in the German Small Investor Protection Act: Content Consequences, Critique and Suggestions* ECL 56, 60 (2016).
[24] Tanya Prive, *Inside the JOBS Act: Equity Crowdfunding,* Forbes, Nov. 6, 2012.

role in fostering a thriving equity crowdfunding industry by establishing clear legal structures that balance investor protection with entrepreneurial growth. These countries have demonstrated that well-regulated crowdfunding can serve as a powerful tool for startups and SMEs to access capital, while ensuring transparency and safeguarding the interests of individual investors. As India's crowdfunding landscape remains in its nascent stages, it must follow the lead of these developed nations by implementing a comprehensive legal framework tailored to its market. By adopting global best practices, India can create a robust crowdfunding ecosystem that encourages innovation, supports small businesses, and protects investors, driving the country towards greater economic growth and financial inclusion.

7. Recommendations for India

The Securities and Exchange Board of India (SEBI) recognized the need for a distinct regulatory framework for equity-based crowdfunding in 2014, when it released a consultation paper titled "Consultation Paper on Crowdfunding in India."[25] However, despite the passage of over a decade, no significant follow-up action has been taken. During this time, India's crowdfunding industry has expanded significantly, making it imperative to revisit and implement those proposed regulations. A thorough analysis of SEBI's consultation paper highlights several key proposed regulations that could serve as a foundation for structuring and formalizing the rapidly growing industry in India.

a. Eligibility of investors

The proposed regulation mandates that only "Accredited Investors" can participate in crowdfunding activities. Under the present law, only High Net-Worth Individuals (HNIs) and Qualified Institutional Buyers (QIBs) come under the bracket of Accredited Investors. They include organizations with a minimum net worth of INR 25 crores and individuals with a minimum net income of INR 5 crores.[26] Such eligibility conditions clearly restrict Indian retail investors from accessing the crowdfunding market.

b. Eligibility of entities

The consultation paper proposes that the entities interested in raising capital must be "unlisted

[25] Consultation Paper on Crowdfunding in India, 2014, Securities and Exchange Board of India (June 14, 2014).
[26] SEBI Introduction of Framework for Accredited Investors in Securities Market, 2021, Securities and Exchange Board of India (June 2021).

public company' incorporated in India, not more than 48 months old, and not promoted, sponsored or related to an industrial group which has a turnover in excess of INR 250 million". Moreover, it mandates that the directors, promoters or other managerial staff of the company do not suffer from any disqualification under SEBI or RBI regulations.

c. Eligibility of Crowdfunding Platform

The paper proposes that the owners and key members of the crowdfunding platform must meet certain requirements to ensure their integrity, experience, and solvency. SEBI has categorized these entities into three classes: Class I, II, and III. While Class I entities are entities that are already under the SEBI's domain an have proved a good track record in the securities market over the years; Class II entities (also referred to as the technology business incubators) are specialized domain experts in the field of startup mentoring and funding; and lastly, Class III include market participants such as private equity or angel investors.

Although these proposed regulations are a step in the right direction, they also fall short of addressing some important issues. Firstly, the regulation mandating that only Accredited Investors can invest in equity-based crowdfunding is flawed in nature. The underlying premise of 'crowdfunding' is to raise finance from relatively small contributions from a large group of people (crowd) and not from a small group of sophisticated investors. Jurisdictions around the world, including the USA and UK, allow small investors to invest in the crowdfunding market and at the same time provide appropriate safeguards to protect their interests. Therefore, it is suggested that small investors must be allowed to access the crowdfunding market while at the same time imposing appropriate safeguards such as investment limits and disclosure requirements in place.

Secondly, the Section 42 of Companies Act, 2013 read with Companies (Prospectus and Allotment of Securities) Rules, 2014 which mandates that private placement can only be offered to not more than 200 investors except for QIBs and employees is inadequate. It is suggested that this rule must be amended to carve out an exception for crowdfunding. Private placement offers must be allowed to be made to at least 1000 investors for the purpose of crowdfunding only. Restricting the number of investors to 200 would hamper the crowdfunding industry.

8. Conclusion

Therefore, the recent SEBI scrutiny of crowdfunding platforms, as seen in cases like Solargridx Ventures and Anbronica Technologies, highlights the regulatory challenges facing equity-based crowdfunding (EBC) in India. The current regulatory framework, especially Section 42 of the Companies Act, 2013, fails to address the unique nature of crowdfunding, leading to issues like breaching the private placement threshold and ambiguity around public advertisements. To resolve these challenges, the proposed recommendations suggest amending Section 42 to allow crowdfunding exceptions and implementing safeguards like differential voting rights and investment caps for retail investors. These measures, combined with lessons from countries like the UK and the USA, can help establish a clear regulatory framework that supports startups and SMEs while ensuring investor protection. This approach will legitimize crowdfunding as a viable alternative funding model, fostering innovation and growth in India's entrepreneurial ecosystem.