

A SOCIO-LEGAL ANALYSIS OF CROWDFUNDING IN INDIA

Areena Parveen Ansari*

ABSTRACT

Needless to say, FinTech is intensifying, attempting to capture the entire area of the mainstream financial market. Every other day novel technologies are emerging, and these technologies are keen to produce advanced products and services to satisfy their customers whilst aiding the financial flows. Crowdfunding is such an example where latent borrowers, investors, and fund-raisers meet over a platform provided by the aggregator. Crowdfunding platforms are intended to be a cost-effective source for deposits, lending and capital raising. Crowdfunding platforms in former years have seen tremendous growth from the alternative method of microfinance to an innovative system of financial intercession. However, online financial activities are exposed to numerous challenges, such as the threat to privacy, data breach, consumer protection and fraud to name a few. Crowdfunding is no exception to the menace of Cyberspace. Moreover, the absence of a comprehensive statutory framework and limited regulation annihilates the incentives provided by the crowdfunding platforms and also creates qualms in the minds of people. The study is based on the socio-legal analysis of the same.

Keywords- *Crowdfunding, Peer-to-Peer lending, FinTech, Decentralised Finance.*

* Assistant Professor, Dharmashastra National Law University, Jabalpur.

I. INTRODUCTION

The Digital era is known to be an age of exploring, transforming and quantifying the product and services by way of providing a plethora of financial products that could not only be beneficial for the consumers but ensures an advanced economy filled with opportunities.

*“FinTech has the potential to fundamentally transform the financial landscape, provide consumers with a greater variety of financial products at competitive prices, and help financial institutions become more efficient.”*¹

FinTech is emerging as sustainable finance². The fundamental feature of FinTech is to facilitate novelty in products and services with the aim of supporting the notion of Sustainability. The Decentralised Financial (DeFi) market efficiently ensures that the technology is being used in such a way that it is eliminated the centralised finance models by encouraging the services free of entry barriers. Having said this, Crowdfunding is that important component of the FinTech where small and medium-sized enterprises (SMEs and MEs), start-up entrepreneurs and even an individual through a platform can raise, invest and generate funds, internally or externally³. DeFi provides ample opportunities in the decentralised financial market all around the world.

The phenomenon of crowdfunding achieved an extreme rise in the year 2011. The concept of Crowdfunding existed way ahead in the international arena. However, India has adopted it way after due to a lack of technology and finances. India has seen a new dawn post-liberalization and specifically the investment market rise amidst the pandemic. The notion of Digital India, encouragement and adoption of numerous development plans FinTech is rising immensely in the Indian

¹ RBI Article on FinTech: The Force of Creative Disruption, 2020 *“FinTech is generally described as an industry that uses technology to make financial systems and the delivery of financial services more efficient. It is “technologically enabled financial innovation that could result in new business models, applications, processes or products with an associated material effect on financial markets and institutions and the provision of financial services” (FSB, 2019). FinTechs are “start-ups and other companies that use technologies (Table 1) to conduct the fundamental functions provided by financial services, impacting how consumers store, save, borrow, invest, move, pay, and protect money” (McKinsey, 2016).*
<https://rbidocs.rbi.org.in/rdocs/Bulletin/PDFs/7FINTECHEED4C43FC31D43C9B9D7F8F31D01B08E.PDF>

² Sustainable Finance Progress Report 2019- *“Sustainable finance as financial services, products, processes as well as institutional and market arrangements that contribute directly and indirectly to the delivery of the Sustainable Development Goals (SDGs)”*
<https://wedocs.unep.org/handle/20.500.11822/34534;jsessionid=56329827C35BDE9848385D196E4E23BA>

³ Garry A Gabison, *Understanding Crowdfunding and its Regulation*, 2015.
<https://publications.jrc.ec.europa.eu/repository/bitstream/JRC92482/lbna26992enn.pdf>

Financial Market too. Crowdfunding has been used by several individuals, SMEs, MEs and NGOs as well. Where businesses have been boosted up, several donation programmes are also running with the help of Crowdfunding platforms Ketto, Milaap, Crowdera, etc. These platforms are providing wider connectivity for raising the funds which include but are not limited to Education, Personal Care, Health Care, Funds for Start-up, Arts, etc. However, when it comes to regulation, needless to state that an unregularized FinTech imposes several challenges, because of which SEBI was sceptical about the crowdfunding and raised the question that *Is Crowdfunding really needed?* SEBI analysed the market in its consultation paper comparing the regulation of Crowdfunding in other countries such as the USA, UK, New Zealand, Australia, France and Canada.⁴ since the nature of DeFi is such that it is unprotected from several cyber risks including data reach, privacy infringement, cross-boundaries implications, frauds to name a few. Nonetheless, considering the need for Digital India Crowdfunding continued to grow with the limited regulation, we have yet to adopt the proper comprehensive compliance and legal framework for the Crowdfunding to use it up to its fullest potential so that menace of crowdfunding can be minimised.

II. CROWDFUNDING

There is no statutory definition for the term Crowdfunding. However, at several junctures, the concept has been applied as it, *“refers to the efforts by entrepreneurial individuals and groups cultural, social, and for-profit to fund their ventures by drawing on relatively small contributions from a relatively large number of individuals using the internet, without standard financial intermediaries.”*⁵

Thus, the aggregators⁶ provide a platform where a group of people from all around the world can get connected through cyberspace.⁷ Here with a small contribution made through platform one can invest, raise funds without the interference of traditional financial intermediaries, investors, and campaigners.

⁴ Securities and Exchange Board of India, Consultation Paper on Crowdfunding in India 2014. https://www.sebi.gov.in/sebi_data/attachdocs/1403005615257.pdf

⁵ Ethan Mollick, The dynamics of crowdfunding: An exploratory study. Journal of Business Venturing 2014

⁶ The Code on Social Security, 2020, Section 2 (2): *“aggregator” means a digital intermediary or a market place for a buyer or user of a service to connect with the seller or the service provider;*

⁷ Information Technology Laboratory, Computer Security Resource Center, Glossary, *A global domain within the information environment consisting of the interdependent network of information systems infrastructures including the Internet, telecommunications networks, computer systems, and embedded processors and controllers.* <https://csrc.nist.gov/glossary/term/cyberspace>

Another notion states “to provide financial resources that mostly takes place on an internet-based platform and links fundraisers to funders with the aim of funding a particular campaign by, typically, many funders. In these definitions, the important characteristics of this new financial mechanism are emphasized. The process could be initiated by a group or an individual for launching a new project of a cultural, social or for-profit nature. The funds are obtained from the crowd online, without financial intermediaries.”⁸

Whereas the Securities Exchange Board of India in its consultation paper defined the term as “Crowdfunding is solicitation of funds (small amount) from multiple investors through a web-based platform or social networking site for a specific project, business venture or social cause.”⁹

All of the above notions lie in the composition of the term itself Crowdfunding, which indicated the involvement of stakeholders for the purpose of fundraising which is facilitated by the web-based platform under the subhead of DeFi.

III. CLASSIFICATION

There are several classifications of crowd-funding based on the different practices of deposit, capital raising and business practices being governed by the countries. For example- Cambridge Center for Alternative Finance provided 16 different model crowdfunding types.¹⁰ Whereas according to IOSCO¹¹ Research Department Crowdfunding can be categorised into four broad areas such as social lending or donation crowdfunding, reward crowdfunding, peer-to-peer lending and lastly equity crowdfunding.¹² The same has been quoted by the SEBI in its consultation paper.

⁸ Paul Belleflamme, and Nessrine Omrani, and Martin Peitz, *The Economics of Crowdfunding Platforms*, 2015 Available at SSRN: <https://ssrn.com/abstract=2585611> or <http://dx.doi.org/10.2139/ssrn.2585611>

⁹ Ibid

¹⁰ Crowdfunding regulation models: International and Russian experience in context of sustainable development, 2020. https://www.e3s-conferences.org/articles/e3sconf/pdf/2020/68/e3sconf_ift2020_06009.pdf

¹¹ The International Organization of Securities Commissions (IOSCO) is the international body that brings together the world's securities regulators and is recognized as the global standard setter for the securities sector. IOSCO develops, implements and promotes adherence to internationally recognized standards for securities regulation. It works intensively with the G20 and the Financial Stability Board (FSB) on the global regulatory reform agenda. IOSCO was established in 1983. <https://www.iosco.org/>

¹² IOSCO Staff Working Paper of the IOSCO Research Department by Eleanor Kirby and Shane Worner, *Crowd-funding: An Infant Industry Growing Fast*, 2014. <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD459.pdf>

1. **Social lending or donation Crowdfunding-** as the name itself suggests, is fundraising for social or charitable causes. The important ingredient is that it doesn't provide any sort of financial return. Here, the inbuilt idea of solicitation of funds for compassion, charity, and philanthropy.

2. **Reward Crowdfunding-** Investors in such fundraising get rewarded, they are guaranteed either certain existing or imminent rewards, such as coupons, or any product, membership etc.

3. **P2P Lending (Peer-to-Peer)-** This is also known as Debt Crowdfunding. *"P2P lending is a form of crowd-funding used to raise loans which are paid back with interest. It can be defined as the use of an online platform that matches lenders with borrowers in order to provide unsecured loans. The borrower can either be an individual or a legal person requiring a loan. The interest rate may be set by the platform or by mutual agreement between the borrower and the lender."*¹³ P2P lending is where through the crowdfunding platform the lenders or the investors get linked with other borrowers or the issuers to provide unsecured loans. P2P assists in assembling the loan, and pool funds for individuals, start-ups etc. The platform sets the interest rate.

4. **Equity Crowdfunding-** Equity crowdfunding can be defined as where the funding is done in an early stage in exchange for Equity shares of that company. The raising of capital for start-ups or small businesses in return for equity shares.¹⁴

IV. ISSUES AND REGULATIONS

The platforms, the aggregators, potential investors and the crowd all contribute to crowdfunding. It provides several benefits such as, it is convenient, less complicated, less procedural, and provides marketing opportunities. However, just like any other thing Crowdfunding too has certain shortcomings. Additionally, there are some specific regulatory standards set for the limited areas of crowdfunding. Speaking of the same, RBI, from time-to-time issues and revised the master circulars for Peer-to-Peer Lending Platform¹⁵ the circular is an operational direction whereby the RBI specifies the prudential norms to be carried out by the P2P platform including registration, activities, mechanism, fair practice code along with the grievance redressal. The prominent issue with the

¹³ Reserve Bank of India Consultation Paper on Peer-to-Peer Lending, 2016. <https://rbidocs.rbi.org.in/rdocs/content/pdfs/CPERR280416.pdf>

¹⁴ Ibid

¹⁵ Reserve Bank of India, Master Directions - Non-Banking Financial Company – Peer to Peer Lending Platform (Reserve Bank) Directions, 2017 (Updated till 2021), https://www.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=11137

online platform is the incompetent complaint mechanism. The RBI, to resolve the issues involved has provided the mechanism of the redressal through Ombudsman¹⁶. The intermediaries are also required to comply with the master direction of the Information Technology Framework for the NBFC¹⁷ and P2P sector, which makes it mandate to provide security, safety and most importantly efficiency for the benefit of consumers.¹⁸

On the other hand, Equity Crowdfunding is illegal in India. As the SEBI in its press release notified that *“It has come to the notice of SEBI that certain electronic platforms are facilitating fund raising on digital platforms like websites and other internet platforms, which are similar to the platforms of stock exchanges. These digital platforms are neither authorized nor recognized under any law governing the securities market. The electronic platforms are allegedly facilitating investment in the form of private placement with companies, as the offer is open to all the investors registered with the platform amounting to a contravention of the provisions of Securities Contract (Regulation) Act, 1956 (SCRA) and the Companies Act, 2013. Only recognized stock exchanges provide a platform where equity and other securities issued by companies are listed and traded in accordance with the provisions of the Securities Contracts (Regulation) Act (SCRA).”*¹⁹

This result of the same was reflected when the SEBI has taken an extreme step to shut down several platforms engaged with Equity Crowdfunding.²⁰ In addition to this, SEBI recently suggested cautions

¹⁶ Ombudsman Scheme for Non-Banking Financial Companies, 2018 (The Scheme) updated till 2021. The Scheme is available on the RBI website <http://www.rbi.org.in>.

¹⁷ A Non-Banking Financial Company (NBFC) is a company registered under the Companies Act, 1956 engaged in the business of loans and advances, acquisition of shares/stocks/bonds/debentures/securities issued by Government or local authority or other marketable securities of a like nature, leasing, hire-purchase, insurance business, chit business but does not include any institution whose principal business is that of agriculture activity, industrial activity, purchase or sale of any goods (other than securities) or providing any services and sale/purchase/construction of immovable property. A non-banking institution which is a company and has principal business of receiving deposits under any scheme or arrangement in one lump sum or in instalments by way of contributions or in any other manner, is also a non-banking financial company (Residuary non-banking company). <https://www.rbi.org.in>

¹⁸ *ibid*

¹⁹ SEBI Press release, Cautions Investor, 2016. https://www.sebi.gov.in/media/press-releases/aug-2016/sebi-cautions-investors_33094.html

²⁰ Reference Article- Crowd control: Sebi warning turns off crowdfunding tap for start-ups, 2016 <https://timesofindia.indiatimes.com/business/startups/companies/crowd-control-sebi-warning-turns-off-crowdfunding-tap-for-startups/articleshow/54218934.cms>
<https://m.economictimes.com/small-biz/money/key-concerns-about-online-payments-and-ways-to-overcome-them/articleshow/91847946.cms>

SEBI directed Disclaimer for crowdfunding, 2017
<https://www.livemint.com/Money/ic0BUI5NSsO1yeJSNAAP11/Sebi-wants-crowdfunding-bodies-to-warn-investors.html>

required to be taken by the investors dealing with non-regulated platforms to protect the consumers from personal data breaches.²¹

Other than these, the platform itself consists of smart contracts and browse-wrap agreements²² where the access to the contents of the platform is subject to the terms and conditions of several laws which the platform specifies in its term of use. The browser is abided by various laws applicable as amended from time to time, including but not limited to the Contract Law, Copyright laws, Income Tax Act, 1961, the Foreign Contributions Regulation Act, 2010, Information Technology Act, 2000 or any rules thereunder.²³ There are privacy policies also attached to the websites that certify the protection of personal data and guarantee the protection by way of updated enhanced technology and software.

On the other hand, the absence and deficiency of uniform regulation and inadequate guidelines lead to cyber fraud, data breaches, lack of efficiency in the market, Taxation issues, and risks relating to unlicensed activities. The problem also persists in terms of Cross-border risks, non-awareness of the consumer etc. all these forms an additional load to the existing problems which are yet to be answered. This is uncalled for that India lacks in quality education, finance, stability, advanced technology, laws based on contemporary practices and the list goes on. Web illiteracy is a key concern of this advanced age along with the issue of privacy and security. The scams are occurring quite frequently these days, in the name of donations for medical, health care, cancer or for whatsoever reasons, the unlawful funding is taking place such as funding by the terrorist organisation, unchecked use of money, fake funding campaigns, obscure use of funds²⁴, campaigning for political purpose.²⁵

²¹ SEBI, Caution to Investors against dealing with unregulated platforms offering Algorithmic Trading, 2022. https://www.sebi.gov.in/media/press-releases/jun-2022/caution-to-investors-against-dealing-with-unregulated-platforms-offering-algorithmic-trading_59672.html

²² A website agreement (typically the website's terms of use or service) that aims to bind the user by virtue of the user browsing the website. Browse wrap agreements do not require a user take action to affirm consent to be bound. Instead, browse wrap terms typically state that use of the website is deemed acceptance of the agreement. [https://uk.practicallaw.thomsonreuters.com/5-508-6048?transitionType=Default&contextData=\(sc.Default\)&firstPage=true](https://uk.practicallaw.thomsonreuters.com/5-508-6048?transitionType=Default&contextData=(sc.Default)&firstPage=true)

²³ For reference <https://www.ketto.org/terms-of-use.php>; <https://pages.milaap.org/terms-of-use/>; <https://www.gocrowdera.com/termsfuse>.

²⁴ Kiruthika vs The State Represented Madras High Court, 2022

²⁵ For reference <https://www.news18.com/news/politics/kanhaiya-kumar-raised-highest-amount-in-online-crowdfunding-followed-by-aaps-atishi-shows-data-2116887.html>

Mother-daughter duo misuse ailing kid's pics for crowdfunding fraud, 2021, <https://www.newindianexpress.com/cities/kochi/2021/jul/10/mother-daughter-duo-misuse-ailing-kids-pics-for-crowdfunding-fraud-2328015.html>

<https://theconversation.com/convenient-but-susceptible-to-fraud-why-it-makes-sense-to-regulate-charitable-crowdfunding-172029>

<https://sanctionscanner.com/blog/crowdfunding-fraud-and-money-laundering-risks-139>

Another aspect is that at times reward-based crowdfunding involves the uncertainty of getting the guaranteed reward, now for sake of reward if the fund is given then what's the remedy available to the user? Then the issue of data theft or disclosure and sharing of private and confidential information. The position on the Personal Data Protection Bill, 2019²⁶ is yet to be decided to deal with these facets. Amidst these issues, the incompetency of wide-ranging regulation, adds up to demanding concrete laws. There is also an increase in demand concerning regularising Equity Crowdfunding where it is observed that donation-based crowdfunding is generating substantial public funds so do the businesses be allowed to raise money taken the colour from countries like United States of America, Australia, Malaysia, etc. The government of India is yet to realise that the current high-tech age requires high-tech laws. the fundamental idea of Digital India requires stringent regulation of the FinTech and special guidelines for the DeFi.²⁷

V. CONCLUSION

During and post-pandemic we have seen a rapid rise of numerous digital platforms providing a variety of investments and money-making in a short while. In comparison to the mainstream approach, FinTech is more viable in the contemporary scenario provided it is properly regulated. If the objective of Crowdfunding is carried out in its true sense without any ill-will, then raising and generating funds will be handier and hassle-free, which will not only serve the individual interest but assist in Sustainable development²⁸ as well. For any project or business venture, related to Arts, scholarship, sponsorship health or could be for any public causes, crowdfunding can be tactfully used. It saves you from going to Banks, Angel investors or Agents, then vetting the potential investors, and spending time and money. Even the state government²⁹ and the NGOs are too gradually shifting to Donation-based crowdfunding. The notion is acknowledged by the Hon'ble High Delhi court as well.³⁰

<https://www.thenewsminute.com/article/fake-fundraising-campaigns-tarnish-growing-crowdfunding-concept-india-153349>

²⁶ <https://prsindia.org/billtrack/the-personal-data-protection-bill-2019>

²⁷ For reference- Crowdfunding industry eyes clarity on regulation and legal accountability in Budget 2022 <https://economictimes.indiatimes.com/small-biz/sme-sector/crowdfunding-industry-eyes-clarity-on-regulation-and-legal-accountability-in-budget-2022/articleshow/89194162.cms>

²⁸ UN system's work on all three pillars of sustainable development- economic, social and environmental. Also refer Johensberg Declaration 2022. <https://www.un.org/ecosoc/en/sustainable-development>

²⁹ Arif vs The State of Kerala Kerala High Court 2022

³⁰ Lakshya Kumar Goyal vs Union Of India & Anr. Delhi High Court, 2021

Now on the issue of governance of Crowdfunding, the prominent issue is misappropriation of sources and funds. This can be minimised if we integrate blockchain technology with crowdfunding and facilitate efficient technology along with mandatory verification of documents (KYC), web literacy and awareness, we will be able to overcome the issues. Financial innovation along with laws is a crucial prerequisite that requires in-depth study of existing laws and amendments considering the need of the present. To mitigate the risk the government has to step up and regulatory bodies need to assist in boosting the confidence of investors, and aggregators by providing direction from time to time to standardise the crowdfunding platforms. SEBI is also required to re-assess the Crowdfunding market in terms of business, security, laws and policies in India and overseas, looking at the present-day FinTech market environment. The government need to reconsider the Companies Act, Securities act and Rules to make it beneficial for crowdfunding. They are also required to look through the interest of the consumers along with the harmonisation of interest of the aggregators, small business investors and the crowd involved.