SEBI CAUTIONS ONLINE CROWDFUNDING PLATFORMS; CLARIFIES APPLICABILITY OF INSIDER TRADING REGULATIONS

This update discusses the implications of a recent cautionary notice issued by the Securities and Exchange Board of India (the "**SEBI**") in respect of equity funding websites catering to the capital requirements of Indian start-ups.

Further, this update also discusses an informal guidance order issued by the SEBI to HDFC Bank Limited ("**HDFC Bank**") in respect of applicability of the SEBI (Prohibition of Insider Trading) Regulations, 2015 (the "**Insider Trading Regulations**") to investments through the discretionary portfolio scheme.

Online equity funding platforms under the SEBI's scanner

On August 1, 2016, the SEBI issued a cautionary press release declaring as unauthorized and illegal online equity funding platforms which facilitate fundraising by companies (the "**Press Release**"). The SEBI also cautioned investors against investing on such platforms and declared such dealings to be in contravention of Indian securities laws.

The Press Release has questioned the legality of online equity funding platforms such as Grex, LetsVenture, Termsheet, Equity Crest and Tracxn, which are crowdfunding platforms. The primary concern raised by the SEBI is that on such platforms equity shares are allotted to investors on a private placement basis; however, the offer for subscription is open to the public at large. Such online equity funding platforms are comparable to platforms offered by recognized stock exchanges, which have to comply with the Securities Contract (Regulation) Act, 1957. As the online equity funding platforms are not undertaking any such compliance, they are unauthorized and illegal. It must be noted that under the Companies Act, 2013, any offer for subscription of securities to more than 200 persons is considered as a public offer and has to comply with the requirements of the Securities Contract (Regulation) Act, 1957, and the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009. Further, only recognized stock exchanges registered under the Securities Contract (Regulation) Act, 1957, are authorized to engage in the business of facilitating buying, selling and trading of securities.

India is home to one of the largest and the fastest growing start-up ecosystems. The Indian government has also initiated programs such as "Start-up India" giving tax breaks and regulatory benefits to encourage start-ups. Early stage entrepreneurs in need of capital often prefer crowdfunding as a means of raising capital in a quick, cheap and efficient manner.

In fact, in 2014, the SEBI had issued a consultation paper on crowdfunding in India inviting responses from the public on creating a regime to regulate crowdfunding. The SEBI contemplated that per issuance limits and/or per investor limits could be imposed to regulate the quantum of capital that may be raised by an entrepreneur in one issuance and to cap the exposure of an inexperienced investor, as was done in many overseas jurisdictions like the USA, the UK, Australia, France and Canada. However, until date, the SEBI has not issued regulations governing crowdfunding in India.

<u>In view of the exponential growth in funding in the start-up industry, there is no doubt that the SEBI needs to put in place regulations governing crowdfunding so as to ensure that inexperienced investors having</u>

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little or no knowledge about financial markets are not duped or exposed to unnecessary risks. Further, given that failure rates in the start-up industry can be significantly greater as compared to a highly regulated listed entity, the move by the SEBI to issue a cautionary notice is in the best interests of investors. However, given the impetus of the Start-up India initiative of the Modi-led government, we feel that this Press Release may work to be a major dampener for Indian start-ups as a very efficient and successful method of capital raising is now suddenly being questioned. In the best interests of the start-up industry as well as investors, we hope that the SEBI issues regulations governing crowdfunding soon.

Investments under the discretionary portfolio scheme to comply with the Insider Trading Regulations

Pursuant to an application dated May 26, 2016 from HDFC Bank, the SEBI issued a guidance letter to HDFC Bank (the "**Guidance Letter**") and clarified that investments made by employees of HDFC Bank (who may be in possession of unpublished price sensitive information ("**UPSI**") of HDFC Bank or other listed companies) under the discretionary portfolio management scheme are not exempt from the applicability of the Insider Trading Regulations.

In India, portfolio managers are registered under the SEBI (Portfolio Managers) Regulations, 1993. As per these regulations, a "discretionary portfolio manager" is one who exercises complete control over the investment decisions made for a client in accordance with the terms of the contract of portfolio management. HDFC Bank had applied to the SEBI to ascertain whether its employees (who may be in possession of its or other listed companies' UPSI) can continue making investments through the discretionary portfolio management scheme as they have no control over the decisions made by their managers.

The Insider Trading Regulations provide that any insider shall not trade in securities listed or proposed to be listed when in possession of UPSI. By definition, an "insider" includes "connected persons", which includes intermediaries registered with the SEBI such as portfolio managers. Further, the explanatory note to Regulation 4 of the Insider Trading Regulations states that any person who has traded in securities in possession of UPSI shall be presumed to have done so being motivated by the knowledge and awareness of the UPSI. The SEBI relied on the foregoing provisions of the Insider Trading Regulations in confirming that investments under the discretionary portfolio scheme must comply with the Insider Trading Regulations.

It must be noted that guidance letters issued by the SEBI under the SEBI (Informal Guidance) Scheme, 2003, do not have the binding nature of law; however, in all likelihood, the SEBI may take a similar view in any legal proceedings on this issue.

The SEBI's interpretation under the Guidance Letter is in compliance with the letter of the law as the Insider Trading Regulations clearly cover transactions of this nature. Having said that, the SEBI should have taken note of the fact that the very nature of discretionary portfolio management ensures that no instructions on the investments are communicated between the investor and the portfolio manager. Practically, it is possible that a discretionary portfolio manager may independently (and coincidently) decide to invest in a listed company at a time when his client is in possession of UPSI of the same listed company, as a consequence of which the client will be presumed to be in violation of the

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Insider Trading Regulations. Therefore, in light of the Guidance Letter, persons having UPSI of listed entities may have to cease to invest through discretionary portfolio management schemes completely to mitigate risks of deemed contravention of the Insider Trading Regulations. One solution to this issue can be that the investors provide a restricted list of entities to their discretionary portfolio managers, However, impliedly, this can be regarded as communication of the fact that the investor has some UPSI relating to these companies, which may again be in violation of the Insider Trading Regulations.

Lastly, while the SEBI has not extended this view to investments in mutual funds under this Guidance Letter, it is not free from doubt that in the future, the SEBI may apply the same principle to mutual fund investments by persons possessing UPSI.

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