Should You Consider a "Crowdfunding" Offering?

On October 30, 2015, the Securities and Exchange Commission (SEC) voted to adopt "Regulation Crowdfunding," or "Regulation CF". On May 16, 2016, the final Regulation CF went active. Regulation CF is meant to make it easier for privately held companies to raise investment capital. Unlike other crowdfunding platforms like *Kickstarter*™, *GoFundMe*™ and *IndieGoGo*™ that raise funds from the public for personal causes and cool ideas where the donors have no expectation of a return on investment, Regulation CF is meant to open the door for private companies to sell investment securities to the public.

Historically, Regulation D under the Securities Act of 1933 served as the primary method for companies to privately raise funds. Due to the restrictions on selling to unaccredited investors and the inability to advertise an offering, companies dependent on investor capital anxiously awaited the adoption of Regulation CF so they could more broadly solicit investment. What has become clear in the last 3 months is that, while great in principle, for most companies crowdfunding is not a viable means to raise capital.

Before jumping in with both feet to a crowdfunding strategy, you should know and consider the significant limitations imposed by Regulation CF.

CROWDFUNDING RULES OF THE GAME

Offering Limitation	$1 million in any 12-month period
Who Can Invest	Anyone
Investment Amount:	
Annual Income Less than $100,000	$2,000 or 5% of income or net worth
Annual Income and Net Worth More than $100,000	10% of annual income or net worth, capped at $100,000
Manner of Offering:	Registered broker-dealer or SEC-registered/FINRA approved portal
Disclosure Requirements:	
Less than $100,000	GAAP financial statements/tax returns, certified by CEO
Less than $500,000	GAAP financial statements reviewed by CPA
Less than $1 million	GAAP financial statements reviewed by CPA, including CPA report, unless it is not your first Regulation CF offering, in which case the financial statements must be audited
Form C:	Pre-offering disclosure document (PPM)
Advertising:	Only "tombstone" directing investors to the portal

The table above is a very general, high-level list of regulations related to conducting a Regulation CF offering. There are nuances to these rules that are not addressed in this article, but that need to be considered before considering a crowdfunding offering. You should engage qualified counsel to be advised of these nuances and qualifications to the table above.

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IS CROWDFUNDING A VIABLE OPTION FOR YOU?

As set forth above, Regulation CF limits the amount you can raise in a crowdfunding offering to $1 million during a 12-month period. While this may not be problematic for small companies with relatively small capital needs, most businesses cannot get from formation to profit on that level of funding. While limiting your offering to $1 million, Regulation CF imposes significant expenses and compliance burdens well in excess of those in a traditional Regulation D offering. Regulation CF expenses include engaging a broker-dealer or SEC/FINRA approved portal, engaging an accountant for the financial statement disclosure and engaging counsel to prepare the Form C and other disclosure documents required to be included in the portal.

Consumer-Driven Businesses Better Served

If your business is not consumer-facing, it will be more difficult to fund your crowdfunding offering. Through *Kickstarter*™ and its progeny, we know the public is keen to give money to personal causes, consumer gadgets and good deeds. If your company is releasing the best and coolest action sports product, the crowdfunding audience is tailor-made for your offering. Your business is easily understood and fun. If, on the other hand, you are DNA mapping or building B2B software, there will be very little public excitement. To be sure, professional and seasoned investors will be very interested in that company due to growth potential, ROI and exit opportunities. For "Joe Six Pack," however, that doesn't create the kind of excitement for him to write you a check; and he likely won't.

Messy Cap Table

One of the primary disadvantages to a crowdfunding offering is the sheer number of shareholders you will have going forward with your business. Typically, the general public will not write large checks to fund a business but instead will, as they do with *Kickstarter*™ and other portals, write very small checks just to become "part of the story."

If you are seeking to raise $1 million, and come anywhere close to that number, you likely will have hundreds if not thousands of shareholders. The data collected thus far on Regulation CF offerings bears this out. In his *Series D Blog*, Steven Dresner noted that 76% of all Regulation CF investments were under $500

The administrative burden, not to mention the exponential risk of shareholder complaints, could make many crowdfunded ventures unfundable in future rounds. As a company matures and raises funds in future rounds, new investors will conduct due diligence on the company and its shareholder base. Larger investors, and particularly institutional investors and venture capital firms, like tight cap tables with a shareholder base consisting of management, employees and friends and family. These shareholders are unlikely to bring suit, whereas a public, passive investor poses the kind of risk most large round investors will not tolerate. In addition, when an exit by merger or acquisition is the goal, having a massive shareholder base could (depending on the transaction) make approval and notification difficult and expensive. In a very competitive funding environment, most investors will take a pass before jumping on board with thousands of individual, public shareholders.

It's worth noting that prior to the implementation of Regulation CF, commentators urged the SEC to allow companies to issue securities through a special purpose fund that would house all of the small shareholders. Basically, the company would only have one additional shareholder, consisting of hundreds or thousands of individual investors. The SEC declined to provide this exemption on the basis that such a single purpose fund would constitute an "investment company" under the ICA.

"Ankle-Biters"

There is an adage that the smaller the shareholder, the more hand-holding the company will need to do to keep him or her happy. On completion of a crowdfunding offering, your business will consist of small shareholders who may ask for information, updates or have questions about current developments or progress. Many will also have great ideas for the direction of the business they would like to convey or have introductions they would like to make to the company.

These types of shareholders require time on telephone calls, responding to e-mails and requests for information, and managing a clear and consistent message. Public companies with thousands of shareholders employ a full time investor relations person to manage the influx of calls and requests. As a start-up, you likely will not have the resources and manpower to manage this number of shareholders.

CONCLUSION

Before launching a crowdfunding offering, you should carefully consider the costs and compliance burdens of conducting the offering and the costs and burdens that will follow your company after the closing. Although Regulation CF does give companies access to the public for investment capital, that access comes with substantial risks and compliance costs. You should carefully consider whether your company is right for crowdfunding, and whether the trajectory of your company will support bringing along hundreds, if not thousands of public shareholders.

Feel free to contact me with any questions. Looking forward to discussing which crowdfunding option may be right for you and your company.

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