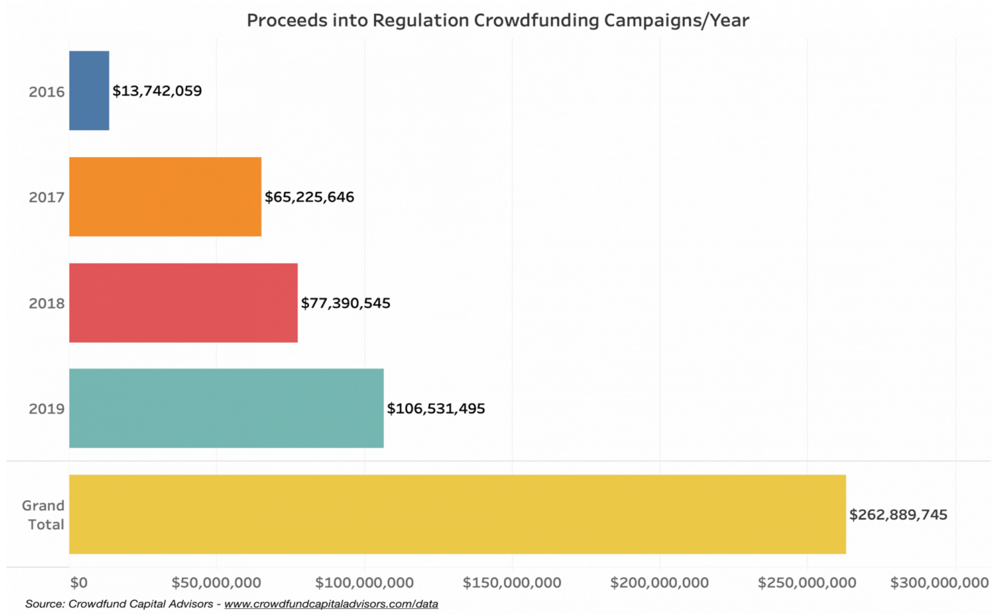
The Equity Crowdfunding Micro-Niche



For some time now I have been writing a series of articles (https://www.legalexecutiveinstitute.com/author/patrick-j-mckenna/) on what I've categorized as lucrative (and most often, unrecognized) "micro-niche" practices – everything from esports and synthetic biology to digital transformation and last week's social-media influencers.

While Covid-19 may be decimating many businesses, it is already creating scores of new ones and serving as a catalyst for improved sources of "alternative financing" – and one notable micro-niche within alternative financing is **equity crowdfunding** (or **Reg CF**). By way of a small example, take a look on LinkedIn at #crowdfunding to see that there are already 86,350 followers. On July 10 I noticed a posting from Jose Montero, a California-based CEO, announcing the official close of "our crowdfunding campaign" after maxing out early with 3800+ investors reaching his funding goal of $1.7 million (the regulated cap) to finance Blue, a smart business card and mobile app.

As an alternative funding option and launched in May 2016, one of the more intriguing doors that entrepreneurs can open to access capital is equity crowdfunding. In essence, Reg CF is raising capital from the crowd through the sale of securities (shares, convertible note, debt, revenue share, and more) in a private company (that is not listed on stock exchanges). Anyone can invest in your offering and what makes this appealing is that the entrepreneur raising capital has total control of the offering: what to sell, how much, and at what price are entirely up to the company raising capital. They set the terms, including their valuation and how much capital they hope to raise.

Think of it as similar in function to a Kickstarter or Indiegogo campaign, in which potential investors visit a funding portal website and can explore different equity crowdfunding investment opportunities. There are certain restrictions, in that there are limits on how much capital an individual can invest based on their income and net worth. Investors in Reg CF stand to make a profit if the company they invested in grows. This also benefits the company in it can create hundreds of "*brand ambassadors*" who want to see their investment succeed and that becomes an audience the company can depend on to spread the word about their business and share the product within their own networks.

According to Bevilacqua PLLC, a six-lawyer boutique firm in Washington DC, and one of many that specializes in startup financing and business formation:

> *Equity crowdfunding has become the new way that legitimate early stage companies and startups raise capital to grow their businesses. Equity crowdfunding is an excellent tool for entrepreneurs seeking capital. It allows an entrepreneur to raise capital from both accredited and non-accredited investors. Since most entrepreneurs don't have a huge network of high net worth friends who qualify as "accredited investors", equity crowdfunding allows entrepreneurs to ask for small investment amounts ($100 to $300) from a large number of their friends, families, acquaintances, fans and social media contacts. Entrepreneurs are able to generate interest through online general solicitation and advertising, while also tapping friends and family, networks, affinity groups and others to support their cause. I also believe that investors will be protected because they will receive full disclosure by way of a Form C offering statement and the amount of their investment is limited. Besides, SEC enforcement is always standing by to pounce on the fraudsters.*

In 2019, there were 714 Reg CF offerings by 643 unique companies across 44 states (including Washington, DC and Puerto Rico). The total amount raised was up an impressive 37% from $77.7 million in 2018 to $106.5 million in 2019 (see attached graph). The average raise of successfully funded companies jumped from $183k in 2018 to $270k in 2019. The running average raise since the launch of Reg CF is $239k. And, since the launch of Reg CF there have been 75 offerings that have raised over $1 million with 15 from companies that completed a follow-on round of financing.

Based on these results Crowdfund Capital Advisors concluded that:

a) given the increase in average raises over time, Reg CF is a viable funding alternative for startups and small businesses that are facing the valley of death ($25k to $250k in capital that they cannot fund themselves);

b) given the 60% average success rate, companies seeking capital have a much greater chance of success with Reg CF than with pretty much any other funding alternative;

c) given the geographic distribution of companies, Reg CF as a model has proven that communities across the U.S. are capable of deploying capital into their local businesses and supporting valuable enterprises; and

d) given the large number of follow-on rounds and their higher average raises, Reg CF continues to be popular as a funding mechanism (and an alternative to Angels/VCs) well past an initial funding round.

Upon scrutinizing the data, Reg CF seems to have **broad appeal to any law firm's client base**. For example, there is a fairly even split between startups (less than 2 years old) and more established firms, with 20% being more than 5 years old that are tapping into equity crowdfunding. While some might expect that the majority of capital goes to only a handful of industries, this is not the case. Companies in 58 different industries have been successfully funded. Typically, about 80% of the capital committed goes to 17 different industries from application software and consumer packaged goods to biotechnology and personal services.

Nevertheless, there have been complaints.

Many companies thought the $1.07 million raise limit too small. And rules restricted Accredited Investors to relatively tiny amounts despite no such constraints with Reg D. Moreover, regulations forbade issuers from discussing and gauging interest in their raise before spending money on legal and accounting services. Finally, retail investors meant messy cap tables that dismayed later investors.

So, in March 2020 the Securities and Exchange Commission (SEC) proposed sweeping changes to Regulation Crowdfunding as well as the other private capital-raising exemptions. The actual proposed rule change is entitled "*Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets*." These proposed changes are particularly significant such that knowledgeable observers are claiming that with these changes, **equity crowdfunding is poised to explode**. The changes cover:

• Raising the overall limit from $1 to $5 million
While not as big as some had hoped, this new ceiling allows for larger institutional players to invest alongside retail investors and may witness many midsize companies jumping into the online finance arena.

• Removing Accredited Investor limits
Successful equity crowdfunds usually have a mix of accredited and nonaccredited investors. Accredited Investors send important signals to each other and the larger market. Removing arbitrary limits increases the chance for a successful fund raising.

• Allowing 'testing the waters' communications prior to the raise
Equity crowdfunding companies tend to be newer and less experienced with complex securities laws. This gives companies a better idea of their raise metrics, while still protecting investors. by preserving liability for misleading statements.

• Allowing Special Purpose Vehicles
Allowing issuers to "clean up" their cap table by placing Reg CF issuers into an SPV was perhaps the most consistent Reg CF failing. According to the SEC proposal: "*In particular, public feedback has indicated that allowing the use of such vehicles could address concerns*

associated with managing the potentially large number of direct investors that could result from a crowdfunding offering, as those investments would be held through a single purpose entity."

These long-sought changes could have lasting effects on the private capital market. It could truly democratize capital raising, allowing everyone an equal opportunity at potentially lucrative investments. It could encourage entrepreneurs normally off the angel investor / venture capital radar to bypass traditional-funding methods. Issuers can synergize crowd effects by melding their investors, supporters, and customers. It could geographically disperse capital investing to every corner of the country.

And it could lead to entrepreneurial-minded, law firm industry groups identifying and developing this micro-niche as an area of particular expertise, as equity crowdfunding continues to grow.