



Introducing REG CF+

The Future of Small Business Finance

Introduction

Although I have been active in investment crowdfunding for a while, I have stayed away from offerings listed on the Regulation Crowdfunding (Reg. CF) funding portals. Until now, I have not seen the funding portals as a good place for any company to raise capital.

The primary reason had been an awkward and restrictive fundraising process that did not allow most investors to invest more than \$2,200 in any one Reg. CF issue. The Reg. CF market naturally tilted toward the idea that the offerings needed to be structured to appeal to large groups of small investors.

The funding portals have been encouraging issuers to accept investments as little as \$100-\$250. The issuers were burdened with the cost of a marketing campaign that needed to reach out to tens, if not hundreds, of thousands of potential investors.

The chief impediment to the growth of the Reg. CF market up has been that too many of the Reg. CF offerings have failed to raise the funds they seek. Large groups of investors can be costly to reach. Many of the Reg. CF campaigns seem to lack the resources to shoulder the burden of that expense.

Before March 2021 the maximum amount any company could raise using Reg. CF was \$1,070,000. That maximum has now been increased to \$5 million much to the anticipation of the crowdfunding community.

Personally, I think that the increased size of Reg.CF offerings is largely irrelevant. Most small businesses in need of capital will go to a bank. The average small business loan is less than \$1 million.

The real game changer in the new amendments is the way they enable accredited investors to actively participate in offerings on Reg. CF portals. Accredited and non-accredited investors can now truly co-mingle in every Reg. CF offering. Reg. CF is now perfectly aligned with investors who can afford to invest. This will expose each Reg. CF offering to a substantially larger pool of capital

There have been thousands of companies in the last several years that might have raised funds on a funding portal, but did not, even though they would have gotten better terms than they would have at a bank or commercial lender.

Given the enormous need for small business capital post-pandemic, I think the Reg. CF market is destined to take a significant portion of the market for small business financing away from banks

and commercial lenders. I think that tens of thousands of small businesses will come to Reg. CF portals for an infusion of capital in the same way they now go to banks.

As Reg. CF is now written this new marketplace is now positioned to fulfill that destiny. I have re-titled the current regulation to be **Reg. CF+**. I think it is worthy of that designation.

But before they can succeed, the funding portals are going to have to significantly up their game.

A quick survey of the roughly 30 funding portals that have been in operation more than 1 year will reveal a great many very small offerings (\$100,000 or less) that are currently posted that have been live for many weeks or months. That should never be allowed to happen.

We are already at the point where an intelligently planned, well-funded, and professionally executed crowdfunding campaign should be successful in raising the desired funds *every time*. Modern data mining and other digital marketing methods and techniques are being applied to investment crowdfunding campaigns with consistent success. There is no reason for so many campaigns to take many months or ultimately fail.

Reg. CF now has a 3 tiered structure for investor limitations:

Smaller investors can invest the greater of \$2,200, or 5 percent of the greater of the investor's annual income or net worth, if either the investor's annual income or net worth is less than \$107,000. A person with an income of \$150,000 and a \$50,000 net worth might now invest up to \$7,500.

Middle level investors can invest ten percent of the greater of the investor's annual income or net worth, not to exceed an amount sold of \$107,000, if both the investor's annual income and net worth are equal to or more than \$107,000; A person with an income of \$150,000 and a net worth of \$500,000 might invest \$50,000.

Accredited investors with a net worth of \$1 million (exclusive of their home) or who earn at least \$200,000 per year can purchase an unlimited amount of any offering that is listed on a Reg. CF funding portal.

About Accredited Investors

Prior to the JOBS Act, companies seeking capital would overwhelmingly use the Regulation D private placement market. More than \$2 trillion in new funds come into this market every year. The bulk of that capital is provided by institutions for institutional sized offerings. Many of those financial instruments pay interest or distribute income.

There is also a smaller “retail” market for private placements. Regulation D created the designation called “accredited investors” It was designed to restrict these unregistered offerings to investors who: 1) could afford to hire attorneys, CPAs and other experts to properly review the offering and 2) could afford to withstand the loss if the investment was a total loss.

About 10% of US households qualify as accredited or roughly 15 million households. Collectively they represent about \$75 trillion in net worth. Most of those households are baby-boomers. The value of having these accredited investors in the Reg. CF market cannot be overstated.

Private placements are classified as alternative investments in the mainstream stockbrokerage industry. They are considered to be “speculative” investments because of their very high risk of non-performance or total loss.

The mainstream stockbrokerage industry aggressively sells these Regulation D private placements to accredited investors who qualify. These private placements will pay a stockbroker sales commission of 8%-10% or more. They are among the highest commission paying investment products that an individual stockbroker can sell.

The brokerage firms also extract another 5% or more from each issue as re-imbursement for their firms’ marketing and due diligence costs. A total upfront sales load of 15% or more is not unusual for a Regulation D offering sold through a stockbrokerage firm. Additional management and other fees are also taken out of the operations.

What types of Private Placements do Accredited Investors Want?

It is not so much what accredited investors’ want, as it is about what they have been told that they want by the mainstream stockbrokerage industry. Investors have been told that these investments will provide them with passive income. The stockbrokers who put these products in front of accredited investors always highlight the monthly or quarterly distributions that investors will receive.

Private placements have been used to fund all types of real estate purchases and development projects. They fund a lot of domestic oil and gas exploration and alternative energy projects. Private placements are used to fund independent films and entertainment projects. Private placements can be used as a mechanism for funding whenever a business is started or purchased.

These offerings can often be structured to also provide ways for investors to accumulate income tax free or in a tax deferred account. There is often also an expectation of additional appreciation when the underlying asset is sold.

Investors in these private placements are told that these investments come with a high degree of risk that their funds will be lost. The sponsors often take steps to mitigate some transactional or market risks. Investors expect to be compensated for the higher risk they are taking with higher returns.

What the JOBS Act did

Before the JOBS Act stockbrokers were restricted to selling private placements only to people with whom they had a prior business relationship. They were not allowed to take out ads of any kind that solicited strangers to invest in an ongoing offering.

The JOBS Act eliminated that rule against general solicitation for Regulation D private placements. It also eliminated the need for an issuer to use a broker/dealer as an underwriter of the securities.

As this segment of the crowdfunding industry has evolved, it is now possible for any company that wishes to make an offering of securities under Regulation D to do so from the company website. You can rent the necessary plug-ins for a few thousand dollars a month. You control the e-mails and advertisements that you use to attract investors.

This direct investor solicitation, although not free, still eliminated most of the 15% or more in commissions and fees that the mainstream stockbrokers had tacked on and which had diluted the investors. Before crowdfunding, a company seeking to raise \$10 million to purchase an office building would need to raise \$11.5 million or more to cover those fees. Those extra investors would share in the profits so each investor would get less.

Eliminating the rule against general solicitation and eliminating the need for a broker/dealer to sell Regulation D securities has proved to be a winning combination. Accredited investors have felt comfortable enough to have purchased billions of dollars worth these securities on-line.

Crowdfunding has been a monumental success as a method to sell Regulation D private placements. By replacing the stockbrokers and their commissions, crowdfunding substantially reduced the issuers' cost of capital and offered a higher yield to investors.

The Reg. CF Market is substantially different

As a general rule, when a company issues securities in the US, those securities need to be registered with the US SEC. Both Regulation D and Reg. CF exempt certain funding transactions from registration. The rules for an offering of securities that is made under Regulation D are substantially different than the rules for securities issued under Reg. CF.

Regulation D defined and targeted accredited investors. Accredited investors can now invest as much as they want in offerings exempt under both Regulation D and Reg. CF. Reg. CF offerings can now specifically target accredited investors as well.

When it adopted Reg. CF the SEC set up an entirely new marketplace, patterned very much upon the existing one. Reg. CF created a new type of financial intermediary called a funding portal, set forth specific types of information an issuer needed to give to potential investors and restricted the type and content of advertisements that issuers could use.

Every funding portal is required to join FINRA which has itself created a series of rules and guidelines for the day-to-day operations of the funding portals. There can be no question that the SEC wanted this hands-on regulation because the Reg. CF investor was typically less experienced and less savvy than accredited investors.

Funding portals, because they are registered with the SEC and licensed by FINRA, just like mainstream stockbrokers, can and do receive a commission or “success” fee denominated as a percentage of the total funds raised for each issuer. It is not unusual for a funding portal to charge 7% or more of the total amount of funds raised plus a carried interest or warrants in the issuer as well.

Most funding portals seem to host very few offerings and most funding portals remain unprofitable. Approximately 30 funding portals were operating pre-pandemic and while that number seems about to double, until now there has really not been enough capital raised to sustain them all.

Five or six funding portals currently dominate this market. It seems that the largest portal raises about \$1 million per week for Reg. CF offerings. This Reg. CF marketplace should rightfully grow to the point where several dozen funding portals each raise \$1 million per day and more.

Successful Offerings

When one looks at successful investment crowdfunding campaigns, they have two things in common:

1. They offer investors an investment that is attractive because it provides a real return on investment (ROI) commensurate with a high-risk investment, and
2. They engage the services of a professional marketing company with specific experience in investment crowdfunding and put enough time and money behind the marketing campaign to make it work.

A company that is crowdfunding for capital sets the terms of its offering. The wrong terms can result in an unsuccessful offering or costly problems down the road. The most important terms define how investors will get paid and when. Issuers need to convince investors that they can execute their business plan and deliver the projected returns.

Issuers also need to appreciate what other issuers are offering. A real estate offering promising investors 8% ROI might be competing with others on the same funding portal offering 9% or more.

It is worth repeating the company that is seeking funding sets the terms of the financing because it is an invitation for creativity available in few other branches of finance. It is not difficult to

find companies financing projects, inventory or advertising campaigns and sharing the revenue with investors, leaving their capitalization tables unchanged.

Making the Right Offer to Investors

It makes no sense to spend money marketing an offering that is not attractive to investors. Creating the terms of an offering usually requires a serious review of how the company will use the proceeds of the offering and how much revenue the company expects to generate from this influx of capital.

Investors usually ask two questions: 1) what is the company going to do with my money, and 2) what kind of return can I expect? Satisfactory answers to those questions are always required.

No two offerings are exactly alike. Funding portals that encourage issuers to use a template or boilerplate to prepare their offering are doing these companies a disservice. If the business is good, it will hire professionals to help them.

I spend an inordinate amount of time dissuading companies from issuing a SAFE or similar derivative. Most do not understand it themselves. I discourage clients from selling SAFEs when there is a huge pool of investors who are much more comfortable with offerings that favor the KISS principle.

The Cost of Marketing is Everything

As I have said before, an intelligently planned, well-funded, and professionally executed crowdfunding campaign should be successful in raising the desired funds *every time*.

The “experts” who suggest that an issuer can rely upon “free” social media or who can turn their customers into investors and get the funds they need are offering those issuers false hope. While campaign costs have come down substantially, very few companies have demonstrated that they can raise money in this market without spending money.

Funding portal operators should insist that each issuer have a good marketing plan and adequate budget. Funding portals should also recommend marketing companies that have demonstrated that they can stay on budget and sell out offerings.

In addition to some amount of online advertising that will be purchased, most crowdfunding campaigns reach out with e-mail campaigns to prospective investors. It is axiomatic that the costs of finding investors go up with the number of investors sought. There is a substantial difference in the cost of finding enough accredited investors to provide the funds desired and the cost of finding 10x or more non-accredited investors to raise the same amount.

If you want to raise \$1 million, you might need 50 accredited investors each investing \$ 20,000. To raise the same \$1 million under Reg. CF you might price shares at \$500 and need 2000 investors to sell out. You might need to send out tens of thousands of e-mails to attract 50

accredited investors but hundreds of thousands of e-mails or more to attract 2000 non-accredited investors.

Accredited investors have been sought by the mainstream stock brokerage industry for decades. Ten years ago, a stockbroker could obtain an e-mail list of accredited investors in a desired zip code. They could then invite local accredited investors to a seminar where a representative of a company that sponsored many offerings would explain the benefits of owning real estate, etc. through a private placement.

Since the JOBS Act, the cost of selling a private placement to accredited investors using Regulation D has come down by 90%. Modern data mining techniques provide a much more targeted audience. Identifying and marketing to accredited investors has become much more efficient.

There are approximately 15 million households in the US that qualify as accredited investors. Many will never purchase a private placement because they do not want the speculative risk.

Those who will invest comprise a segmented market. Some will purchase real estate offerings, others oil and gas or clean energy projects. Still others will only invest in independent films. That segmentation allows issuers to target investors more likely to be familiar with what they are funding.

Where a typical accredited investor may have a portfolio of other investments, including other private placements, statistics about repeat investors in the Reg. CF market are hard to find. Most investors come to the Reg. CF market to invest in a specific company.

One of the “big lies” told by too many of the funding portals is that they have a “stable of loyal followers ready to invest” in companies that they host. This is not true. Each issuer should consider that they are on their own as regards marketing and marketing costs.

The costs of reaching out to a great many potential investors for a relatively small investment have stunted the growth of the Reg. CF market. Many of the start-ups and small businesses selling shares at \$100 or \$250 per share do not have the backing for a marketing campaign intended to reach millions of people to raise \$1 million or \$5 million in small amounts.

The SEC certainly took notice of this fact when it modified Reg. CF to unleash accredited investors and to allow some non-accredited investors to purchase substantially more than the prior \$2,200 limit. Overall, an issuer now needs far fewer investors to fully fund a Reg. CF offering than before. That will bring the costs of selling a Reg. CF offering down even further.

Testing the waters

Mainstream stockbrokers created workarounds to the rule that prohibited them from soliciting Regulation D private placements investments from people with whom they did not have a prior

relationship. Seminars were especially popular, often offering these high risk investors to seniors and retirees.

Reg. CF now includes permission for issuers to “test the waters” of the crowdfunding campaign. “Testing the waters” is an existing term of art in the securities industry. Every issuer needs to take care to remain compliant with the rules regarding the information that is given to prospective investors.

What an issuer or a funding portal can say, must say and what they cannot say in an advertisement or e-mail is strictly regulated. An issuer has the most latitude to say nice things about the company, its product, management, plans, etc. before the offering starts.

A Reg. CF offering goes “live” when its Form C is filed with the SEC, after which investors can actually purchase the shares through the funding portal. Before the Form C is filed the issuer can only make a presentation about itself telling viewers that “the company intends to raise money from investors in the near future” and inviting them to leave their name and contact information. When the offering goes live, those who indicated an interest will be directed to the company’s landing page on the funding portal where they will be given the formal terms of the offering.

This testing the waters process has two benefits. It allows the marketing company the opportunity to pre-test e-mail headings and content to determine which get the best responses. This should bring additional efficiency to the offering and continue to lower the overall marketing costs.

There is also a school of thought that suggests increased spending on advertising should start many months before the offering to raise the value of the business, and to increase the notoriety of the brand and customer base. Revenue growth in the months before an offering can favorably alter financial projections that investors will see.

Portions of the testing the waters campaign can be targeted to accredited investors and other portions of the campaign at non-accredited investors. The testing the waters campaign should give an issuer a pretty good idea of how to target the actual crowdfunding campaign and what to say.

The Best Investors Are the Ones that Cost Nothing to Obtain

Offerings that were once open only to accredited investors, can now accept investors regardless of their income or net worth. This will prove to have a significant advantage to certain businesses that can readily identify potential investors from their own customers.

For example:

Real Estate

Real estate brokers have been looking to crowdfunding to purchase commercial properties that they list for sale. Finding investors to come together to buy the property will double the commission a listing broker would otherwise receive. It also eliminates interminable walk-throughs by other brokers who “might” have a buyer and hours of negotiations likely to go nowhere.

Syndicating an office or apartment building that might sell for \$5 million would create a commission of \$300,000. A broker listing a property and syndicating the purchase would claim 100% of that commission. At a 3/1 LTV the crowdfunding campaign might raise \$1.3 million to cover the equity, all costs and include a reserve for maintenance.

That same real estate broker might have represented hundreds of households that purchased homes over the years that might now be solicited for an investment in an office building that many drive past on a daily basis. Logic suggests that these homeowners, even if not accredited, might have an interest in putting \$5000-\$10,000 into a local investment that will certainly pay them more than the current rate they might get in a savings account at a bank.

Accountants

Accountants also have clients that they have not been able to monetize. Over the years, I have helped accounting firms purchase the office building they occupy. Besides a stable rent for their own firm, the accountants receive a management fee for collecting rents from other tenants and a separate fee for the preparations of tax returns and K-1s.

As importantly, the accounting firms’ partners (and now every employee) can take an equity interest in the company that will own the property. The investment will build equity as the accounting firm and other tenants pay their rent. It can be liquidated or refinanced in the future to allow for lump sum distributions as the partners near retirement.

Start-ups

Start-ups, especially, are often short on cash to pay what it takes to run a successful crowdfunding campaign. For discussion, this is how I might prepare the offering for a typical, cash-strapped start-up. I call it **Prof. Stein’s Reg. CF Hybrid Template**.

An offering seeking \$1 million from investors could use Reg. CF rather than Regulation D and spend its limited amount of marketing budget where it is likely to get the highest return. Assume that the offering is structured to raise \$1 million by selling 100 slices (shares, bonds, LLC interests, etc.) at \$10,000 each.

In most cases 3-5 slices could be set aside and broken into smaller slices for non-accredited investors. That could include friends and family, employees, vendors, customers and anyone who responded favorably to the testing the waters campaign.

A Reg. CF offering can be structured to have multiple closings, so that the issuer might have an early closing when the first \$30-\$50,000 is raised and redeploy those funds to pay for the costs of marketing the offering to accredited investors.

Structured this way, the company seeking capital will spend very little reaching the non-accredited investors who are otherwise expensive to reach and focus what money they raise from early investors to reach accredited investors who will invest more per investor and who cost much less to reach.

Everyone, large investors and smaller investors would be in the same offering on the same terms. It is the perfect democratization of capital that the crowdfunding industry has wanted all along.

Benefits of Reg. CF to Accredited Investors

Operating correctly and within FINRA's guidelines, a funding portal should refuse to list companies where the issuer raises red flags about its disclosures that cannot be resolved. A funding portal should use a reasonable amount of diligence to verify the representations that are being made to investors. Funding portals have an affirmative duty to weed out offerings that may be fraudulent.

Funding portals are also required to weed out companies where the business plan is not practical. To be allowed to raise capital on a funding portal a company should have a reasonable chance of executing its business plan. Not every funding portal has the personnel or the inclination to make that judgment.

Funding portals that take those responsibilities seriously are more likely to attract accredited investors and angel investors. These investors appreciate working with funding portals that weed out offerings that no one should see. But there is more.

Accredited investors typically do not receive audited financial information about issuers using Regulation D. Reg. CF requires offerings that have a target offering amount of more than \$535,000, but not more than \$1,070,000, provide financial statements that have been reviewed by an independent public accountant. Financial statements for companies seeking more than \$1,070,000 need to be audited. Reg. CF also requires companies funded under Reg. CF to send periodic financial reports to their investors for the first two years.

Many of the family offices and angel groups are investing other people's money. They take legitimate comfort in dealing with a funding portal because it is a licensed intermediary. Where small investors with little to lose may just chalk up an offering run by a con artist to experience,

an investor putting up \$50,000 or more might take some comfort in knowing that FINRA has an active and efficient arbitration system where defrauded investors can recover their losses.

The Current Paradox

There are today, companies that are running both a Regulation D fundraising campaign from their own website and a Reg. CF on a funding portal targeted at non-accredited investors. I suspect many of the portals do not know that they could have pushed to combine the two into one offering.

Some issuers may object to paying the portal its 7% for the accredited investors. The funding portal charges nothing for these investors if the offerings are kept separate and the Regulation D offering is channeled through the issuers' website.

If for no other reason than there are a great many new funding portals coming on line, I suspect that the "success fee" of 7% may also come down. Logic says that it was always too high.

These same issuers that complain about the 7% currently charged by the funding portals might not balk if a bank or commercial lender charged 3% (points) or more on any loan. Given that the portals offer financing for companies on better terms than a commercial lender, a success fee of 4%-5% seems more reasonable.

The Future

Eventually the funding portals will associate with marketing companies that will create marketing campaigns that work. Eventually some of the funding portals will be able to fund company after company at a cost that can be put on the founder's credit cards and complete those offerings in 30 days or less before the credit card payment is due.

There will always be a lot of competition for accredited investors' dollars. Issuers that target both accredited and non-accredited investors on funding portals will have to step up their game. The offerings will need to get better and better if the funding portals expect to compete with a more established and better funded Regulation D market which is still dominated by mainstream stockbrokers.

If the Reg. CF market develops as it should, the funding portals should be able to develop significant followings of investors who will come back year after year. That can only happen when investors trust the funding portals to provide offerings that are good investments.

We are no longer speaking of a market that just takes \$100 from a lot of people but a market that also take \$25-\$50,000 or more from truly sophisticated investors. We are now talking about a new industry maturing to take a significant portion of the market for small business financing away from banks and commercial lenders.

The long-term effect of providing billions of dollars annually to small businesses, many of which would not otherwise get funded, may yet lead to the JOBS Act becoming one of the most significant laws of the early 21st Century.

About the Author

Irwin Stein is a Wall Street trained attorney who advises companies seeking capital and the financial industry firms and professional investors who provide that capital. He has qualified as an expert on matters relating to financial service industry rules, regulations, customs and procedures in state and federal courts.

Mr. Stein has taught Economics, Law and Economics, Finance and related courses to business school students at Golden Gate University in San Francisco as an Adjunct Assistant Professor. He was a member of the faculty budget committee for 5 years, serving one year as its chairperson.

His blog, <http://laweconomicscapital.com>, in which he often writes about his thoughts about investment crowdfunding in its various forms enjoys a global following of thousands of people interested his perspective on the continuing evolution of the capital markets.,

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