

Spring 2017

Crowdfunding – Buyer Beware!

My winter newsletter provided a brief introduction to the concept of crowdfunding and introduced the recently-approved securities-based crowdfunding rules issued by the Securities and Exchange Commission (known as Regulation Crowdfunding, or Reg CF). The new securities-based crowdfunding rules are intended to “democratize” the process of raising money for start-ups and smaller established companies – meaning more and smaller companies can raise money from more and smaller investors. But by making the fund-raising process more inclusive, the regulators actually built-in some issues that cause a good deal of concern. Let’s take a look at the fund-raising process first, then we can look at some of the troublesome issues. **But please note – this is all general information meant as an introduction. If you are considering investing in a crowdfunding offering or raising money through a Reg CF offering you will need to do your own research. The regulation was only recently issued and new developments are fairly regular.**

Fund-Raising Process

All Reg CF fund-raising must go through one of about 25 “portals” that are registered with the Financial Industry Regulatory Authority (“FINRA”). These portals are the framework through which a small company can raise equity or debt over the Internet. The portals generally charge a small up-front

fee to register and get started (as low as \$500 on some portals to as high as several thousand dollars on others). The portals also charge a percentage of the amount raised (can be 10% or more on some portals). Many of the portals advise companies to be prepared to spend additional money for legal and accounting work, which some note as approximating \$10,000.

Many portals help the company prepare the “offering” or refer them to a fee-for-service provider that will help them with it. In general terms, the “offering” is descriptive information about the company and the securities being offered for sale. Securities sold in a Reg CF offering can be any of the following:

- Loans – term loans, convertible loans, revenue-sharing notes and other loans.
- Preferred stock
- SAFE (and similar securities) – Simple Agreement for Future Equity
- Equity

Issues

The important thing to remember is that these are actual securities that place obligations on the company and hold out the prospect of some sort of return to the investor; which brings up a few issues. An extremely important issue is that the portals all emphasize that any security they issue is very speculative and that it is quite possible that investors will not receive any return on their



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investment – or even the return of their investment. Investors could simply be giving their money away.

Another issue to confront is that although the portals say they are selling a security, it's not like a typical security you buy from a stock-broker. Reg CF securities are extremely illiquid – for the most part they are unsalable after they are originally purchased. Investors are legally restricted from selling them for a period of one year. Once the one-year restriction ends, it could still be a very difficult process to sell a Reg CF security. One portal recently started a secondary market for Reg CF securities but it is so new it is difficult to tell how well it will work.

Most important to me, though, is that many portals do little to no screening of the valuations in the offerings. There is no requirement in Regulation CF for a company to obtain a valuation – they are only required to disclose how they came up with their valuation. And based on some of the offerings I have read, the valuations can be highly speculative.

There are a number of other issues related to crowdfunding securities that create problems for both companies and investors. So my advice is – be very careful if you are thinking about either raising money through a crowdfunding portal or investing through one. The Reg CF market is very new and there are still a number of issues to be worked-out.

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Please contact Ronald DiMattia at Corporate Value Partners at (216) 741-1330 or ron@corporatevaluepartners.com with any questions or if you need help with a valuation or corporate finance matter.

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