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Proposed Crowdfunding Rules Bring Opportunities and Obstacles

FINANCE: Some Say Regulations Would Still Be Too Cumbersome
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Startups seeking capital may find fertile ground through the proposed federal rules covering crowdfunding, but some of those rules could also inhibit businesses from using this process to raise money.

The U.S. Securities and Exchange Commission recently released rules that would allow new companies to obtain up to $1 million annually from non-accredited investors, generally those with a net worth of less than $1 million.

But complying with the regulations won't be easy. The proposed regulations run 585 pages.

While daunting, observers say the rules aren't set in stone, and provide a starting point for expanding an existing investing channel many startup companies are already using.

"I see this marketplace exploding because now you'll be able to make bets on these companies," said Bernhard Schroeder, director of the Lavin Entrepreneurship Center at San Diego State University.

Because of the expanded access, Schroeder predicts a wave of new companies raising rounds of $500,000 to $900,000 without having to give up huge chunks of their equity as required through the venture capital raising process.

Not for Everyone

Yet even new startups hunting for investors aren't jumping for joy over the proposals.

Mario Mireles, founder of Southdoctors.com, which creates websites for Mexican doctors to solicit patients in the U.S., said he isn't considering using crowdfunding to raise new money.

"We haven't thought about it," said Mireles, who launched the business in June. "We're looking for investors from venture capital and angels."

Southdoctors.com, which has offices in San Diego and Tijuana, is seeking an investment of $400,000 for a 10 percent equity stake.

Eric Patten, president of Ocean Aero, a San Diego developer of unmanned oceangoing vessels founded last year, said his company is seeking about $2 million, most likely through venture funds or private equity firms.

"We have much larger funding goals that seem to be outside the realm of crowdsourcing," Patten said.

Ocean Aero, which attracted $275,000 in angel investment, has built a prototype vessel that runs on wind and solar power. It's aimed at several uses, including scientific, commercial and fisheries, and would compete in the market today estimated at $500 million, and in three years could be about $1 billion, Patten said.

Even a local business that used Kickstarter, the biggest crowdfunding site, to obtain funding wasn't sure whether it would go back to crowdfunding for additional capital.

This summer Oceanside-based Vectolabs LLC raised $54,000 to develop a new motorcycle brake light system. Marketing director Jesse Szynal said the funds came from about 450 backers that gave $1 to $500, with the average ranging from $69 to $129. At that level, backers will soon receive the system that causes brake lights to light up when a bike downshifts, making it more visible to other drivers.

Under the current crowdfunding arrangements, backers receive a company's product or recognition, such as mention in film credits for their money. Starting sometime next year — after the proposed rules are formally adopted — investors will receive stock.

Setting Limits

And like most startup businesses, most of them will fail, resulting in investors losing their money. To address this issue, the SEC proposed limiting non-accredited investments to $2,000 or 5 percent of annual incomes or net worth, whichever is greater for those with net worth or annual incomes of less than $100,000. Above that threshold, investors could invest 10 percent annually.

Such restrictions angered some businesses that have already been established to facilitate the attraction of new investment. People should be free to invest their money into legal ventures without government interference, said Alon Goren, founder of InvestedIn, a Santa Monica-based crowdfunding portal.

Big Responsibilities on Portals

Such portals will be required to educate investors, providing them with financial data supplied by the company, and determine investors' financial ability to invest. The portals would also need to exclude companies not in compliance with rules or suspected of fraud.

"I'm scared about the government imposing these new rules that will mean too many hurdles for people to overcome," Goren said. "It's well known that if a [registration] process takes more than 10 minutes, a lot of people are going to change their minds."

Goren said that despite restrictions, crowdfunding isn't going away and that the rules represent a step in the right direction.

"Whether or not these rules stay in place, the technology is here to stay and will revolutionize multitudes of industries."