

# The JOBS Act – A 21<sup>st</sup> Century Funding Highway

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## An Act

To increase American job creation and economic growth by improving access to the public capital markets for emerging growth companies.

*Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,*

### **SECTION 1. SHORT TITLE.**

This Act may be cited as the “Jumpstart Our Business Startups Act”.

On April 5, 2012, President Obama signed into law the Jumpstart Our Business Startups Act (the “JOBS Act.”) Some commentators have described the Act as a “well-intentioned bill . . . [that] dismantles some of the most basic protections for the most susceptible investors”<sup>1</sup> and “an annoyingly named piece of legislation that purports to create jobs” but is “a sad reminder of what a sausage factory Congress is.”<sup>2</sup> While the JOBS Act does loosen some protections for a class of less traditional, i.e., less sophisticated, investors and does, like most acts of Congress, contain a little bit of this and a little bit of that. It should also be described as a forward-looking, affirmative attempt to address a real problem that has not only slowed our recovery from the recent recession, but hindered progress and innovation for more than the past decade.

Since 2001 small companies have had little to no access to investment capital. Venture capital backed deals dropped from 239 in 2000 to 28 in 2001.<sup>3</sup> In 2000 73% of initial public offering (IPOs) involved companies with annual sales of less than \$50 million; in 2001 that percentage dropped to 32%. From 1980 to 2000, almost 55% of IPOs were for companies with sales less

<sup>1</sup>Sorkin, Andrew Ross, (2012, April 2). Jobs Act Jeopardizes Safety Net for Investors, *The New York Times*, retrieved April 6, 2012 from <http://dealbook.nytimes.com/2012/04/02/jobs-act-jeopardizes-safety-net-for-investors/>

<sup>2</sup>Davidoff, Steven M., (2012, April 3), From Congress a Law Befitting a Sausage Factory, *The New York Times*, retrieved April 6, 2012 from <http://dealbook.nytimes.com/2012/04/03/from-congress-a-law-befitting-a-sausage-factory/>

<sup>3</sup>Ritter, Jay R. (2012). *Initial Public Offerings: Sales Statistics Through 2011*. Retrieved April 6, 2012 from <http://bear.warrington.ufl.edu/ritter/IPOs2011VC-backed%20IPOs1912.pdf>

\$50 million; from 2001 to 2011 only 28% of IPOs were for small companies.<sup>4</sup> We will leave railing against the JOBS act provisions that loosen Sarbanes-Oxley and other disclosure requirements to the media. We believe that the environment for small and early stage businesses. With the Internet as an avenue to funding, small businesses and investors can work together again.

Prior to the JOBS Act, the Internet was effectively off limits to companies seeking to raise capital. In essence, strict securities regulations meant that the largest network in history was out of bounds for companies that needed capital and were willing to sell ownership interests to fund growth and innovation. But existing securities regulations did not completely stifle the flow of Internet capital to fledgling companies. Some entities, known collectively as “crowdfunding platforms,” arose to help finance creative ideas and works that were either too small or too risky to attract angel investors or venture capital firms. In a nutshell, these crowdfunding platforms created an Internet-based clearinghouse to help for-profit entities assemble a crowd of people to pledge funds to help finance the development of a new product or service. In this setting, entrepreneurs and other creative types present their ideas via the platform, and individual community members decide whether to support these ideas with pledges or donations. Because of federal and state securities laws, contributing members do not receive an equity stake in the company. Instead, contributors receive anything from a handwritten “thank you” to a promise to receive one of the first products created by the company.

Despite limitations that prevent willing members of the crowd from becoming equity investors in the business, some crowdfunding platforms have successfully matched entrepreneurial individuals with much-needed capital. The best known crowdfunding platform is Kickstarter, the self-described “world’s largest funding platform for creative projects.” On Kickstarter ([www.kickstarter.com](http://www.kickstarter.com)) people propose projects and seek funding in exchange for “rewards,” usually creative material, such as a book, movie, digital file or artwork to be produced upon successful funding. The average project seeks backers to pledge small amounts of money to reach a total of less than \$10,000. According to Kickstarter, almost 12,000 projects (about 46%) were successfully funded in 2011 and total pledges exceeded \$99 million (less than that was actually funded as Kickstarter deals are all or nothing).<sup>5</sup> An example of one of the most successful projects is the “Tik Tok + Luna Tik Multi-Touch Watch Kit” venture, which sought capital to produce a line of watch bands for the iPod Nano. The initial goal for this project was \$15,000. Interest in this project was so large that more than 13,000 individuals backed the idea and pledged a total of more than \$940,000.<sup>6</sup>

This crowdfunding internet platform is easily distinguished from the financing efforts of a traditional investment banking firm. From 1991 to 2000, an investment banking firm operated by one of the authors of this commentary raised over \$120 million for development stage companies. On a given deal, the firm might have interacted with hundreds of prospective investors. It was expensive, hard, and sometimes grubby work that usually took at least several months from start to finish. Fees for this process typically consisted of 10% plus equity in the company.

Contrast this process with Kickstarter, where fees are only 5% and funding for the project must be wrapped up within 60 days of its launch, and most successful projects are funded within 30

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<sup>4</sup>Ritter. Retrieved April 6, 2012 from <http://bear.warrington.ufl.edu/ritter/IPOs2011Sales1912.pdf>

<sup>5</sup> Kickstarter (2012). Retrieved April 11, 2012 from <http://www.kickstarter.com/blog/2011-the-stats>

<sup>6</sup> Kickstarter, (2012). Retrieved April 11, 2012 from <http://www.kickstarter.com/projects/1104350651/tiktok-lunatik-multi-touch-watch-kits>

days. Importantly, Kickstarter deals often involve thousands of backers from all over the world. Because of the speed in which the Internet can congregate groups of interested individuals, deals can be completed much faster than that. One Kickstarter project, a point and click adventure game titled the "Double Fine Adventure," reached its original funding goal of \$400,000 in only eight hours, and ultimately raised approximately \$3.3 million from more than 87,000 backers.<sup>7</sup>

Clearly, crowdfunding has shown that the Internet has the ability to quickly and efficiently organize large groups of people who are willing to contribute small amounts of capital towards a creative idea or company. The JOBS Act harnesses this power to regulate and expand the fast-moving market for small project financing. It does this by modifying longstanding prohibitions against general solicitation and general advertising in connection with private placements and providing for an exemption under the Securities Act for "crowdfunding" offerings. It also knocks down the numerous impediments found in state securities laws. Here are the basic conditions for the exemption:

- The aggregate amount sold to all investors by the issuer, including any amount sold in reliance on the crowdfunding exemption during the 12-month period preceding the date of the transaction, is limited to not more than \$1 million;
- The aggregate amount sold to any investor by the issuer, including any amount sold in reliance on the crowdfunding exemption during the 12-month period preceding the date of the transaction, does not exceed
  - (1) the greater of \$2,000 or 5% of the annual income or net worth of the investor, as applicable, if either the annual income or the net worth of the investor is less than \$100,000; or
  - (2) 10% of the annual income or net worth of an investor, as applicable, not to exceed a maximum aggregate amount sold of \$100,000, if either the annual income or net worth of the investor is equal to or more than \$100,000;
- The transaction is conducted through a broker or funding portal that complies with certain requirements.

One important feature of the JOBS Act is that the intermediary brokers or funding portals must be registered with the SEC. In effect, the JOBS Act deputizes the brokers or portals and tasks them with watching over the small investors to ensure compliance with the above limitations. Issuers must also comply with some basic and manageable disclosure requirements. The disclosures are not as detailed as those required of companies going public. For instance, for offerings of less than \$500,000, no audit is required. These small financing opportunities can present a higher level of risk to the individual investor. But on the other hand, the JOBS Act limitations are supposed to keep investors from betting the ranch on any one deal and the platforms and brokers will have responsibility for compliance.

Some commentators criticize the JOBS Act and suggest that a better approach would have been to create a pilot program and give the SEC power to adapt crowdfunding rules to market

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<sup>7</sup> Kickstarter, (2012). Retrieved April 11, 2012 from <http://www.kickstarter.com/projects/66710809/double-fine-adventure>

conditions.<sup>8</sup> A more salient point is to ask why the SEC has not already taken such steps. The Internet has been a pervasive force in business for more than fifteen years. Yet the SEC has been unable or unwilling to propose any meaningful changes that would tap the market created by the Internet. By passing the JOBS Act, Congress has now forced the SEC's hand to stop over-regulating small capital offerings. The JOBS Act clears a trail toward more capital for small businesses, more funding for innovation at the grass roots level, and maybe, just maybe, more jobs.

Of course issues remain, and the devil will be in the details of the regulations yet to be written and put into effect. The biggest concern is the overhanging fear of fraudulent offerings that will clean-out innocent investors. While this fear exhibits a very real threat, it should also be noted that the potential for the same type of fraud exists in internet retailing. Yet somehow the intelligent consumer has been able to weave their way past fraudulent offerings and concentrate on respectable businesses that help police potential scammers. A second major concern will be liquidity. For many investors, it will likely be very difficult to sell their investments because many companies will remain small and never go public. As with all private stock, there will simply be no secondary market.

In the end, the JOBS Act is not *the* answer to the jobless recovery we are suffering through. The JOBS Act alone will not jumpstart the economy. But lack of access to capital has severely hindered new business development and the job creation and innovation that necessarily ride along. The JOBS Act gives us a 21<sup>st</sup> century funding highway that may once again make the United States "the jurisdiction of choice for both domestic and non-U.S. companies contemplating an IPO."<sup>9</sup> Success is not dependent on the limitations on how fast or how far an investor can drive or on what type of vehicle a new business proposes. No, success depends on us, on our willingness to back our colleagues and neighbors and to watch out for bad drivers. Congress and the President have, for a change, given us the keys. They want us to get out and drive the creation of new businesses and new jobs. They want us to help finish paving the road. They trust us to drive carefully and watch out for one another. Some of us can't wait to get behind the wheel.

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<sup>8</sup> Jacobs, Deborah L. (2012, April 4). JOBS Act Gives Full Employment to Journalists, *Forbes*. Retrieved April 6, 2012 from <http://www.forbes.com/sites/deborahljacobs/2012/04/04/jobs-act-gives-full-employment-to-journalists/>

<sup>9</sup> Spangler, Timothy, *Forbes*, <http://www.forbes.com/sites/timothyspangler/2012/03/28/with-the-jobs-act-congress-throws-open-the-door-for-private-stock-offerings/>