

Summer 2018

## Online Arbitration as a Remedy for Crowdfunding Fraud

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### Recommended Citation

C. Steven Bradford, *Online Arbitration as a Remedy for Crowdfunding Fraud*, 45 Fla. St. U. L. Rev. (2018).  
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# ONLINE ARBITRATION AS A REMEDY FOR CROWDFUNDING FRAUD

C. STEVEN BRADFORD\*

## ABSTRACT

*It is now legal to sell securities to the general public in unregistered, crowdfunded offerings. But offerings pursuant to the new federal crowdfunding exemption pose a serious risk of fraud. The buyers will be mostly small, unsophisticated investors, the issuers will be mostly small startups about whom little is known, and crowdfunded offerings lack some of the protections available in registered offerings. Some of the requirements of the exemption may reduce the incidence of fraud, but there will undoubtedly be fraudulent offerings.*

*An effective antifraud remedy is needed to compensate investors and help deter wrongdoers. But because of the small dollar amounts involved, neither individual litigation nor class actions will usually be feasible; the cost of suing will usually exceed the expected recovery. Federal and state securities regulators are also unlikely to focus their limited enforcement resources on small crowdfunding offerings. A more effective remedy is needed.*

*Arbitration is cheaper, but even ordinary arbitration will often be too expensive relative to the small amounts invested in crowdfunding. In this Article, I attempt to design a simplified, cost-effective arbitration remedy to deal with crowdfunding fraud. The arbitration remedy should be unilateral; crowdfunding issuers should be obligated to arbitrate, but not investors. Crowdfunding arbitration should be online, with the parties limited to written submissions. But it should be public, and arbitrators should be required to publish their findings. The arbitrators should be experts on both crowdfunding and securities law, and they should take an active, inquisitorial role in developing the evidence. Finally, all of the investors in an offering should be able to consolidate their claims into an arbitration class action.*

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## I. INTRODUCTION

Dazzle, LLC, a new software startup, posts an offer to sell its securities on a public website.<sup>1</sup> It raises \$500,000 through a large number of \$100 to \$500 investments by unsophisticated investors. Later, those investors discover that Dazzle lied to them—the investment is not as attractive as they believed. Dazzle is clearly liable for securities fraud, but the cost to sue would exceed the amount investors would recover. Even a class action is not feasible; \$500,000 is too small an amount to interest securities class action lawyers. The defrauded investors have no effective recourse.

This is the dilemma of investment crowdfunding—the sale of securities to the general public through an intermediary on the Internet. It has been touted as a way to ease the capital formation burdens of small businesses<sup>2</sup> and as a way to make business fundraising more “democratic” by giving less wealthy investors an opportunity to invest in business startups.<sup>3</sup> But crowdfunding also has its dark side. It could be used by the unscrupulous to defraud investors.<sup>4</sup>

Ordinarily, the Securities Act of 1933 (Securities Act) requires that securities offerings be registered with the Securities and Exchange Commission (SEC); unless an offering is exempt from the registration requirement, an issuer cannot sell securities until the SEC’s review is completed and the registration statement becomes effective.<sup>5</sup> The registration requirement is intended, in part, to protect

1. The Dazzle example is hypothetical. Dazzle, LLC is not intended to represent any real company.

2. See, e.g., C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 100-04 [hereinafter Bradford, *Crowdfunding and the Federal Securities Laws*].

3. See, e.g., John S. Wroldsen, *The Crowdfund Act’s Strange Bedfellows: Democracy and Start-Up Company Investing*, 62 U. KAN. L. REV. 357, 360-62 (2013); Lindsay Sherwood Fouse, Note, *The Crowdfunding Act: A New Frontier*, 16 DUQ. BUS. L.J. 21, 39-40 (2013).

4. See, e.g., Thomas Lee Hazen, *Crowdfunding or Fraudfunding? Social Networks and the Securities Laws—Why the Specially Tailored Exemption Must Be Conditioned on Meaningful Disclosure*, 90 N.C. L. REV. 1735, 1763-68 (2012); Zachary J. Griffin, Note, *Crowdfunding: Fleecing the American Masses*, 4 CASE W. RES. J.L. TECH. & INTERNET 375, 391-95 (2013).

5. See Securities Act of 1933 § 5(c), 15 U.S.C. § 77e(c) (2012) (declaring securities cannot be offered for sale until a registration statement has been filed); *id.* § 5(a)(1), 15 U.S.C. § 77e(a)(1) (declaring securities cannot be sold unless a registration statement is effective).

investors from fraud.<sup>6</sup> But over the objections of some securities regulators,<sup>7</sup> Congress has exempted investment crowdfunding from the registration requirement.

It is now legal to sell securities in the United States through crowdfunding. In November 2015, the SEC adopted Regulation Crowdfunding to implement the new crowdfunding exemption mandated by Congress.<sup>8</sup> Under the new exemption, in section 4(a)(6) of the Securities Act, issuers may raise up to \$1.07 million in any twelve-month period without either federal or state registration.<sup>9</sup> The exemption became effective in May 2016, and companies have already used it to raise millions of dollars.<sup>10</sup>

Some of the exemption's requirements could reduce the risk of fraud. The securities must be sold through a neutral, regulated intermediary, and the issuer is subject to detailed disclosure requirements.<sup>11</sup> But the amount of disclosure required by the crowdfunding

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6. See *What We Do*, U.S. SEC. & EXCH. COMM'N, <https://www.sec.gov/Article/whatwedo.html> [<https://perma.cc/DS3M-REKE>] (last modified June 10, 2013) (noting that one of the two objectives of the Securities Act is to "prohibit deceit, misrepresentations, and other fraud in the sale of securities"); see also Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 pmb. (declaring that the purpose of the Securities Act is "[t]o provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof").

7. See, e.g., Luis A. Aguilar, Comm'r, U.S. Sec. & Exch. Comm'n, Public Statement, Investor Protection Is Needed for True Capital Formation: Views on the JOBS Act (Mar. 16, 2012), <http://www.sec.gov/News/PublicStmnt/Detail/PublicStmnt/1365171490120> [<https://perma.cc/G2YY-B3CR>]; NASAA: *The JOBS Act an Investor Protection Disaster Waiting to Happen: Legislation Remains Fundamentally Flawed Product of Rush to Legislate*, N. AM. SEC. ADMIN. ASS'N (Mar. 22, 2012), <http://www.nasaa.org/11548/nasaa-the-jobs-act-an-investor-protection-disaster-waiting-to-happen/> [<https://perma.cc/QZ7P-W4M4>] (quoting Jack E. Herstein, President of the North American Securities Administrators Association, on his opposition to crowdfunding).

8. 17 C.F.R. §§ 227.100-503 (2017); see also Crowdfunding, 80 Fed. Reg. 71,388 (Nov. 16, 2015) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, 249, 269, 274) [hereinafter SEC Adopting Release] (adopting the crowdfunding rules).

9. Securities Act of 1933 § 4(a)(6), 15 U.S.C. § 77d(a)(6); 17 C.F.R. § 227.100(a). The cap was originally \$1 million, but the statute requires the SEC to adjust the amount periodically for inflation and it has already made the first adjustment. See Inflation Adjustments and Other Technical Amendments Under Titles I and III of the JOBS Act, 82 Fed. Reg. 17,545, 17,552 (Apr. 12, 2017) (to be codified at 17 C.F.R. pts. 210, 227, 229, 230, 239, 240, 249) (amending Rule 100(a) to adjust the amount to \$1.07 million).

10. Sources differ as to the exact amount raised. Compare VLADIMIR IVANOV & ANZHELA KNYAZEVA, U.S. SECURITIES-BASED CROWDFUNDING UNDER TITLE III OF THE JOBS ACT 6 tbl.1 (2017), [https://www.sec.gov/files/2017-03/RegCF\\_WhitePaper.pdf](https://www.sec.gov/files/2017-03/RegCF_WhitePaper.pdf) [<https://perma.cc/V8JA-U5L6>] (reporting \$8.1 million raised in offerings that closed by December 31, 2016), with 2016 Year End Regulation Crowdfunding Analysis, CROWDFUND CAP. ADVISORS (Jan. 6, 2017), <http://crowdfundcapitaladvisors.com/2016-year-end-regulation-crowdfunding-analysis/> [<https://perma.cc/7U2B-KFZN>] (reporting \$13.1 million raised in offerings that closed by the end of 2016).

11. See *infra* Part II.

exemption is more limited than in a registered offering, and, unlike registered offerings by small businesses, the offering is not contingent on SEC review and approval.<sup>12</sup> Moreover, the companies using the exemption will be small companies whose securities are not publicly traded, so little additional public information will be available. Many of those companies will be startups with little or no operating history. Finally, unlike the Rule 506(c) exemption for sales to accredited investors,<sup>13</sup> which is also sometimes called crowdfunding,<sup>14</sup> section 4(a)(6) allows issuers to sell securities to the general public, not just to accredited investors. Many of the purchasers will be small, unsophisticated investors who are less able to protect themselves from fraud.

Even if the incidence of fraud is low, some fraud is inevitable. An effective antifraud remedy is needed, both to deter fraud and to compensate investors for their losses when fraud occurs. Without such a remedy, crowdfunding could face a serious lemons problem: fraudulent offerings could drive out honest offerings and destroy crowdfunding as a viable investment vehicle.<sup>15</sup>

The existing remedies for securities fraud are unlikely to be effective in the crowdfunding context.<sup>16</sup> The SEC and state securities regulators can bring actions against fraudulent issuers, but their resources are limited, and they are unlikely to focus those resources on small, relatively insignificant crowdfunding offerings. Private enforcement will also be problematic, even though the crowdfunding exemption includes a liberal, pro-plaintiff liability provision—section 4A(c) of the Securities Act. Because of the individual investment caps in the exemption, each investor's loss in a fraudulent offering will be relatively small—a few thousand dollars or less for most investors. The cost to sue, including attorneys' fees, will exceed any possible recovery—making an individual lawsuit unfeasible. Much private securities fraud enforcement is through class-action lawsuits, but the \$1.07 million maximum offering amount limits recovery to an

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12. Compare 1 THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION §§ 3.34-3.40 (6th ed. 2009) (discussing SEC review of Securities Act registration statements), with Regulation Crowdfunding, 17 C.F.R. §§ 227.100-227.503 (not containing any requirement for SEC review or approval of the offering documents).

13. See 17 C.F.R. § 230.506(c).

14. The use of the term “crowdfunding” to refer to section 506(c) offerings is a misnomer, since issuers are not selling to the public crowd, only to investors who meet selective accreditation requirements. I will use the term “crowdfunding” in this Article to refer only to offerings pursuant to the section 4(a)(6) exemption.

15. See Darian M. Ibrahim, *Equity Crowdfunding: A Market for Lemons?*, 100 MINN. L. REV. 561, 587-603 (2015) (discussing the lemons problem and whether the crowdfunding exemption is likely to result in a market for lemons).

16. See *infra* Part IV.

amount that is unlikely to attract serious attention from class-action lawyers. Some other remedy is needed.

Arbitration is less expensive than litigation, so it could be a viable option for crowdfunding investors. However, even arbitration is not free, so cost is still a major concern. In this Article, I consider how to structure a cost-effective arbitration remedy to deal with crowdfunding fraud claims. I suggest the following features:

1. **Unilateral.** The crowdfunding arbitration agreement should obligate the crowdfunding issuer, but not investors, to arbitrate. Investors should remain free to sue if a lawsuit is feasible.
2. **Online.** The entire crowdfunding arbitration should be conducted online, to reduce the cost of resolving claims.
3. **“Written” submissions.** Oral testimony should be eliminated in favor of written, online submissions by the parties.
4. **Expert arbitrators.** The arbitrators should be experts who are familiar with both crowdfunding and securities law.
5. **Arbitrator as an active participant.** The arbitrator should take a more inquisitorial role than normal—asking for documents, raising questions, filling out the record—to make sure that all the necessary evidence is presented by both sides.
6. **Transparency.** The arbitration proceeding should be public, and the result of the arbitration, including a written opinion briefly stating the arbitrator’s findings, should be publicly available.
7. **Consolidation/Class actions.** Investors should be allowed, but not required, to consolidate their claims and bring arbitration “class actions.”

The proposed arbitration remedy will not be perfect. It sacrifices some of the protections available to parties in litigation. And even with those sacrifices, problems remain. The expense may still be too high to make some fraud claims feasible, and, even when investors win, collection of arbitration awards will sometimes be difficult. But the perfect should not be the enemy of the good; the proposed remedy is clearly better than the litigation status quo. A feasible but imperfect remedy is better than no remedy at all.

An arbitration remedy also meshes nicely with other changes scholars have proposed to protect crowdfunding investors, such as enhancing the section 4A(c) cause of action or offering investors fraud insurance. Even if such changes are adopted, the online arbitration remedy still has value; it enhances, rather than replaces, other suggested changes.

## II. THE CROWDFUNDING EXEMPTION

### A. Introduction

The SEC's new Regulation Crowdfunding implements the securities registration exemption for crowdfunded securities offerings added by Title III of the Jumpstart Our Business Startups (JOBS) Act, enacted in 2012.<sup>17</sup> The crowdfunding exemption is in the new section 4(a)(6) of the Securities Act,<sup>18</sup> but section 4(a)(6) incorporates many of its requirements from section 4A of the Securities Act,<sup>19</sup> also added by the JOBS Act.

Sections 4(a)(6) and 4A specify the requirements of the exemption in great detail, but the statutory exemption requires implementing rulemaking by the SEC.<sup>20</sup> The JOBS Act required the SEC to implement the required rules by the end of 2012,<sup>21</sup> but the Commission did not propose the crowdfunding rules until the fall of 2013,<sup>22</sup> and did not adopt them until November 2015.<sup>23</sup> The final rules became effective in May 2016.

The section 4(a)(6) exemption has four primary requirements. It limits the amount of the offering.<sup>24</sup> It limits the amount each investor may invest.<sup>25</sup> It requires the issuer to comply with section 4A(b) of the Securities Act.<sup>26</sup> And it requires that the offering be conducted

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17. Jumpstart Our Business Startups (JOBS) Act of 2012, Pub. L. No. 112-106, §§ 301-05, 126 Stat. 306 (codified as amended in scattered sections of 15 U.S.C.). The portion of the JOBS Act dealing with crowdfunding is known as the "CROWDFUND Act," an acronym for "Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure." *Id.* § 301. For a brief legislative history of the crowdfunding exemption, see C. Steven Bradford, *The New Federal Crowdfunding Exemption: Promise Unfulfilled*, 40 SEC. REG. L.J. 195, 198-99 (2012) [hereinafter Bradford, *The New Federal Crowdfunding Exemption*].

18. Securities Act of 1933 § 4(a)(6), 15 U.S.C. § 77d(a)(6) (2012). The JOBS Act actually places the exemption in section "4(6)" of the Securities Act, ignoring a prior amendment that added lettered subsections to section 4. It has been codified as subsection 4(a)(6) in the United States Code, so I will refer to it as section 4(a)(6).

19. *Id.* § 4A, 15 U.S.C. § 77d-1.

20. See *Information Regarding the Use of the Crowdfunding Exemption in the JOBS Act*, U.S. SEC. & EXCH. COMM'N, <http://www.sec.gov/spotlight/jobsact/crowdfundingexemption.htm> [<https://perma.cc/XX2H-J6MY>] (last modified Apr. 23, 2012) (reminding issuers that offerings in reliance on the crowdfunding exemption are unlawful until the SEC adopts implementing regulations).

21. JOBS Act § 302(c) (270 days after enactment of the Act).

22. See Crowdfunding, 78 Fed. Reg. 66,428 (proposed Nov. 5, 2013) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, 249) [hereinafter SEC Proposing Release].

23. See SEC Adopting Release, *supra* note 8.

24. See *infra* Section II.A.

25. See *infra* Section II.B.

26. See *infra* Section II.C.

through an intermediary that complies with section 4A(a) of the Securities Act.<sup>27</sup>

### B. Offering Amount

The crowdfunding exemption is limited to relatively small offerings. Originally, an issuer could not raise more than \$1 million in any twelve-month period.<sup>28</sup> A subsequent inflation adjustment by the SEC raised the limit to \$1.07 million.<sup>29</sup> Only section 4(a)(6) sales count against that limit.<sup>30</sup> Sales pursuant to other exemptions do not affect the availability of the section 4(a)(6) exemption.<sup>31</sup>

### C. Investment Limits

The crowdfunding exemption limits how much each investor may invest, not just in one particular offering but also in the aggregate in all section 4(a)(6) offerings. The investment limits are based on each investor's net worth and annual income.<sup>32</sup> They have been adjusted for inflation since the original enactment of the exemption,<sup>33</sup> which explains the unusual breakpoints in the current rule.

If *either* the investor's net worth or the investor's annual income is less than \$107,000, the investment limit is the greatest of three figures: \$2,200; 5% of the investor's annual income; or 5% of the investor's net worth.<sup>34</sup> Thus, the limit for poorer investors will be between \$2,200 and \$5,350. If *both* the investor's net worth and the investor's annual income are at least \$107,000, the investment limit is the greater of 10% of the investor's annual income or 10% of the inves-

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27. See *infra* Section II.D.

28. Securities Act of 1933 § 4(a)(6)(A), 15 U.S.C. § 77d(a)(6)(A) (2012); 17 C.F.R. § 227.100(a)(1) (2017).

29. See Inflation Adjustments and Other Technical Amendments Under Titles I and III of the JOBS Act, 82 Fed. Reg. 17,545, 17,552 (Apr. 12, 2017) (to be codified at 17 C.F.R. pts. 210, 227, 229, 230, 239, 240, 249) (adjusting the offering amount to \$1.07 million).

30. See 17 C.F.R. § 227.100(a)(1).

31. See SEC Adopting Release, *supra* note 8, at 71,391; SEC Proposing Release, *supra* note 22, at 66,432.

32. The limits in the statute are ambiguous. See SEC Proposing Release, *supra* note 22, at 66,433; Bradford, *The New Federal Crowdfunding Exemption*, *supra* note 17, at 200-02. The limits discussed in the text are from the regulation, which clarifies those ambiguities. The limits in the text have also been adjusted for inflation by the SEC since the exemption's original enactment. See Inflation Adjustments and Other Technical Amendments Under Titles I and III of the JOBS Act, 82 Fed. Reg. at 17,552 (amending Rule 100(a) to adjust the amount to \$1.07 million).

33. See Inflation Adjustments and Other Technical Amendments Under Titles I and III of the JOBS Act, 82 Fed. Reg. at 17,552 (amending Regulation Crowdfunding to adjust various dollar amounts for inflation).

34. 17 C.F.R. § 227.100(a)(2)(i).



tor's net worth, subject to a maximum of \$107,000.<sup>35</sup> Thus, wealthier investors will have a limit between \$10,700 and \$107,000.

These are annual limits.<sup>36</sup> An investor with a \$5,000 limit could invest \$5,000 in crowdfunded offerings now, and another \$5,000 a year from now. They are also aggregate limits on all section 4(a)(6) investments, not just limits on how much an investor may invest in a single issuer's offering.<sup>37</sup> If an investor with a \$3,000 cap invests \$2,000 in an offering by Issuer A, he or she may invest only \$1,000 more in crowdfunding offerings by all issuers, including Issuer A, within the same twelve-month period.

#### D. Requirements Imposed on Issuers

To qualify for the exemption, issuers must comply with the requirements in section 4A(b) of the Securities Act and the related regulations.<sup>38</sup> Among other things, the exemption limits the companies that may use the exemption, imposes extensive disclosure requirements, and limits the issuer's solicitation of investors.

##### 1. Eligible Companies

The section 4(a)(6) exemption is limited to smaller companies because it excludes reporting companies under the Securities Exchange Act of 1934 (Exchange Act).<sup>39</sup> The issuer must be organized under U.S. law,<sup>40</sup> and certain companies—including investment companies,<sup>41</sup> com-

35. *Id.* § 227.100(a)(2)(ii).

36. *See* Securities Act of 1933 § 4(a)(6)(B), 15 U.S.C. § 77d(a)(6)(B) (2012); 17 C.F.R. § 227.100(a)(2).

37. In the statute, the limits are initially expressed as limits on how much an investor may invest in a particular issuer's offering. *See* Securities Act of 1933 § 4(a)(6)(B), 15 U.S.C. § 77d(a)(6)(B). However, the statute also provides that crowdfunding intermediaries must ensure that the amount an investor invests "in the aggregate, from all issuers," does not exceed the annual limit. *Id.* § 4A(a)(8), 15 U.S.C. § 77d-1(a)(8). The final regulation makes it clear that the amount sold to any investor "across all issuers" may not exceed the applicable limit. 17 C.F.R. § 227.100(a)(2). However, the rules allow intermediaries to rely on investors' representations about how much they have invested, unless the intermediary has some reason to question those representations. *Id.* § 227.303(b)(1) (2017).

38. Securities Act of 1933 § 4(a)(6)(D), 15 U.S.C. § 77d(a)(6)(D); 17 C.F.R. § 227.100(a)(4). Most of the regulatory requirements applicable to issuers appear in Rules 201 to 205 of Regulation Crowdfunding. *See* 17 C.F.R. §§ 227.201-.205 (2017).

39. Securities Act of 1933 § 4A(f)(2), 15 U.S.C. § 77d-1(f)(2); 17 C.F.R. § 227.100(b)(2). Generally, a company is required to file reports under the Exchange Act if (1) its securities are traded on a national securities exchange, or (2) it has at least \$10 million in assets and either 2,000 record shareholders or 500 record shareholders who are not accredited investors. *See* Securities Exchange Act of 1934 § 12(a), (g)(1), 15 U.S.C. § 78l(a), (g)(1) (2012).

40. Securities Act of 1933 § 4A(f)(1), 15 U.S.C. § 77d-1(f)(1); 17 C.F.R. § 227.100(b)(1).

41. The Securities Act and the regulation exclude both investment companies and companies that would be investment companies but for the exclusions in sections 3(b) and

panies that fall within an extensive list of “bad actor” disqualifications,<sup>42</sup> and some others<sup>43</sup>—are excluded.

## 2. Required Disclosure

Section 4A(b) and the new regulations impose extensive disclosure requirements on issuers. The required information must be filed with the SEC and provided to the crowdfunding intermediary, investors, and potential investors.<sup>44</sup> The crowdfunding intermediary, in turn, is required to make the issuer’s disclosure publicly available on its platform at least twenty-one days before the offering closes.<sup>45</sup> The disclosure required is less than would be required if the offering were registered,<sup>46</sup> but it is still substantial.<sup>47</sup>

The issuer is required to disclose information about the company, its business, and its anticipated business plan.<sup>48</sup> It must provide information about its officers, directors, and anyone who owns more than twenty percent of its equity.<sup>49</sup> It must provide financial information about the company; the type of information required depends, in part, on the size of the offering.<sup>50</sup> It must provide information

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3(c) of the Investment Company Act. See Securities Act of 1933 § 4A(f)(3), 15 U.S.C. § 77d-1(f)(3); 17 C.F.R. § 227.100(b)(3).

42. The JOBS Act requires the SEC to adopt disqualification rules “substantially similar” to those applied to Regulation A offerings, with some additional disqualifications added. See JOBS Act § 302(d) (2012). Regulation Crowdfunding includes an extensive list of issuer disqualifications. See 17 C.F.R. § 227.503(a) (2017). Those companies are ineligible to use the exemption. See *id.* § 227.100(b)(4).

43. See 17 C.F.R. § 227.100(b)(5), (6).

44. Securities Act of 1933 § 4A(b)(1), 15 U.S.C. § 77d-1(b)(1); 17 C.F.R. § 227.201 (2017).

45. Securities Act of 1933 § 4A(a)(6), 15 U.S.C. § 77d-1(a)(6); 17 C.F.R. § 227.303(a)(2) (2017).

46. See Form S-1, 17 C.F.R. § 239.11 (2017) (containing the full registration statement for nonreporting issuers).

47. A general summary of the major requirements is sufficient for purposes of this Article. For a more complete discussion of the disclosures required by the statute, see Bradford, *The New Federal Crowdfunding Exemption*, *supra* note 17, at 203-05. Section 4A(b) also authorizes the SEC to require additional disclosures. See Securities Act of 1933 § 4A(b)(1)(I), 15 U.S.C. § 77d-1(b)(1)(I). The SEC has taken advantage of that power to require some disclosures not specifically listed in the statute. See 17 C.F.R. § 227.201.

48. See Securities Act of 1933 § 4A(b)(1)(A), (b)(1)(H), 15 U.S.C. § 77d-1(b)(1)(A), (b)(1)(H); 17 C.F.R. § 227.201(d)-(e).

49. See Securities Act of 1933 § 4A(b)(1)(B), (b)(1)(H)(iii), 15 U.S.C. § 77d-1(b)(1)(B), (b)(1)(H)(iii); 17 C.F.R. § 227.201(b)-(c), (m)(3).

50. The statute splits offerings into three classes: (1) offerings of \$100,000 or less; (2) offerings for more than \$100,000 up to \$500,000; and (3) offerings for more than \$500,000. See Securities Act of 1933 § 4A(b)(1)(D), 15 U.S.C. § 77d-1(b)(1)(D). Those breakpoints have now been changed in the exemption to adjust for inflation: (1) offerings of \$107,000 or less; (2) offerings for more than \$107,000 up to \$535,000; and (3) offerings for more than \$535,000. 17 C.F.R. § 227.201(s)-(t); Inflation Adjustments and Other Technical Amendments Under

about the offering, including: its purpose; how much the issuer is seeking to raise and the deadline for raising that amount; the securities being sold and their terms, including the price and how that price was determined; and the risks to investors.<sup>51</sup>

Issuers successfully selling securities pursuant to the crowdfunding exemption are also subject to ongoing, annual reporting requirements after the offering is completed.<sup>52</sup> An issuer's annual reports must, among other things, describe the financial condition of the issuer and include the same types of financial information required for the offering itself.<sup>53</sup>

### 3. *Restriction on Solicitation*

An issuer's solicitation of investors is generally restricted to the intermediary's web platform. Off-platform advertising is limited.<sup>54</sup> An issuer may only publish a notice directing investors to the intermediary's site, describing the terms of the offering, and providing very limited information about the company.<sup>55</sup> These advertising limits are intended to focus investors on the intermediary's platform, where the required disclosure is available.<sup>56</sup> Additional communications between the issuer and potential investors are generally limited to public communication channels on the intermediary's website.<sup>57</sup>

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Titles I and III of the JOBS Act, 82 Fed. Reg. 17,545, 17,552 (Apr. 12, 2017) (to be codified at 17 C.F.R. pts. 210, 227, 229, 230, 239, 240, 249) (adjusting the amounts in Rule 201(t) for inflation). The larger the offering, the greater the burden. If the offering is for more than \$535,000, the issuer must provide audited financial statements, unless the issuer is a first-time user of the crowdfunding exemption. First-time users of the exemption only need to provide financial statements reviewed by an independent public accountant. 17 C.F.R. § 227.201(t)(3). If the offering is for \$107,000 or less, the issuer is only required to provide the amount of its total income, taxable income, and total tax from its most recent federal income tax return, but the company's CEO must certify that the information provided is correct. *Id.* § 227.201(t)(1).

51. See Securities Act of 1933 § 4A(b)(1)(E)-(H), 15 U.S.C. § 77d-1(b)(1)(E)-(H); 17 C.F.R. § 227.201(f)-(m).

52. See Securities Act of 1933 § 4A(b)(4), 15 U.S.C. § 77d-1(b)(4); 17 C.F.R. § 227.202.

53. 17 C.F.R. § 227.202.

54. See Securities Act of 1933 § 4A(b)(2), 15 U.S.C. § 77d-1(b)(2); 17 C.F.R. § 227.204.

55. 17 C.F.R. § 227.204(b). The issuer may disclose only the following about the terms of the offering: "the amount of securities offered, the nature of the securities, the price of the securities and the closing date of the offering period." Instruction to § 227.204, 17 C.F.R. § 227.204. The factual information about the issuer is "limited to the name of the issuer . . . the address, phone number and Web site of the issuer, the email address of a representative of the issuer and a brief description of the business of the issuer." *Id.* § 227.204(b)(3).

56. "Limiting the advertising of the terms of the offering to the information permitted in the notice is intended to direct investors to the intermediary's platform and to make investment decisions with access to the disclosures necessary for them to make informed investment decisions." SEC Proposing Release, *supra* note 21, at 66,455.

57. 17 C.F.R. § 227.204(c).

### *E. Requirements Imposed on Intermediaries*

The crowdfunding exemption also imposes requirements on the intermediaries on whose platforms the securities are offered and sold.<sup>58</sup> Securities in a section 4(a)(6) offering may be sold only through a platform operated by a federally-registered securities broker or funding portal, and that intermediary must comply with the requirements of section 4A(a) of the Securities Act.<sup>59</sup> Funding portals are a new type of regulated entity, created just for the crowdfunding exemption, subject to special limitations not applicable to registered brokers.<sup>60</sup> Neither the intermediary nor its officers, directors, or partners may have a financial interest in any of the issuers using the intermediary's platform.<sup>61</sup>

As previously discussed, issuers using the crowdfunding exemption must provide detailed disclosure about, among other things, the company, its principals, and the offering.<sup>62</sup> The crowdfunding intermediary must make that disclosure available on its platform at least twenty-one days prior to the closing of the offering.<sup>63</sup> If there are any material changes after investors commit to invest, the intermediary must send the updated information to those investors and require them to recommit.<sup>64</sup>

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58. The statute and the regulation subject crowdfunding intermediaries and their platforms to a number of requirements; only the requirements that relate directly to how the offering is conducted are discussed here. For a fuller discussion of the statutory requirements applicable to crowdfunding intermediaries, see Bradford, *The New Federal Crowdfunding Exemption*, *supra* note 17, at 205-08. For a fuller discussion of the other requirements the regulation imposes on intermediaries, see SEC Adopting Release, *supra* note 8, at 71,428-54; SEC Proposing Release, *supra* note 22, at 66,458-78. For a fuller discussion of the additional requirements in the regulation applicable only to funding portals and not to other intermediaries, see SEC Adopting Release, *supra* note 8, at 71,454-74; SEC Proposing Release, *supra* note 22, at 66,478-96.

59. Securities Act of 1933 § 4(a)(6)(C), 15 U.S.C. § 77d(a)(6)(C); 17 C.F.R. § 227.100(a)(3).

60. See Securities Exchange Act of 1934 § 3(a)(80), 15 U.S.C. § 78c(a)(80) (2012); see also 17 C.F.R. § 227.402 (2017) (providing a safe harbor permitting funding portals to engage in certain activities without violating the statutory limits). For a fuller discussion of funding portals, see Bradford, *The New Federal Crowdfunding Exemption*, *supra* note 17, at 205-06.

61. The statute does not apply this disqualification to the intermediary itself, only to its directors, officers, partners, and similar persons. See Securities Act of 1933 § 4A(a)(11), 15 U.S.C. § 77d-1(a)(11). However, the regulation extends the ban on any financial interest in the issuer to the intermediary as well. See 17 C.F.R. § 227.300(b) (2017). The SEC reasoned that the conflict-of-interest concerns motivating the statutory prohibition also apply to the intermediary. SEC Proposing Release, *supra* note 22, at 66,461.

62. See *supra* Section II.C.2.

63. Securities Act of 1933 § 4A(a)(6), 15 U.S.C. § 77d-1(a)(6); 17 C.F.R. § 227.303(a) (2017).

64. 17 C.F.R. § 227.304(c) (2017). If the investor does not reconfirm his commitment, his commitment is cancelled. *Id.*

This issuer information on the crowdfunding platform must be available to the general public, not just people who have opened accounts with the intermediary.<sup>65</sup> However, investors may invest in an offering only after they have opened an account.<sup>66</sup> Before opening an account for an investor, the intermediary must provide educational materials to the investor explaining how section 4(a)(6) offerings work and their risks.<sup>67</sup> The investor must represent to the intermediary that he or she “has reviewed the intermediary’s educational materials . . . understands that the entire amount of his or her investment may be lost, and is in a financial condition to bear the loss.”<sup>68</sup> The investor must also complete a questionnaire “demonstrating the investor’s understanding” of some of these points.<sup>69</sup>

Crowdfunding intermediaries must also provide communication channels on their platforms where investors and potential investors may communicate with each other and with representatives of the issuer.<sup>70</sup> The communication channels must be open to the general public, but only investors who have already opened accounts are allowed to post.<sup>71</sup> Except for the limited offering notice the issuer is allowed to circulate off the platform, communications between the issuer and potential investors about the offering must be on these communication channels.<sup>72</sup>

Issuers posting offerings are required to specify a target amount and a deadline for reaching the target amount.<sup>73</sup> Investors’ funds are held in escrow until the offering has reached the target amount *and* the deadline has expired.<sup>74</sup> Investors may cancel their

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65. 17 C.F.R. § 227.303(a); SEC Proposing Release, *supra* note 22, at 66,557.

66. 17 C.F.R. § 227.302(a)(1) (2017).

67. *Id.* § 227.302(b); *see also id.* § 227.302(c)-(d) (requiring disclosure of additional information). The statutory basis for these provisions is section 4A(a)(4)(A) of the Securities Act, 15 U.S.C. § 77d-1(a)(4)(A).

68. 17 C.F.R. § 227.303(b)(2)(i); *see also* Securities Act of 1933 § 4A(a)(4)(B), 15 U.S.C. § 77d-1(a)(4)(B).

69. 17 C.F.R. § 227.303(b)(2)(ii); *see also* Securities Act of 1933 § 4A(a)(4)(C), 15 U.S.C. § 77d-1(a)(4)(C).

70. 17 C.F.R. § 227.303(c). Representatives of the issuer must disclose their status when posting on these communication channels. *Id.* § 227.303(c)(4); *see also* Securities Act of 1933 § 4A(b)(3), 15 U.S.C. § 77d-1(b)(3).

71. 17 C.F.R. § 227.303(c)(2)-(3).

72. *See* SEC Proposing Release, *supra* note 22, at 66,472; *see also* 17 C.F.R. § 227.204 (2017).

73. Securities Act of 1933 § 4A(b)(1)(F), 15 U.S.C. § 77d-1(b)(1)(F); 17 C.F.R. § 227.201(g) (2017).

74. 17 C.F.R. § 227.303(e); *see also* Securities Act of 1933 § 4A(a)(7), 15 U.S.C. § 77d-1(a)(7) (declaring crowdfunding intermediaries may provide offering proceeds to the issuer only when the target amount is reached). Issuers that reach their target amount before the

commitments at any time up to forty-eight hours prior to the deadline.<sup>75</sup> If, for any reason, an offering does not close by the deadline, the intermediary must notify investors and return the escrowed funds.<sup>76</sup>

The exemption gives crowdfunding intermediaries an enforcement role to protect investors from fraud.<sup>77</sup> Among other requirements,<sup>78</sup> the intermediary must deny its platform to the issuer if the intermediary has a reasonable basis for believing that the bad actor disqualifications apply.<sup>79</sup> The intermediary may not rely on the issuer's representations in making that determination; it must conduct "a background and securities enforcement regulatory history check" on the issuer and its officers, directors, and twenty-percent shareholders.<sup>80</sup> The intermediary must also deny its platform to an issuer if the intermediary "believ[es] that the issuer or the offering presents the potential for fraud or otherwise raises concerns about investor protection."<sup>81</sup> If the intermediary "is unable to adequately or effectively assess the risk of fraud," it must deny access to the offering.<sup>82</sup> This last requirement is loaded with ambiguity and liability risk, but it *may* impose an affirmative due diligence obligation on the crowdfunding intermediary.<sup>83</sup>

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deadline may close earlier, but only if certain conditions are met. *See* 17 C.F.R. § 227.304(b) (2017).

75. 17 C.F.R. § 227.304(a); *see also* Securities Act of 1933 § 4A(a)(7), 15 U.S.C. § 77d-1(a)(7) (stating that the investor must be allowed to cancel as the SEC, by rule, determines appropriate).

76. 17 C.F.R. § 227.304(d).

77. The statute merely requires the SEC to specify measures to be taken by intermediaries to reduce the risk of fraud. *See* Securities Act of 1933 § 4A(a)(5), 15 U.S.C. § 77d-1(a)(5). The SEC's response to that mandate is in Rule 301 of Regulation Crowdfunding. *See* 17 C.F.R. § 227.301 (2017).

78. In addition to the requirements discussed in the text, intermediaries must have a reasonable basis for believing that the issuer has complied with the exemption and that the issuer has established means to keep accurate records of security holders. 17 C.F.R. § 227.301(a)-(b). In both cases, the intermediary may rely on the issuer's representations to that effect unless the intermediary has some reason to question those representations. *Id.*

79. *Id.* § 227.301(c)(1).

80. *Id.*

81. *Id.* § 227.301(c)(2).

82. *Id.*

83. *See* C. Steven Bradford, *Shooting the Messenger: The Liability of Crowdfunding Intermediaries for the Fraud of Others*, 83 U. CIN. L. REV. 371, 376-77 (2014) [hereinafter Bradford, *Shooting the Messenger*].

### III. THE CROWDFUNDING FRAUD PROBLEM

#### A. *The Risk of Fraud*

Crowdfunding poses a significant risk of fraud. The amount of disclosure required is more limited than in a registered offering<sup>84</sup> and, unlike registered offerings by smaller companies, the offering is not contingent on SEC review and approval of the required disclosure.<sup>85</sup> The exemption is limited to nonreporting companies, so less public information about the issuer will be available.<sup>86</sup> Many of the companies using the exemption will be startups with little or no operating history,<sup>87</sup> so there will be serious information asymmetries between the issuer and investors.<sup>88</sup> Moreover, many of these small issuers will have little previous experience with securities offerings and will not have access to sophisticated securities counsel, so even well-intentioned companies may “bungle the extensive, complicated disclosures required by the exemption.”<sup>89</sup>

Finally, the crowdfunding exemption, unlike some of the other

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84. See Form S-1, 17 C.F.R. § 239.11 (2017). Form S-1 is the registration form available to nonreporting companies such as those eligible to use the crowdfunding exemption. See 1 HAZEN, *supra* note 12, § 3.4(4)(A).

85. See 1 HAZEN, *supra* note 12, § 3.7 (discussing SEC review of Securities Act registration statements).

86. See 2 HAZEN, *supra* note 12, § 9.3(1) (discussing the periodic disclosure requirements applicable to reporting companies); see also Thomas G. James, Note, *Far From the Maddening Crowd: Does the JOBS Act Provide Meaningful Redress to Small Investors for Securities Fraud in Connection with Crowdfunding Offerings?*, 54 B.C. L. REV. 1767, 1770 (2013) (“[M]any fledgling startups are unlikely to have generated much financial information . . .”).

87. See SEC INV’R ADVISORY COMM., RECOMMENDATION OF THE INVESTOR ADVISORY COMMITTEE: CROWDFUNDING REGULATIONS 6 (2014), <https://www.sec.gov/spotlight/investor-advisory-committee-2012/investment-adviser-crowdfunding-recommendation.pdf> [<https://perma.cc/P346-M8TA>].

88. See Abraham J.B. Cable, *Fending for Themselves: Why Securities Regulations Should Encourage Angel Groups*, 13 U. PA. J. BUS. L. 107, 121-22 (2010); Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067, 1076-77 (2003); Darian M. Ibrahim, *The (Not So) Puzzling Behavior of Angel Investors*, 61 VAND. L. REV. 1405, 1407-08 (2008).

89. Bradford, *The New Federal Crowdfunding Exemption*, *supra* note 17, at 217; see also SEC INV’R ADVISORY COMM., *supra* note 87, at 6 (“[V]iolations can be expected to be common even among the best intentioned of issuers.”); David Mashburn, Comment, *The Anti-Crowd Pleaser: Fixing the Crowdfund Act’s Hidden Risks and Inadequate Remedies*, 63 EMORY L.J. 127, 157 (2013) (asserting that crowdfunding startups will not have sufficient resources to hire compliance experts and may not even realize the need). These entrepreneurs, either because of their psychology or because of crowdfunding’s “unique blend of customer marketing and investor pitching,” may also be more optimistic than the facts justify. Mashburn, *supra*, at 163.

registration exemptions, allows sales to the general public.<sup>90</sup> Many of the purchasers will therefore be small, unsophisticated investors who are less able to protect themselves.<sup>91</sup> And some people contend that the Internet environment itself may lead to less careful deliberation, creating “fertile ground for fraud.”<sup>92</sup>

In fact, many people opposed a crowdfunding exemption because of the risk of fraud.<sup>93</sup> Jack Herstein, at the time the President of the North American Securities Administrators Association (NASAA), warned that “[t]his legislation will needlessly expose Main Street investors to greater risk of fraud by creating new jobs for promoters of Internet investment scams. . . . This is an investor protection disaster waiting to happen.”<sup>94</sup> Roberta Karmel opined that the crowdfunding bills “should be renamed ‘Fraud-Funding through Crowd-Funding.’”<sup>95</sup> Some scholars pointed to the fraudulent offerings under Rule 504, when the SEC temporarily loosened Rule 504’s requirements, as a harbinger of what is likely to happen under the crowdfunding exemption.<sup>96</sup>

Some of the crowdfunding exemption’s requirements will help reduce the risk of fraud. Crowdfunded offerings must be funneled through an intermediary without a financial interest in the issuer.<sup>97</sup>

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90. See Securities Act Rule 506(b)(2)(ii), 17 C.F.R. § 230.506(b) (2017) (limiting sales to accredited or sophisticated investors); Securities Act Rule 506(c)(2)(i), 17 C.F.R. § 230.506(c)(2)(i) (limiting sales to accredited investors).

91. See Bradford, *Crowdfunding and the Federal Securities Laws*, *supra* note 2, at 109-12, and sources cited therein; see also Sharon Yamen & Yoel Goldfeder, *Equity Crowdfunding—A Wolf in Sheep’s Clothing: The Implications of Crowdfunding Legislation Under the JOBS Act*, 11 *BYU INT’L L. & MGMT. REV.* 41, 59 (2015) (“New investors that lack the sophistication or financial stability of accredited investors are now asked to gamble in a market more risky than it has ever been.”).

92. Sherief Morsy, Note, *The JOBS Act and Crowdfunding: How Narrowing the Secondary Market Handicaps Fraud Plaintiffs*, 79 *BROOK. L. REV.* 1373, 1380 (2014); see also James, *supra* note 86, at 1780.

93. See, e.g., Hazen, *supra* note 4; Roberta S. Karmel, *Crowd-Funding and Related Deregulation*, N.Y. L.J. (Feb. 16, 2012, 12:00 AM), <https://www.law.com/newyorklawjournal/almID/1202542375938>; see also Yamen & Goldfeder, *supra* note 91, at 58 (“Because of the law’s decrease in regulations and transparency, many financial observers believe that the increased risks of fraud and scam to the public outweigh the small benefits the law provides a limited group of companies, investment managers, and broker-dealers.”).

94. N. AM. SEC. ADMIN. ASS’N, *supra* note 7.

95. See Karmel, *supra* note 93.

96. See Michael B. Dorff, *The Siren Call of Equity Crowdfunding*, 39 *J. CORP. L.* 493, 523 (2014); Hazen, *supra* note 4, at 1763; Karmel, *supra* note 93, 8; see also NASAA Warns of Potential Dangers of Crowdfunding Investment Opportunities, N. AM. SEC. ADMIN. ASS’N (May 15, 2012), <http://www.nasaa.org/12835/nasaa-warns-of-potential-dangers-of-crowdfunding-investment-opportunities/> (comparing crowdfunding to the “similar investor trap” created after the National Securities Markets Improvement Act prohibited states from reviewing Rule 506 offerings prior to sale).

97. See 17 C.F.R. § 227.300(b) (2017).



The presence of this neutral intermediary will help prevent fraud.<sup>98</sup> The intermediary has a long-term business interest in minimizing fraud: the more fraud there is on the intermediary's platform, the less likely investors are to use that platform. The exemption supplements this business incentive by requiring the intermediary to take steps to reduce the risk of fraud.<sup>99</sup> Intermediaries hosting fraudulent offerings also run the risk of liability in actions by investors or securities regulators.<sup>100</sup> The intermediary's interests may not totally align with those of investors,<sup>101</sup> but its presence should provide some protection against fraudulent offerings.

The public nature of the crowdfunding platform will also help reduce the risk of fraud.<sup>102</sup> The issuer's solicitation, including pre-offering communications with individual investors, will be publicly accessible on the crowdfunding platform.<sup>103</sup> This gives the so-called "wisdom of the crowd" an opportunity to operate.<sup>104</sup> Investors with particular knowledge about the offering or the issuer, or with better skills at analyzing offerings, can communicate that knowledge to less informed investors, making deception more difficult.<sup>105</sup>

Finally, although a section 4(a)(6) offering involves less disclosure than a registered public offering, the exemption still requires a significant amount of disclosure by the issuer.<sup>106</sup> In fact, the required

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98. See Christine Hurt, *Pricing Disintermediation: Crowdfunding and Online Auction IPOs*, 2015 U. ILL. L. REV. 217, 252 ("Theoretically, the requirement that retail equity crowdfunding take place on a registered portal subject to liability will force the portal to take on a gatekeeping role similar to an underwriter in both private placements and IPOs.").

99. See *supra* text accompanying notes 77-83.

100. See generally Bradford, *Shooting the Messenger*, *supra* note 83.

101. Screening offerings for fraud imposes a cost on the intermediary that it must weigh against the benefits of fraud protection. See Mashburn, *supra* note 89, at 165 ("Since crowdfunding will involve smaller sums of money . . . and because issuers will ultimately have to foot the bill for due diligence, expensive and lengthy due diligence is not practical." (footnote omitted)). In addition, to the extent that the intermediary's compensation depends on the success of the offering (for example, if it receives a commission dependent on successful completion of the offering), it has a short-term incentive to look the other way.

102. See Seth C. Oranburg, *Bridgdfunding: Crowdfunding and the Market for Entrepreneurial Finance*, 25 CORNELL J.L. & PUB. POL'Y 397, 425-26 (2015) (arguing that the online nature of crowdfunding makes fraud less likely).

103. See *supra* Section II.C.2.

104. See generally JAMES SUROWIECKI, *THE WISDOM OF CROWDS: WHY THE MANY ARE SMARTER THAN THE FEW AND HOW COLLECTIVE WISDOM SHAPES BUSINESS ECONOMIES, SOCIETIES, AND NATIONS* (2004).

105. See Bradford, *Crowdfunding and the Federal Securities Laws*, *supra* note 2, at 134. Ethan Mollick looked at nonsecurities crowdfunding on Kickstarter and found a surprisingly low level of fraud, even with a relatively broad definition of "fraud." See Ethan Mollick, *The Dynamics of Crowdfunding: An Exploratory Study*, 29 J. BUS. VENTURING 1, 11-12 (2014).

106. See *supra* Section II.C.

disclosure may be too costly and complex for these small offerings.<sup>107</sup> Nevertheless, this required disclosure should help reduce the risk of fraud.

However, no amount of regulation can eliminate fraud. Even crowdfunding's strongest supporters recognize the risk of fraud but argue that the capital formation gains outweigh the risks.<sup>108</sup> The question, then, is what to do about fraud when it occurs. An effective antifraud remedy is needed, both to deter fraud and to compensate injured investors. Without such a remedy, there is a serious risk of a market-for-lemons problem: fraudulent crowdfunding offerings could drive out honest offerings, and the promise of crowdfunding will not be realized.<sup>109</sup>

#### IV. THE PROBLEM WITH EXISTING PUBLIC AND PRIVATE REMEDIES

The federal securities laws include a number of antifraud remedies. Actions may be brought by the SEC or by injured investors. State securities law remedies are also available. But neither public nor private enforcement is likely to adequately police crowdfunding fraud under the current enforcement system.

##### A. Public Enforcement

One option is public enforcement. The SEC can bring an action under a number of federal antifraud provisions.<sup>110</sup> State securities regulators can bring actions under state securities antifraud rules; the crowdfunding exemption preempts state registration requirements, but not state antifraud enforcement.<sup>111</sup> But government enforcement is unlikely to suffice.

The SEC has limited resources for enforcement and, because of the small amounts involved, crowdfunding is unlikely to be one of its

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107. See Bradford, *The New Federal Crowdfunding Exemption*, *supra* note 17, at 217.

108. See, e.g., Bradford, *Crowdfunding and the Federal Securities Laws*, *supra* note 2, at 98-116.

109. See Hurt, *supra* note 98, at 254.

110. The most likely candidates are section 17(a) of the Securities Act, 15 U.S.C. § 77q(a) (2012), and Rule 10b-5 under the Exchange Act, 17 C.F.R. § 240.10b-5 (2017). The government could also bring criminal actions for violations of either antifraud provision. See Securities Act of 1933 § 24, 15 U.S.C. § 77x (2012); Securities Exchange Act of 1934 § 32, 15 U.S.C. § 78ff (2012).

111. Section 18(a)(1) of the Securities Act preempts state registration requirements as to "covered securities." Securities Act of 1933 § 18(a)(1), 15 U.S.C. § 77r(a)(1) (2012). Securities sold pursuant to the section 4(a)(6) exemption are covered securities. *Id.* § 18(b)(4)(C), 15 U.S.C. § 77r(b)(4)(C). But the statute does not divest state securities commissioners of jurisdiction to bring enforcement actions for fraud or deceit. *Id.* § 18(c)(1)(B), 15 U.S.C. § 77r(c)(1)(B).

enforcement priorities.<sup>112</sup> In deciding whether to bring an enforcement action, the SEC has traditionally considered the likely social benefit, including, among other things, the amount of harm to investors and the likely deterrent effect of an enforcement action.<sup>113</sup> Crowdfunding and other small, private offerings understandably fall far down that social impact scale.<sup>114</sup> The SEC could get a bigger bang for its enforcement buck elsewhere.

It is possible that the SEC might focus on crowdfunding fraud despite the small amounts involved. In 2013, the SEC established a Microcap Fraud Task Force that specifically targets “abusive trading and fraudulent conduct in securities issued by microcap companies.”<sup>115</sup> Crowdfunding issuers would fall squarely within that initiative. In addition, the SEC’s attitude toward crowdfunding has been ambivalent at best. Commissioners questioned the entire JOBS Act initiative as it moved through Congress,<sup>116</sup> and the SEC took its time proposing and adopting the rules required to implement the crowdfunding exemption.<sup>117</sup> The SEC might, therefore, monitor crowdfunding issuers more closely than one would otherwise expect. But, if crowdfunding proves popular, the SEC simply does not have the resources to investigate and prosecute all the potential crowdfunding fraud.

Crowdfunding fraud may be a higher priority for state regulators, many of whom opposed the section 4(a)(6) exemption because of the

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112. See Hazen, *supra* note 4, at 1757 (“[T]he SEC’s resources are limited, and the Commission cannot be expected to be effective in the crowdfunding arena—especially considering widely reported enforcement failures involving much larger economic stakes.”); Alan R. Palmiter, *Pricing Disclosure: Crowdfunding’s Curious Conundrum*, 7 OHIO ST. ENTREPRENEURIAL BUS. L.J. 373, 375 (2012) (“Public enforcement by the SEC would likely happen only in egregious cases, in view of the agency’s limited resources and political preference to go after high-profile cases.”); see also Mashburn, *supra* note 89, at 151 (“Given the expected high number of crowdfunding investments and their small size, such investments will likely escape close regulatory oversight.”).

113. Palmiter, *supra* note 112, at 418-19.

114. See *id.*

115. Press Release, U.S. Sec. & Exch. Comm’n, SEC Announces Enforcement Initiatives to Combat Financial Reporting and Microcap Fraud and Enhance Risk Analysis (July 2, 2013), <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171624975> [<https://perma.cc/EF96-V8R2>].

116. See Aguilar, *supra* note 7; David S. Hilzenrath, *JOBS Act Could Remove Investor Protections, SEC Chair Schapiro Warns*, WASH. POST (Mar. 14, 2012), [http://www.washingtonpost.com/business/economy/jobs-act-could-open-a-door-to-investment-fraud-sec-chief-says/2012/03/14/gIQA1vx1BS\\_story.html](http://www.washingtonpost.com/business/economy/jobs-act-could-open-a-door-to-investment-fraud-sec-chief-says/2012/03/14/gIQA1vx1BS_story.html).

117. The statutory deadline for the SEC to adopt the crowdfunding rules was December 31, 2012, 270 days after enactment of the statute. JOBS Act, Pub. L. No. 112-106, § 302(c), 126 Stat. 306 (2012). The SEC did not propose the required rules until late in 2013, see SEC Proposing Release, *supra* note 22, and did not adopt the final rules until late in 2015, see SEC Adopting Release, *supra* note 8.

risk of fraud.<sup>118</sup> But the resources of state regulators are even more limited than those of the SEC.<sup>119</sup> Therefore, no matter how actively involved regulators are, private enforcement will still be crucial.

### B. Private Enforcement

Private securities litigation has long been seen as a necessary supplement to government enforcement of the antifraud provisions.<sup>120</sup> Private litigation comes in two forms: individual actions by injured investors and class actions brought on behalf of groups of defrauded investors. Neither is likely to suffice in dealing with crowdfunding fraud.

The crowdfunding exemption includes a liability provision that is generous to private plaintiffs. Section 4A(c) of the Securities Act allows purchasers in section 4(a)(6) offerings to rescind their investments.<sup>121</sup> A successful plaintiff is entitled to recover “the consideration paid for such security with interest thereon, less the amount of any income received thereon, . . . or . . . damages if such person no longer owns the security.”<sup>122</sup> The investor does not have to prove that the fraud caused a loss. Instead, section 4A(c) is subject to a negative causation defense; once the fraud is established, the plaintiff recovers his or her entire purchase price unless the defendant shows that

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118. At least two of the presidents of the NASAA, the organization of state securities administrators, warned about the exemption’s likely negative effect on investors. See Heath Abshire, President, NASSA, Remarks at NASAA, SEC 19(d) Conference (Apr. 17, 2013) [hereinafter Heath Abshire’s Remarks at NASAA], <http://www.nasaa.org/22565/nasaa-president-heath-abshures-remarks-at-nasaa-sec-19d-conference/> [<https://perma.cc/BW35-KFWJ>]; *NASAA Warns of Potential Dangers of Crowdfunding Investment Opportunities*, N. AM. SEC. ADMIN. ASS’N (May 15, 2012), <http://www.nasaa.org/12835/nasaa-warns-of-potential-dangers-of-crowdfunding-investment-opportunities/> [<https://perma.cc/2BPY-Q692>].

119. For example, the total operating budget of the Texas State Securities Board in 2014 was around \$7 million, less than half of which was devoted to enforcement. See TEX. STATE SEC. BD., OPERATING BUDGET: FISCAL YEAR 2014, pt. II.A (2014), [https://www.ssb.texas.gov/sites/default/files/SSB\\_Op\\_Bdgt\\_FY14.pdf](https://www.ssb.texas.gov/sites/default/files/SSB_Op_Bdgt_FY14.pdf) [<https://perma.cc/7TK8-3GRM>].

120. See, e.g., *Amgen, Inc. v. Conn. Ret. Plans & Tr. Funds*, 568 U.S. 455, 478 (2013) (“Congress, the Executive Branch, and this Court . . . have ‘recognized that meritorious private actions to enforce federal antifraud securities laws are an essential supplement to criminal prosecutions and civil enforcement actions brought, respectively, by the Department of Justice and the Securities and Exchange Commission.’” (quoting *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 313 (2007))); Samuel Issacharoff, *Regulating After the Fact*, 56 DEPAUL L. REV. 375, 381 (2007) (“There is little dispute about the centrality of private actions in enforcing the complex web of securities law.”).

121. Securities Act of 1933 § 4A(c), 15 U.S.C. § 77d-1(c) (2012). Crowdfunding issuers are also potentially liable to investors under other federal securities law antifraud provisions, such as section 12(a)(2) of the Securities Act and Rule 10b-5 of the Exchange Act, but section 4A(c) is undoubtedly the most favorable liability provision.

122. Securities Act of 1933 § 4A(c)(1)(A), 15 U.S.C. § 77d-1(c)(1)(A).

some portion of the damages recoverable did not result from the fraud.<sup>123</sup>

The investor-plaintiff does not even have to prove that the defendant intended to defraud the investor. Section 4A(c) has no scienter requirement. The plaintiff only has to show that the defendant “[made] an untrue statement of a material fact or omit[ted] to state a material fact required to be stated or necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading.”<sup>124</sup> Once the plaintiff shows a material misstatement, the defendant is liable unless it can prove that it “did not know, and in the exercise of reasonable care could not have known,” of the misstatement.<sup>125</sup>

Finally, liability under section 4A(c) extends not only to the issuer of the securities, but also to the issuer’s principal executive officer, principal financial officer, controller or principal accounting officer, and directors or partners, as well as anyone else who offers or sells the security in the section 4(a)(6) offering.<sup>126</sup> It is unclear, however, if these other persons are liable for misstatements by the issuer or only for their own misstatements.<sup>127</sup>

Even with the liberal section 4A(c) remedy, however, private litigation is unlikely in most cases. Because of the individual investment caps,<sup>128</sup> each investor’s investment—which is the maximum recovery under section 4A(c)<sup>129</sup>—will be relatively small. The poorest investors may invest no more than \$2,200, and even the wealthiest investors are capped at \$107,000. One study found an average investment of

123. An action under section 4A(c) is “subject to the provisions of section 12(b) . . . as if the liability were created under section 12(a)(2).” *Id.* § 4A(C)(1)(B), 15 U.S.C. § 77d-1(c)(1)(B). Section 12(b) provides that

[I]f the person who offered or sold such security proves that any portion or all of the amount recoverable under subsection (a)(2) represents other than the depreciation in value of the subject security resulting from such part of the . . . communication, with respect to which the liability of that person is asserted, not being true or omitting to state a material fact required to be stated therein or necessary to make the statement not misleading, then such portion or amount . . . shall not be recoverable.

*Id.* § 12(b), 15 U.S.C. § 771(b).

124. *Id.* § 4A(c)(2)(A), 15 U.S.C. § 77d-1(c)(2)(A).

125. *Id.* § 4A(c)(2)(B), 15 U.S.C. § 77d-1(c)(2)(B).

126. Section 4A(c)(2) only imposes liability on the “issuer,” but section 4A(c)(3) then defines “issuer” to include all of these additional people in addition to the company itself. *See id.* § 4A(c)(2)-(3), 15 U.S.C. § 77d-1(c)(2)-(3).

127. For a discussion of this issue, see Bradford, *Shooting the Messenger*, *supra* note 83, at 395-97.

128. *See supra* Section II.B.

129. *See Securities Act of 1933* § 4A(c)(1), 15 U.S.C. § 77d-1(c)(1).

only \$800 in early Regulation Crowdfunding offerings.<sup>130</sup> Thus, for most crowdfunding investors, the *maximum* recovery in a cause of action alleging fraud will be a few thousand dollars or less. The cost to sue, including attorneys' fees, will exceed any possible recovery, making individual lawsuits unfeasible.<sup>131</sup> As Heath Abshire, the former President of the NASAA, said, "It's \$1,000. Which attorney is going to take a securities fraud case with a chance to win [a contingent fee of] \$330?"<sup>132</sup>

If crowdfunding fraud litigation is to occur, it will have to be through a class action that consolidates all investors' claims.<sup>133</sup> But even class actions will not be feasible in most cases. The maximum recovery in any crowdfunding class action would be just over \$1 million, the maximum offering amount under section 4(a)(6).<sup>134</sup> Most offerings will be much smaller than that. The median target amount in early Regulation Crowdfunding offerings was only \$53,000, and the mean was only \$110,000.<sup>135</sup>

These small amounts are insufficient to make a class action worthwhile for plaintiffs' attorneys.<sup>136</sup> Because of the expenses of litigation and the risk that a class action will be unsuccessful, there is clearly "a cutoff level in terms of market capitalization below which private [class-action] enforcement appears not to work."<sup>137</sup> Janet Cooper Alexander looked at initial public offerings in 1983 and concluded that "[t]wenty million dollars is about the lowest potential re-

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130. Eliot Abrams reports that as of November 12, 2016, companies had collectively raised over \$13.6 million through 17,000 distinct investments. Eliot Abrams, *Securities Crowdfunding: More Than Family, Friends, and Fools?* 12 (Jan. 19, 2017) (unpublished manuscript), <https://ssrn.com/abstract=2902217>. This equals an average of \$800 per investment (\$13.6 million divided by 17,000).

131. See James, *supra* note 86, at 1788; Mashburn, *supra* note 89, at 165-66; Palmiter, *supra* note 112, at 416.

132. Phyllis Diamond, *Litigation Reform Laws May Be Problematic in New JOBS Act Era, NASAA's Abshire Says*, 44 SEC. REG. & L. REP. 1838, 1840 (Oct. 1, 2012).

133. See James, *supra* note 86, at 1788; Mashburn, *supra* note 89, at 166.

134. See *supra* Section II.A.

135. Ivanov & Knyazeva, *supra* note 10, at 6.

136. See Palmiter, *supra* note 112, at 416-17. David Mashburn contends that attorneys might still bring class actions, or even individual actions, "in anticipation of a quick settlement." Mashburn, *supra* note 89, at 167. However, it is unclear why a culpable defendant would settle quickly if it knows the plaintiffs' attorney cannot afford to pursue the claim beyond the complaint stage.

137. John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1544 (2006); see also Stephen J. Choi, *The Evidence on Securities Class Actions*, 57 VAND. L. REV. 1465, 1473 (2004) ("Because pursuing a class action is costly, plaintiffs' attorneys may opt not to file suit against some companies that potentially may have engaged in actual fraud. Particularly for companies offering only a small dollar amount of securities . . . plaintiffs' attorneys may find that the expected return from filing suit does not exceed the expected cost.").

covery that could be expected to generate an attorney's fee sufficient to justify maintaining a complex securities class action on a contingent fee basis."<sup>138</sup> James Bohn and Stephen Choi examined 3,519 initial public offerings over a twelve-year period, 123 of which resulted in class actions.<sup>139</sup> They found that class actions were significantly less likely to be brought where the losses were smaller.<sup>140</sup> Of 329 IPOs in their sample with an offering size of less than \$1.79 million, only one, a \$1.45 million offering, faced a class action.<sup>141</sup> This does not bode well for class-action lawsuits against issuers using the crowdfunding exemption.<sup>142</sup> Some other enforcement mechanism is needed.

## V. DESIGNING AN ARBITRATION REMEDY

Arbitration is a possible solution to the crowdfunding remedy problem. Arbitration is both cheaper and quicker than litigation,<sup>143</sup> and the lower cost of arbitration "lower[s] the dollar threshold at which claims become viable."<sup>144</sup> But even arbitration can be expensive,<sup>145</sup> and it is

138. Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 513 n.46 (1991).

139. See James Bohn & Stephen Choi, *Fraud in the New-Issues Market: Empirical Evidence on Securities Class Actions*, 144 U. PA. L. REV. 903, 926, 929 (1996).

140. "IPOs that experienced an aftermarket loss of less than five million dollars were sued only 1.48% of the time. Contrast this with IPOs experiencing an aftermarket loss of greater than \$100 million, which were sued 42.86% of the time." *Id.* at 940 (footnote omitted).

141. *Id.* at 936.

142. The section 4A(c) remedy is liberal, making claims under that section relatively easy to prove, but so is the section 11 remedy that would have applied to the initial public offerings in the Alexander and Bohn/Choi studies. See Securities Act of 1933 § 11, 15 U.S.C. § 77k (2012). And less public information would be available about small, nonpublic crowdfunding issuers than about the larger companies involved in those initial public offerings, making it harder to allege and prove fraud.

143. Fred Galves points out that

[A] significant benefit of [alternative dispute resolution (ADR)] is that it imposes lesser time commitments and costs on the parties than traditional litigation does. The average contract-based lawsuit takes approximately two years to resolve in traditional litigation, while ADR cases may be finished in as little as five or six months. . . . ADR is also significantly less expensive than traditional litigation, which involves the expensive analysis of discovery, the hiring of attorneys who may charge \$400.00 per hour, and the costs of extensive travel over a two-year (or more) period. In short, lower costs and time commitments make ADR a more favorable forum than traditional litigation . . . .

Fred Galves, *Virtual Justice As Reality: Making the Resolution of E-Commerce Disputes More Convenient, Legitimate, Efficient, and Secure*, 2009 U. ILL. J.L. TECH. & POLY 1, 41-42 (footnotes omitted); see also ETHAN KATSH & JANET RIFKIN, ONLINE DISPUTE RESOLUTION: RESOLVING CONFLICTS IN CYBERSPACE 25 (2001) (asserting that arbitration is cheaper and faster than traditional litigation); Frank A. Cona, *Application of Online Systems in Alternative Dispute Resolution*, 45 BUFF. L. REV. 975, 984 (1997) (same).

144. Palmiter, *supra* note 112, at 421.

145. "Even in simpler disputes, the costs of arbitration for such things as the fees for the

becoming more expensive as it becomes more litigation-like.<sup>146</sup> Traditional arbitration is likely to be too expensive for small crowdfunding fraud claims.<sup>147</sup> But arbitration is not a single construct with a fixed set of features; it can be molded to fit the particular needs of crowdfunding.

In this Part, I consider how to design an arbitration remedy to facilitate crowdfunding fraud claims. The discussion is on the macro level; I do not attempt to develop a full set of crowdfunding arbitration rules. Instead, I try to identify the most important features needed to make arbitration a less expensive, more effective remedy for crowdfunding claims.

A crowdfunding arbitration remedy should have the following features:

- 1. Unilateral.** Investors should remain free to sue in cases where a lawsuit is feasible. The crowdfunding arbitration agreement should obligate the crowdfunding issuer, but not investors, to arbitrate.
- 2. Online.** The entire crowdfunding arbitration should be conducted online.
- 3. Written submissions.** Oral testimony should be eliminated in favor of written submissions.
- 4. Expert arbitrators.** The arbitrators should be experts who are familiar with both crowdfunding and securities law.
- 5. Arbitrator as an active participant.** The arbitrator should take a more inquisitorial role than normal—asking for documents, raising questions, filling out the record—to make sure that all the necessary evidence is presented by both sides.
- 6. Transparency.** The arbitration proceeding should be public, and the result of the arbitration, including a written opinion briefly stating the arbitrator’s findings, should be publicly available.

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arbitrators and the administering body, as well as charges for the hearing room, can significantly deplete any savings achieved in reduced attorney fees.” Thomas D. Halket, *The Use of Technology in Arbitration: Ensuring the Future is Available to Both Parties*, 81 ST. JOHN’S L. REV. 269, 269 (2007).

146. See Cona, *supra* note 143, at 984 (“[C]omplex cases that are arbitrated may take just as long to resolve as court-based suits.”); Halket, *supra* note 145, at 269 (asserting that as more complex disputes are arbitrated, the arbitral process has become more formal, taking more time and costing more).

147. See Palmiter, *supra* note 112, at 425-26 (“[Even if class action arbitration is allowed,] it is unclear that the cost savings would be enough to make arbitration a viable enforcement tool . . . given the relatively small recoveries in a typical crowdfunding offering.”); Heath Abshire’s Remarks at NASAA, *supra* note 118 (“Arbitration doesn’t make sense for a \$10,000 investment, much less a \$2,000 investment—which is the size contemplated by the crowdfunding provisions in the JOBS Act.”).



**7. Consolidation/Class actions.** Investors should be allowed, but not required, to consolidate their claims and bring arbitration “class actions.”

In the following Sections, I explain the rationale for, and the consequences of, each of these proposed features.

The remedy proposed is not perfect; it involves tradeoffs that make it worse than litigation in some ways. But the relevant comparison is not between litigation and the proposed arbitration remedy; as noted above, the litigation option will not exist for most crowdfunding investors. The comparison is between an imperfect, but accessible, arbitration remedy and no remedy at all. Flawed as it is, the proposed remedy would give defrauded investors a realistic chance to assert their claims.

#### A. *Unilateral*

The obligation to arbitrate should be unilateral. The issuer should be required to arbitrate if the investor chooses to bring his or her claim in arbitration, but investors should not be required to submit their disputes to arbitration. The goal is to expand investors’ remedies, not to limit them. In the rare cases where a lawsuit is feasible, investors should not be precluded from bringing one.

A unilateral arbitration provision reduces the impact of crowdfunding investors’ lack of sophistication. Consumers often do not understand arbitration agreements or the rights they give up when they enter into them.<sup>148</sup> In a recent study, only fourteen percent of the respondents realized that a mandatory arbitration clause in a contract barred them from going to court.<sup>149</sup> If the arbitration provision is unilateral, investors are not giving up any right, so it is less important that they understand the arbitration clause when they invest. The compromises inherent in the proposed remedy are also less troubling since no one is required to accept them. No investor will be in a worse position than he or she would have been without the new arbitration remedy.<sup>150</sup>

Making the remedy unilateral also avoids the continuing controversy about contracts mandating the arbitration of securities law claims. Mandatory arbitration has been an issue in securities law for a long time. The U.S. Supreme Court initially held that pre-dispute

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148. See generally Jeff Sovern et al., “Whimsy Little Contracts” with Unexpected Consequences: An Empirical Analysis of Consumer Understanding of Arbitration Agreements, 75 MD. L. REV. 1 (2015).

149. See *id.* at 46.

150. This cannot be said of issuers, who could be forced to arbitrate even when they would prefer litigation.

agreements to arbitrate securities claims were unenforceable,<sup>151</sup> but it reversed course and upheld them in two cases decided more than thirty years later.<sup>152</sup> The SEC at one point adopted a rule, Exchange Act Rule 15c2-2, that declared mandatory arbitration clauses in customer-broker agreements fraudulent.<sup>153</sup> That rule was subsequently rescinded,<sup>154</sup> but that did not end the SEC's opposition to mandatory arbitration. In 1992, SEC Chair David Ruder asked the securities self-regulatory organizations to consider adopting procedures that would preserve investor access to the courts.<sup>155</sup> The National Association of Securities Dealers dutifully approved a rule excluding class actions from arbitration.<sup>156</sup> More recently, the SEC staff has resisted mandatory arbitration clauses in corporate charters and bylaws.<sup>157</sup> And state securities regulators have already opposed the mandatory arbitration of crowdfunding disputes.<sup>158</sup>

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151. See *Wilko v. Swan*, 346 U.S. 427, 437-38 (1953).

152. See *Rodriguez de Quijas v. Shearson/American Express, Inc.*, 490 U.S. 477, 485-86 (1989) (upholding agreements to arbitrate claims arising under the Securities Act of 1933); *Shearson/American Express Inc. v. McMahon*, 482 U.S. 220, 238 (1987) (upholding agreements to arbitrate claims arising under the Securities Exchange Act of 1934).

153. See 17 C.F.R. § 240.15c2-2 (1986) (rescinded); see also *Recourse to the Courts Notwithstanding Arbitration Clauses in Broker-Dealer Customer Agreements*, 48 Fed. Reg. 53,404 (Nov. 28, 1983) (adopting Rule 15s2-2); *Notice to Broker-Dealers Concerning Clauses in Customer Agreements Which Provide for Arbitration of Future Disputes*, 17 SEC Docket 1167 (July 2, 1979) (questioning the use by brokers and dealers of pre-dispute arbitration clauses).

154. See *Rescission of Rule Governing Use of Predispute Arbitration Clauses in Broker-Dealer Customer Agreements*, 52 Fed. Reg. 39,216 (Oct. 21, 1987) (rescinding Rule 15c2-2); see also Lewis D. Lowenfels & Alan R. Bromberg, *Securities Industry Arbitrations: An Examination and Analysis*, 53 ALB. L. REV. 755, 763 (1989) (discussing the SEC's change of position).

155. See Bradley J. Bondi, *Facilitating Economic Recovery and Sustainable Growth Through Reform of the Securities Class-Action System: Exploring Arbitration as an Alternative to Litigation*, 33 HARV. J.L. & PUB. POL'Y 607, 623 (2010).

156. See Proposed Rule Change by National Association of Securities Dealers, Inc., *Relating to Improvements in the NASD Code of Arbitration Procedure*, 57 Fed. Reg. 30,519 (proposed July 9, 1992); see also Bondi, *supra* note 155, at 623-24 (discussing this change).

157. See Claudia H. Allen, *Bylaws Mandating Arbitration of Stockholder Disputes?*, 39 DEL. J. CORP. L. 751, 775-82 (2015); Gideon Mark, *Multijurisdictional M&A Litigation*, 40 J. CORP. L. 291, 326-27 (2015).

158. Heath Abshire, at the time the President of the NASAA (the organization of state regulators), said,

[W]e also believe that arbitration should not be the sole forum available to aggrieved investors, especially those investing small amounts.

When it comes to addressing disputes that may arise between investors and their broker-dealers, investors should have a choice of arbitration or litigation. Investors should not be forced into the "take it or leave it" scenario they now face with mandatory pre-dispute arbitration clauses in customer agreements with their broker-dealers.

A unilateral arbitration clause is less controversial. The SEC has long supported the right of brokerage customers to voluntarily arbitrate disputes.<sup>159</sup> In fact, the rules of the Financial Industry Regulatory Authority, the self-regulatory organization governing securities brokers, grant customers a unilateral right to arbitrate disputes with brokers and their associated persons.<sup>160</sup>

Later, I will discuss whether the proposed arbitration remedy should be contractual or required by regulation.<sup>161</sup> If it is contractual, there may be a challenge to its enforceability. Some judicial decisions, albeit a minority, refuse to enforce unilateral arbitration agreements, either on the ground that they are unconscionable or because they lack mutuality of obligation.<sup>162</sup> Those decisions should not prevent the use of unilateral arbitration for crowdfunding. The mutuality argument rests on a misinterpretation of the U.S. Supreme Court's decisions on arbitrability. The unconscionability argument is stronger, but it would not apply in the crowdfunding context.

The mutuality challenge to unilateral arbitration clauses rests on a fundamental misapplication of the severability doctrine established by the Supreme Court in the *Prima Paint* case.<sup>163</sup> The severability doctrine is designed to save arbitration clauses in spite of defenses to the underlying contracts in which they appear.<sup>164</sup> *Prima Paint* says that, in deciding whether an agreement to arbitrate is enforceable, the arbitration agreement must be considered by itself, independent of the contract in which it appears.<sup>165</sup> A court may not refuse to compel arbitration because of a defense to the underlying contract.<sup>166</sup>

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159. Jill I. Gross, *The Customer's NonWaivable Right to Choose Arbitration in the Securities Industry*, 10 BROOK J. CORP. FIN. & COM. L. 383, 384 (2016).

160. FINRA R. 12200, 12201 (FINRA 2008), [http://finra.complinet.com/en/display/display\\_main.html?rbid=2403&element\\_id=4106](http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4106) [<https://perma.cc/AY6X-7FTA>].

161. See *infra* Part VII.

162. See Christopher R. Drahozal, *Nonmutual Agreements to Arbitrate*, 27 J. CORP. L. 537, 540 (2002). For a more general review of unconscionability challenges to arbitration agreements, see Willy E. Rice, *Unconscionable Judicial Disdain for Unsophisticated Consumers and Employees' Contractual Rights?—Legal and Empirical Analyses of Courts' Mandatory Arbitration Rulings and the Systematic Erosion of Procedural and Substantive Unconscionability Defenses Under the Federal Arbitration Act, 1800-2015*, 25 B.U. PUB. INT. L.J. 143 (2016).

163. *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395 (1967).

164. Laurent A. Niddam, *Unilateral Arbitration Clauses in Commercial Arbitration*, 1996 ARB. & DISP. RESOL. L.J. 147, 154; Hans Smit, *The Unilateral Arbitration Clause: A Comparative Analysis*, 20 AM. REV. INT'L ARB. 391, 401 (2009).

165. *Prima Paint*, 388 U.S. at 403-04.

166. *Id.*; see also *Buckeye Check Cashing, Inc. v. Cardegna*, 546 U.S. 440, 445-46 (2006).

Some courts have expanded this severability doctrine to hold that unilateral arbitration clauses are unenforceable due to a lack of consideration or mutuality. Considering the arbitration clause by itself, only one party is obligated—the party who does not have the option. The party with the option to arbitrate is not bound in any way. This argument, which takes a doctrine designed to save arbitration clauses and uses it as a weapon against them,<sup>167</sup> has been rejected by most courts<sup>168</sup> and legal scholars<sup>169</sup> who have considered it. Thus, lack of consideration or mutuality is not likely to be a problem for the proposed arbitration remedy. The investment contract as a whole is mutual—both the issuer and the investors have obligations—and that is sufficient. It does not matter that only one party is required to arbitrate.

Unconscionability also should not be a bar to unilateral crowdfunding arbitration. Hans Smit argues that it is “unconscionable for a party to exploit its economically powerful position or the ignorance of the party who agrees to a unilateral arbitration clause without understanding the unfair advantage it gives to its contract partner.”<sup>170</sup> Several courts have invalidated unilateral arbitration clauses on unconscionability grounds,<sup>171</sup> although the majority of decisions are to the contrary.<sup>172</sup>

Whether or not unconscionability should be a valid defense against unilateral arbitration clauses in general, it should not be a reason for refusing to enforce the proposed crowdfunding remedy. The proposed crowdfunding arbitration remedy gives the advantage to the weaker party, the investor.<sup>173</sup> Rather than foreclosing consumer remedies, it expands them, giving investors more protection, not

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167. Smit, *supra* note 164, at 401; *see also* Niddam, *supra* note 164, at 154 (asserting that these decisions “turn the doctrine of separability on its head”).

168. *See* Smit, *supra* note 164, at 403 and cases cited therein; *see also* Drahozal, *supra* note 162, at 544-45 and cases cited therein.

169. *See* Smit, *supra* note 164, at 403; *see also* Drahozal, *supra* note 162; Niddam, *supra* note 164, at 154.

170. Smit, *supra* note 164, at 404. *But see* Drahozal, *supra* note 162, at 555-65 (arguing that unilateral arbitration clauses are not unfair to consumers, even where the consumer is required to arbitrate and the business is not); *see also* Niddam, *supra* note 164, at 156 (“If the clause is bargained for in an arm’s length transaction, or between experienced parties, it is difficult to conclude that it should not be enforced.”).

171. *See* Drahozal, *supra* note 162, at 547 and cases cited therein.

172. *See id.*; *see also* Smit, *supra* note 164, at 405 (explaining that most courts have rejected unconscionability as a basis for eliminating the unilateral aspects from a unilateral arbitration clause).

173. *See* Smit, *supra* note 164, at 395 (the advantages of a unilateral arbitration clause to the beneficiary “are likely to be substantial”); *see also* Niddam, *supra* note 164, at 156 (“[T]he party that can unilaterally choose between [arbitration and litigation] will have an advantage.”)

less. Even Smit concedes that a unilateral clause that favors the weaker party is not objectionable on unconscionability grounds.<sup>174</sup>

### B. Online

Crowdfunding arbitration should be conducted completely online, with no face-to-face hearings or testimony. As a logical matter, it makes sense to resolve disputes involving online transactions online,<sup>175</sup> but this feature is supported by more than just logic. Online dispute resolution shares many of the advantages of face-to-face alternative dispute resolution—including lower costs, increased speed, and greater informality.<sup>176</sup> But online arbitration is both faster and less expensive than traditional arbitration.<sup>177</sup> “[T]he key inconvenience [of traditional alternative dispute resolution] is showing up at a particular time and place for . . . arbitration sessions.”<sup>178</sup> Online arbitration eliminates that cost,<sup>179</sup> making the distance between the parties irrelevant.<sup>180</sup> As one scholar has noted, online arbitration “offers

174. See Smit, *supra* note 164, at 415 (arguing that bilateral investment treaties that give investors, but not states, the option to arbitrate favor the weaker party and are therefore not objectionable).

175. Pablo Cortés, *Online Dispute Resolution for Consumers: Online Dispute Resolution Methods for Settling Business to Consumer Conflicts*, in ONLINE DISPUTE RESOLUTION: THEORY AND PRACTICE: A TREATISE ON TECHNOLOGY AND DISPUTE RESOLUTION 139, 140 (Mohamed S. Abdel Wahab et al. eds., 2012) [hereinafter ODR: THEORY AND PRACTICE].

176. Aura Esther Vilalta, *ODR and E-Commerce*, in ODR: THEORY AND PRACTICE, *supra* note 175, at 113, 114; see also Galves, *supra* note 143, at 7 (stating that online dispute resolution has the same cost-savings and efficiency advantages over litigation as alternative dispute resolution generally).

177. Mohamed S. Abdel Wahab, *ODR and E-Arbitration: Trends and Challenges*, in ODR: THEORY AND PRACTICE, *supra* note 175, at 387, 391; Amy J. Schmitz, “Drive-Thru” Arbitration in the Digital Age: Empowering Consumers Through Binding ODR, 62 BAYLOR L. REV. 178, 205, 223 (2010); see also COLIN RULE, ONLINE DISPUTE RESOLUTION FOR BUSINESS: FOR E-COMMERCE, B2B, CONSUMER, EMPLOYMENT, INSURANCE, AND OTHER COMMERCIAL CONFLICTS 63 (2002) (faster); Galves, *supra* note 143, at 8 (2009) (less expensive); Shekhar Kumar, *Virtual Venues: Improving Online Dispute Resolution as an Alternative to Cost Intensive Litigation*, 27 J. MARSHALL J. COMPUTER & INFO. L. 81, 85-86 (2009) (less expensive); Brian A. Pappas, *ONLINE COURT: Online Dispute Resolution and the Future of Small Claims*, 12 UCLA J.L. & TECH. 2, 6 (2008) (faster); Louise Ellen Teitz, *Providing Legal Services for the Middle Class in Cyberspace: The Promise and Challenge of On-Line Dispute Resolution*, 70 FORDHAM L. REV. 985, 1000 (2001) (faster); Joseph A. Zavaletta, *Using E-Dispute Technology to Facilitate the Resolution of E-Contract Disputes: A Modest Proposal*, 7 U. FLA. J. TECH. L. & POL’Y 1, 19 (2002) (less expensive).

178. KATSH & RIFKIN, *supra* note 143, at 95.

179. Galves, *supra* note 143, at 42; William Krause, *Do You Want to Step Outside? An Overview of Online Alternative Dispute Resolution*, 19 J. MARSHALL J. COMPUTER & INFO. L. 457, 470 (2001); Schmitz, *supra* note 177, at 223; Aashit Shah, *Using ADR to Resolve Online Disputes*, 10 RICH. J.L. & TECH. 25, ¶ 20 (2004).

180. Rachel I. Turner, Note, *Alternative Dispute Resolution in Cyberspace: There is More on the Line, Than Just Getting “Online”*, 7 ILSA J. INT’L & COMP. L. 133, 143 (2000).

a creative solution to the high transaction costs associated with off-line arbitration.”<sup>181</sup>

Those cost differences are important in the crowdfunding context. Where, as in crowdfunding, the value of the transaction is small, “the transaction costs of dispute resolution threaten to swamp the value of the underlying transaction, meaning . . . that victims are less likely to seek vindication of their rights.”<sup>182</sup> If the cost of resolving the dispute is greater than the total value of the case, investors will not use the dispute resolution process.<sup>183</sup> A simple, less costly online dispute resolution mechanism “makes the financial resources of parties—or the value of the transaction—virtually irrelevant.”<sup>184</sup>

Some scholars have cautioned that online dispute resolution may disadvantage those without a computer, easy access to the Internet, and the technological sophistication to use these tools<sup>185</sup>—those on the other side of the so-called “digital divide.”<sup>186</sup> But that argument lacks force in the crowdfunding context. To invest in a crowdfunded offering, investors must have Internet access and the ability to work their way through an intermediary’s crowdfunding platform. If they have the technological capability to do that, they should be able to participate in online arbitration without difficulty.<sup>187</sup> The parties only need to be able to state their positions and share electronic documents,<sup>188</sup> so all that is needed is a computer, an Internet connection, and an email account.<sup>189</sup>

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181. Teitz, *supra* note 177, at 1000.

182. Henry H. Perritt, Jr., *Dispute Resolution in Cyberspace: Demand for New Forms of ADR*, 15 OHIO ST. J. DISP. RESOL. 675, 675 (2000) (footnote omitted); *see also* Schmitz, *supra* note 177, at 223 (discussing how consumers must balance the cost of pursuing claims against the relatively small size of their claims).

183. Shah, *supra* note 179, ¶ 50; *see also* Lucille M. Ponte, *Throwing Bad Money After Bad: Can Online Dispute Resolution (ODR) Really Deliver the Goods for the Unhappy Internet Shopper?*, 3 TUL. J. TECH. & INTELL. PROP. 55, 89 (2001) (arguing that where transactions are low-cost, online dispute resolution, to be valuable, must be provided at little or no cost).

184. Zavaletta, *supra* note 177, at 19; *see also* Galves, *supra* note 143, at 43 (arguing that the low cost of online dispute resolution makes it worthwhile to bring a dispute over a relatively inexpensive transaction).

185. *See* Lan Q. Hang, Comment, *Online Dispute Resolution Systems: The Future of Cyberspace Law*, 41 SANTA CLARA L. REV. 837, 858-59 (2001); Kumar, *supra* note 177, at 87-88; Lucille M. Ponte, *Boosting Consumer Confidence in E-Business: Recommendations for Establishing Fair and Effective Dispute Resolution Programs for B2C Online Transactions*, 12 ALB. L.J. SCI. & TECH. 441, 470-71 (2002) [hereinafter Ponte, *Boosting Consumer Confidence in E-Business*].

186. Schmitz, *supra* note 177, at 218-20.

187. *See* KATSH & RIFKIN, *supra* note 143, at 22; Hang, *supra* note 185, at 859; Shah, *supra* note 179, ¶ 14.

188. KATSH & RIFKIN, *supra* note 143, at 138.

189. Zavaletta, *supra* note 177, at 19.

### C. "Written" Submissions

To reduce the cost of crowdfunding arbitration, all proceedings should be conducted through written, online submissions, with no hearing and no oral testimony. The arbitration could be initiated by a simple complaint on a form such as the one in Appendix A, followed by a written response from the issuer and any additional written submissions the parties choose to make.

In online arbitration, the parties "are normally not afforded the opportunity to make formal presentations of oral testimony and documentary evidence in person,"<sup>190</sup> even though videoconferencing makes that possible. Written submissions are less expensive and more convenient. The parties can communicate from their own homes at their convenience,<sup>191</sup> and there is no need to coordinate schedules to find an acceptable hearing time.<sup>192</sup> Foregoing videoconferencing also reduces any technological advantage the issuer might have over some of the investors.<sup>193</sup>

Oral testimony is not needed to prove that the crowdfunding issuer made the allegedly fraudulent statement. Under Regulation Crowdfunding, the entire transaction, from offering to closing, is conducted online. The offering and the issuer's disclosure are posted on the intermediary's platform and almost all offering-related communications will occur on that platform.<sup>194</sup> Any direct communications between the issuer and investors will be through the communication channels crowdfunding intermediaries are required to provide.<sup>195</sup> Because of these limitations, any fraud by the issuer is going to be on the intermediary's platform or, less likely, in the notice allowed by Rule 204.<sup>196</sup>

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190. LUCILLE M. PONTE & THOMAS D. CAVENAGH, *CYBERJUSTICE: ONLINE DISPUTE RESOLUTION (ODR) FOR E-COMMERCE* 86 (2005).

191. RULE, *supra* note 177, at 69; Schmitz, *supra* note 177, at 223-24.

192. RULE, *supra* note 177, at 69; Schmitz, *supra* note 177, at 227-28.

193. See Ponte, *Boosting Consumer Confidence in E-Business*, *supra* note 185, at 470-71 (arguing that some consumers may lack the videoconferencing software and equipment needed for online arbitration).

194. Issuers may not advertise offerings off-platform except for a limited notice that directs investors to the intermediary's platform. 17 C.F.R. § 227.204 (2017).

195. See *id.* § 227.303(c).

196. If the issuer violates these conditions and engages in additional advertising off the crowdfunding platform, the offering will be in violation of the exemption. Absent an exemption, the offering will violate section 5 of the Securities Act. See Securities Act of 1933 § 5(a), 15 U.S.C. § 77e(a) (2012) (making it unlawful to sell securities unless a registration statement is in effect); Securities Act of 1933 § 5(c), 15 U.S.C. § 77e(c) (making it unlawful to offer to sell securities unless a registration statement has been filed). In that case, investors would be entitled to rescission without having to prove any fraud. See Securities Act of 1933 § 12(a)(1), 15 U.S.C. § 77l(a)(1).

Of course, to recover, an investor must do more than prove that the issuer made a statement; the investor must also prove that the statement was fraudulent. But oral testimony will not usually be needed to prove that either. In the crowdfunding setting, where issuers and investors connect online, investors are unlikely to have any direct personal contact with either the issuer's employees or its business. The investor's determination that a statement is fraudulent will undoubtedly be based on print or online sources, such as electronic communications with the issuer or other investors, newspapers, or financial publications. Oral testimony is not needed to present such evidence.

Limiting the parties to written submissions has its costs. Live testimony is "viewed in the Anglo-American tradition as an important aspect of judging credibility";<sup>197</sup> the elimination of nonverbal cues makes credibility judgments more difficult.<sup>198</sup> But there is an offsetting benefit; the asynchronous nature of written submissions gives the parties an opportunity to research and rebut statements made by others—an opportunity that would not exist in a synchronous, real-time hearing.<sup>199</sup>

Some have noted that conducting arbitration solely through written submissions privileges "those who can organize and eloquently state their cases" in writing.<sup>200</sup> But the converse is equally true: a face-to-face hearing gives an advantage to those with better verbal skills. It is not clear why we should prefer those who speak well over those who write well.

Written submissions have other advantages over oral testimony. The parties have more time to think about their responses<sup>201</sup> and the process is less stressful to those who might be intimidated by face-to-face confrontation.<sup>202</sup>

#### D. Expert Arbitrators

The arbitrators used for online crowdfunding arbitration should be individuals who are familiar with both crowdfunding and securities law. "The possibility of special arbitral panels—conceivably

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197. Teitz, *supra* note 177, at 1000.

198. Krause, *supra* note 179, at 481; Kumar, *supra* note 177, at 88; Perritt, *supra* note 182, at 680.

199. RULE, *supra* note 177, at 83.

200. Krause, *supra* note 179, at 480; *see also* Shah, *supra* note 179, ¶ 36 (stating that parties who cannot organize and write well will be at a disadvantage in online alternative dispute resolution).

201. Krause, *supra* note 179, at 482.

202. Galves, *supra* note 143, at 44; Krause, *supra* note 177, at 482; Kumar, *supra* note 177, at 86-87; Schmitz, *supra* note 177, at 202.



with expertise in the crowdfunding industry . . . and working knowledge of the elements of a section 4A(c) action”—would make the arbitration of claims more efficient.<sup>203</sup> Arbitrators who know the law and understand how crowdfunding works are more likely to render correct decisions. Online arbitration makes it easier to find such experts because the choice of arbitrators is not limited by geography; since the arbitration will be done completely online, the arbitrator can be anywhere.<sup>204</sup>

Of course, expertise is often developed over time. With crowdfunding in its infancy, the number of people with expertise will initially be limited. But, over time, the number of qualified arbitrators will increase.

### *E. Active Participation by the Arbitrator*

The arbitrator in crowdfunding arbitrations should take a more active role than in ordinary arbitration. Arbitrators, like judges, are ordinarily free to ask questions of witnesses, but, like judges, they usually depend on the parties to present evidence. However, the small investors bringing crowdfunding claims will be relatively unsophisticated and may not be represented by counsel. Some of the small startup companies defending those claims may also lack counsel. Because of their lack of sophistication, the parties may not know what evidence is required or how to present it. To overcome this difficulty, the arbitrators in crowdfunding arbitration should take a more inquisitorial role, asking the parties for relevant evidence and raising any important issues the parties themselves fail to raise.<sup>205</sup>

A strong, active arbitrator could help overcome the problems created by the lack of discovery in online arbitration. It is more difficult to resolve factual disputes accurately without discovery; the absence of discovery is particularly hard on the party who has the burden of proof.<sup>206</sup> Both parties will be relying on the same online documents, making discovery less important.<sup>207</sup> But extraneous evidence will sometimes be needed to determine whether the issuer's online statements were fraudulent. That evidence will often rest in the issuer's hands, and investors, who have the burden of proof, will be at a dis-

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203. Palmiter, *supra* note 112, at 421.

204. RULE, *supra* note 177, at 69-70.

205. See Cortés, *supra* note 175, at 153 (stating that the use of an inquisitorial process is often preferable when parties do not have legal representation).

206. Krause, *supra* note 179, at 487; Shah, *supra* note 179, ¶ 37.

207. See PONTE & CAVENAGH, *supra* note 190, at 33 (noting that, in cases where both parties are relying on the same documents, the lack of discovery in online dispute resolution may not be a problem).

advantage.<sup>208</sup> A sophisticated, active arbitrator can make sure that all of the necessary evidence is presented.

An arbitrator's active probing can also substitute, at least to some extent, for the cross-examination that would be available if there were a live hearing.<sup>209</sup> The arbitrator can pose probing questions to fill gaps and resolve ambiguities in the written submissions.

### F. Transparency

The arbitration proceeding should be public, and the results of the online arbitration proceeding, including an opinion which briefly states the arbitrator's findings, should be publicly available.<sup>210</sup> These findings do not have to be as extensive as in a judicial opinion, just enough to show the basis of the arbitrator's decision. A hypothetical example appears in Appendix B. Requiring more than this would unduly increase the cost of the arbitration.

Transparency has several benefits.<sup>211</sup> First, it alerts other investors in the same offering that they may have a potential claim and provides them with a roadmap for proving that claim.<sup>212</sup> Less knowledgeable investors can free ride on the investigative work of others, applying the "wisdom of crowds" idea to fraud enforcement.

Transparency will also help investors and intermediaries prevent fraud in the future by screening out past wrongdoers.<sup>213</sup> Nothing in the crowdfunding exemption precludes multiple rounds of financing; the offering-amount limit is only an annual limit. Issuers who have successfully engaged in fraud in the past could come back for round

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208. See Elizabeth G. Thornburg, *Going Private: Technology, Due Process, and Internet Dispute Resolution*, 34 U.C. DAVIS L. REV. 151, 200 (2000) (arguing that discovery equalizes the relative position of the party without access to relevant information).

209. As Elizabeth Thornburg points out, "Even clearly drafted . . . statements are less helpful than live testimony and a chance to challenge defense witnesses." *Id.* at 207.

210. The publicly available version of the opinion should redact any financial or other personal information about investors or other participants in the proceeding, as well as any other information—such as confidential information about the issuer's business processes or products that the arbitrator determines should remain confidential. *But see* RULE, *supra* note 177, at 269 (discussing the challenge of preserving confidentiality while retaining "enough accurate information . . . to allow readers to get a sense of what the real issues were in the case").

211. See generally Ramona L. Lampley, "Underdog" Arbitration: A Plan for Transparency, 90 WASH. L. REV. 1727 (2015) (arguing for transparency in arbitration of consumer and employee disputes).

212. See Perritt, *supra* note 182, at 682 ("[T]he risk that public knowledge of one dispute may trigger the presentation of other disputes."); see also Thornburg, *supra* note 208, at 210 ("[Confidentiality] may allow companies who have committed hard-to-discover wrongs to hide the problem from a greater number of people.").

213. See Andrew A. Schwartz, *The Digital Shareholder*, 100 MINN. L. REV. 609, 676-78 (2015) (discussing the value of a reputation-feedback system in crowdfunding).

after round.<sup>214</sup> Multiple fraudulent offerings are much less likely if past arbitration claims against the issuer are publicly available.

Transparency also allows for better monitoring of the crowdfunding exemption by the SEC and state regulators. They can monitor investor claims to see how much fraud there is and whether the rules need to be adjusted to prevent it. They can also free ride on investors' enforcement efforts, investigating and prosecuting wrongdoers identified in arbitration claims.<sup>215</sup>

Transparency would also help crowdfunding intermediaries. They can use the information to improve their screening processes to help reduce the future incidence of fraud and to improve their dispute resolution procedures to help investors recover when fraud does occur.<sup>216</sup> Transparency also increases public trust in the dispute resolution process,<sup>217</sup> and that, in turn, should make investors more willing to invest through the intermediary's platform.

Finally, publicly accessible proceedings could have a semi-precedential effect, with "some of the public policy benefits of reported judicial opinions."<sup>218</sup> Although subsequent arbitrators would not be bound to follow past decisions, they could use those past decisions as a guide, leading to greater consistency.<sup>219</sup> And the past body of decisions

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214. The intermediary on whose platform the first fraud occurred would probably have to bar the issuer from subsequent offerings. An intermediary must deny its platform to an issuer if it believes the offering presents the potential for fraud. 17 C.F.R. § 227.301(c)(2) (2017). But the issuer might be able to post offerings with other intermediaries unaware of the fraud.

215. See PONTE & CAVENAGH, *supra* note 190, at 33 ("[S]ome online experts are calling for greater openness in ODR cases to protect the public and to provide information to government agencies concerned about rooting out fraudulent Web-based conduct."); Schmitz, *supra* note 177, at 240 (asserting that confidential awards "fail to . . . generate publicity that may lead to investigations and policy initiatives"); Thornburg, *supra* note 208, at 210 (arguing that confidential proceedings may keep "information about important issues of public health or safety or product reliability" from the government).

216. Transparency improves "quality control over the process, its fairness and effectiveness. . . . Through in depth study of particular cases as well as aggregate data on the outcomes . . . improper conduct, poor performance and problematic process design can be quite easily uncovered." Orna Rabinovich-Einy & Ethan Katsh, *Lessons from Online Dispute Resolution for Dispute Systems Design*, in ODR: THEORY AND PRACTICE, *supra* note 175, at 39, 52; see also RULE, *supra* note 177, at 269 ("[Confidentiality makes it harder] to determine whether or not an ODR system is providing a level playing field for the resolution of disputes. Bias can go undetected and uncorrected.").

217. Philippe Gilliéron, *From Face-to-Face to Screen-to-Screen: Real Hope or True Falacy?*, 23 OHIO ST. J. ON DISP. RESOL. 301, 320 (2008); Ponte, *Boosting Consumer Confidence in E-Business*, *supra* note 185, at 488-89; Schmitz, *supra* note 177, at 233-35; see also Perritt, *supra* note 182, at 682 ("[T]he democratic tradition mistrusts secret proceedings, and the legitimacy and acceptability of online arbitration may be diminished if its proceedings are not opened to public scrutiny at some point.").

218. Schmitz, *supra* note 177, at 241.

219. See Orna Rabinovich-Einy & Ethan Katsh, *Technology and the Future of Dispute Systems Design*, 17 HARV. NEGOT. L. REV. 151, 184 (2012) (describing how an informal

could help participants in the crowdfunding process, including issuers, understand the line between acceptable and unacceptable conduct.<sup>220</sup>

Confidentiality is a “well-established principle in arbitration,”<sup>221</sup> and arguably, one of its main advantages over litigation.<sup>222</sup> Confidentiality can encourage open, frank discussion<sup>223</sup> and allow the parties to freely communicate sensitive or proprietary information.<sup>224</sup> But some scholars have questioned the need for confidentiality in online dispute resolution.<sup>225</sup> And confidentiality is not as important in the crowdfunding context, where most of the relevant information is already public. The issuer’s disclosure and investment-related communications, including a great deal of information about the issuer’s business, are already available to the general public on the crowdfunding platform’s website.

### G. Consolidation/Class Actions

Even the cost of a simplified online arbitration action could exceed the value of a single investor’s claim. To help overcome that problem, investors should be allowed, but not required, to consolidate their claims and bring arbitration “class actions.”<sup>226</sup> A class action would

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system of precedent has developed in an online system used for arbitrating insurance subrogation claims).

220. See Perritt, *supra* note 182, at 682 (“[M]ost advocates of online dispute resolution for Internet governance contemplate the development of a body of decisional law to help people understand the ground rules for conduct. Only if decisions are available to the public can this aspiration be realized.”); see also Ponte, *Boosting Consumer Confidence in E-Business*, *supra* note 183, at 489 (stating that published decisions will give e-businesses “written guidance when dealing with similar issues in the future”).

221. Wahab, *supra* note 177, at 400; see also M. Ethan Katsh, *Dispute Resolution in Cyberspace*, 28 CONN. L. REV. 953, 971 (1996) (“An assurance of confidentiality is generally a feature of alternative dispute resolution.”).

222. Shah, *supra* note 179, ¶ 31; see also Thornburg, *supra* note 208, at 211 (“Arbitration providers advertise privacy as one of their major advantages.”); Turner, *supra* note 180, at 145 (“A classic advantage to ADR is confidentiality.”).

223. PONTE & CAVENAGH, *supra* note 190, at 25; Katsh, *supra* note 221, at 971.

224. RULE, *supra* note 177, at 269; Perritt, *supra* note 182, at 682.

225. See PONTE & CAVENAGH, *supra* note 190, at 33 (“[S]ome online experts are calling for greater openness in ODR cases.”); Gilliéron, *supra* note 217, at 320 (arguing for the publication of online dispute resolution awards, but not records or communications between the parties); Ponte, *Boosting Consumer Confidence in E-Business*, *supra* note 185, at 488-89 (explaining why online dispute resolution awards should be published). *But see* Teitz, *supra* note 177, at 1008 (“Transparency, encouraged by some, may not be desirable in all forms of ODR, such as on-line arbitration, where the parties may have pre-selected arbitration for its confidentiality.”).

226. Some have questioned whether mandatory arbitration agreements should be able to prohibit class actions in court. See, e.g., Brian T. Fitzpatrick, *The End of Class Actions?*, 57 ARIZ. L. REV. 161 (2015); Myriam Gilles, *The Day Doctrine Died: Private Arbitration and the End of Law*, 2016 U. ILL. L. REV. 371. The arbitration remedy proposed in this Article

spread the cost of arbitration over a broader base, making claims more cost-effective.<sup>227</sup>

Class actions fit crowdfunding well because there is a common fraud and there are no significant individual issues. As previously discussed, all of the issuer's disclosure and all significant communications between the issuer and investors will occur on the crowdfunding platform,<sup>228</sup> and any alleged fraud will, therefore, be on that platform. Thus, all questions of fraud will necessarily be common ones; all investors will be asserting the same fraudulent statements. If investors were required to establish reliance on the fraud, that would be an individual issue. But section 4A(c) of the Securities Act does not expressly require reliance, and the language of section 4A(c) mirrors the language of section 12(a)(2) of the Securities Act, which courts have held does not require the plaintiff to show reliance.<sup>229</sup>

The only individual issue in these actions would be whether each purchaser was aware of the fraud when he or she purchased the security. Section 4A(c) conditions liability on a provision "that the purchaser did not know of such untruth or omission."<sup>230</sup> However, instances where a purchaser was aware of the fraud before buying will be uncommon. In the rare case where the defendant has evidence that a particular investor is disqualified because of knowledge, the defendant can raise that issue after the common fraud issues have been resolved.

The procedure for such class actions could be relatively simple. Individual arbitration claims could be published on the crowdfunding platform when they are filed. Any other investor who wants to join the proceeding could simply file a brief notice opting into the action. Evidence would be presented online without a formal hearing, so

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does not raise such issues because it is not mandatory. Investors are not required to arbitrate and may still bring a class action in court if they wish. *See supra* Section V.A.

227. Any filing or arbitration fees paid by the initial claimant should be reimbursed as part of the arbitration award. The initial claimant should also be allowed to prove and recover any out-of-pocket expenses incurred in researching and filing the initial claim, to avoid any first-mover disadvantage. Otherwise, investors would have an incentive to delay making a claim to free ride on the efforts of the first person to file. However, even without such provisions, the costs of a streamlined online arbitration might be low enough that free riding would not significantly inhibit the filing of complaints.

228. *See supra* Section II.C.3.

229. *See, e.g.*, *Gustafson v. Alloyd Holdings, Inc.*, 513 U.S. 561, 576 (1995) (noting that Congress decided in 12(a)(2) "to grant buyers a right to rescind without proof of reliance"); *Wright v. Nat'l Warranty Co.*, 953 F.2d 256, 262 (6th Cir. 1992) (reliance is not an element of a § 12(a)(2) cause of action); *see also* 2 HAZEN, *supra* note 12, at 254-55 (stating that it is unnecessary to prove reliance in a section 12(a)(2) action).

230. Securities Act of 1933 § 4A(c)(2)(A), 15 U.S.C. § 77d-1(c)(2)(A) (2012).

there is no need to establish who “controls” the class action.<sup>231</sup> Any investor who opts in could submit written evidence and arguments. Settlements could also be dealt with individually. If a defendant offers to settle, any investor who wants to should be able to accept the offer. Any investors who do not want to settle should be able to continue the action.

## VI. ENFORCEMENT AND COLLECTION

The arbitration remedy in this Article should make it easier for crowdfunding investors to assert fraud claims, but an investor’s attempt to recover does not end with a successful arbitration. The investor still has to enforce the award and collect from the defendant.

Crowdfunding fraudsters have little incentive to pay arbitration awards voluntarily, and not much can be done to change that. Crowdfunding intermediaries could make compliance with arbitration awards a condition to further use of their platforms, and not paying an award could negatively affect the issuer’s reputation. However, once an issuer’s fraud is exposed, future offerings by that issuer are unlikely. Because of that, the fraudster has little reason to care about its reputation or whether it has access to a crowdfunding platform. Therefore, it has little incentive to pay an arbitration award.

If the issuer does not voluntarily pay the award, investors must go to court to get the award confirmed;<sup>232</sup> once confirmed, an arbitration award is enforceable in the same way as a court judgment.<sup>233</sup> Confirmation of an arbitration award is not particularly complicated; the grounds for vacating or modifying an arbitration award are narrow<sup>234</sup> and judicial review is “severely limited.”<sup>235</sup> Nevertheless, this is an additional expense for investors seeking to collect from a crowdfunding fraudster.

The more difficult problem, in many cases, will come after judicial confirmation of the arbitration award. As previously discussed, the crowdfunding exemption targets small business issuers. Reporting companies are ineligible to use the exemption,<sup>236</sup> and the \$1.07 million annual limit makes the crowdfunding exemption relatively

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231. See generally Jessica Erickson, *The Marketplace for Leadership in Corporate Litigation*, 2015 U. ILL. L. REV. 1479 (discussing how the control of corporate class actions is allocated among law firms).

232. See 9 U.S.C. § 9 (2012) (judicial confirmation of arbitration awards).

233. JAY E. GREINIG, *ALTERNATIVE DISPUTE RESOLUTION* § 12:22 (4th ed. 2017).

234. See 9 U.S.C. §§ 10, 11.

235. GREINIG, *supra* note 233, § 26:1.

236. Securities Act of 1933 § 4A(f)(2), 15 U.S.C. § 77d-1(f)(2) (2012); 17 C.F.R. § 227.100(b)(2) (2017).

unattractive even for larger nonpublic issuers.<sup>237</sup> The median offering in 2016, the exemption's first year, involved an issuer with only three employees and \$43,000 in assets;<sup>238</sup> in one-fourth of the offerings, the issuer had no reported assets.<sup>239</sup> Therefore, many issuers will not have sufficient assets to satisfy a judgment. Crowdfunding investors may find themselves with an enforceable award, but no way to collect.<sup>240</sup>

However, no procedure, no matter how effective, can guarantee payment. The proposed arbitration remedy at least gives investors an opportunity to recover if assets *are* available. That is an improvement over the status quo.

## VII. IMPLEMENTATION: MANDATORY OR OPTIONAL?

One final question must be addressed: how to implement the proposed arbitration remedy. There are three possibilities. First, individual issuers could voluntarily include arbitration provisions in their contracts with investors. Second, crowdfunding platforms could require issuers and investors to agree to such a remedy as a condition to platform access. Finally, the SEC could mandate an arbitration remedy as a condition of the Regulation Crowdfunding exemption.

Potential investors are unlikely to bargain for such protection before they invest. As many authors have pointed out, it is unlikely that crowdfunding investors will negotiate for any protective provisions.<sup>241</sup> The large number of investors will make collective action unlikely,<sup>242</sup> and each investor is investing a relatively small amount,<sup>243</sup> so individ-

237. Larger issuers are likely to prefer Rules 506(b) or 506(c) of Regulation D, which do not limit the offering amount but do limit sales to accredited investors and, in the case of 506(b), sophisticated, unaccredited investors. See Securities Act Rules 506(b)-(c), 17 C.F.R. § 230.506(b)-(c) (2017).

238. Ivanov & Knyazeva, *supra* note 10, at 14.

239. *Id.*

240. See Palmiter, *supra* note 112, at 426 (noting that crowdfunding intermediaries are likely to be the only defendant capable of satisfying a judgment).

241. See Bradford, *Crowdfunding and the Federal Securities Laws*, *supra* note 2, at 107 (noting that most crowdfunding investors will not have the sophistication to understand the need for contractual protection or the ability to negotiate for such protection); Schwartz, *supra* note 213, at 640-41 (explaining that it is unlikely that crowdfunding investors will ask for and negotiate for preferred stock protection); John S. (Jack) Wroldsen, *The Social Network and the Crowdfund Act: Zuckerberg, Saverin, and Venture Capitalists' Dilution of the Crowd*, 15 VAND. J. ENT. & TECH. L. 583, 625 (2013) (asserting that crowdfunding investors are unlikely to negotiate for protective contractual arrangements because of their weak bargaining positions and lack of sophistication).

242. Eliot Abrams found that, as of November 12, 2016, the average Regulation Crowdfunding issuer had raised money from 120 investors. Abrams, *supra* note 130, at 12.

243. Abrams found that, as of November 12, 2016, over \$13.6 million had been raised through 17,000 distinct investments. *Id.* That is an average of only \$800 per investment.

ual bargaining is unlikely to be worth the cost. Therefore, all aspects of the crowdfunding investment contract, including remedies, are likely to be offered on a take-it-or-leave-it basis.

Crowdfunding issuers could unilaterally offer such a remedy in their investment contracts, but it is against the interests of issuers, especially dishonest issuers, to make it easier to bring fraud claims. Honest issuers might have a signaling motive to offer the proposed arbitration remedy; offering an effective fraud remedy could signal to investors that the offering is not fraudulent. But, given the relative lack of sophistication of crowdfunding investors, it is unclear that signaling would work. In any event, that does not help the investors in fraudulent offerings, who need the arbitration remedy the most.

Crowdfunding intermediaries could voluntarily provide an arbitration remedy. The intermediaries could make agreement to that remedy a requirement for issuers to post offerings on their platforms.<sup>244</sup> Intermediaries have a business incentive to protect investors from fraud.<sup>245</sup> If fraud is prevalent and investors lose money, investors will quit investing through that platform. Thus, it might be in the intermediary's interest to provide a viable remedy.<sup>246</sup>

Currently, crowdfunding intermediaries do not provide such a remedy. The leading crowdfunding platforms to date are Wefunder, NextSeed, OpenDeal/Republic, and StartEngine,<sup>247</sup> with Wefunder the dominant platform by far.<sup>248</sup> None of those crowdfunding intermediaries offers an arbitration remedy for fraud claims.<sup>249</sup> That might change as the crowdfunding market develops, particularly if fraud becomes a major issue. But it has not happened yet.

The final possibility is an SEC mandate. The SEC clearly has the power to mandate an arbitration remedy. Section 4A(a)(12) of the Se-

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244. See Robert C. Bordone, *Electronic Online Dispute Resolution: A Systems Approach—Potential, Problems, and a Proposal*, 3 HARV. NEGOT. L. REV. 175, 206 (1998) (suggesting that system operators could require users to agree to a contractual online dispute resolution system as a precondition to using the site); Zavaletta, *supra* note 177, at 24 (suggesting that internet service providers could modify their agreements so users agree to online dispute resolution when they subscribe to the service).

245. See Krause, *supra* note 179, at 472 (arguing that online shopping sites know trust is important and they gain if they can convince consumers that their purchases are safe).

246. On the other hand, this could make naive investors more aware of the risk of fraud, making them less likely to invest.

247. See Ivanov & Knyazeva, *supra* note 10, at 23 tbl.9.

248. Wefunder accounts for 42.9% of completed offerings and 63.5% of the money raised. *Id.*

249. See *FAQ: Investing and Fundraising 101*, WEFUNDER, <http://wefunder.com/faq> [<https://perma.cc/UX43-DCCY>]; *FAQ*, NEXTSEED, <http://www.nextseed.com/about/faq> [<https://perma.cc/SPE7-FF26>]; *How It Works*, REPUBLIC, [http://republic.co/how\\_it\\_works](http://republic.co/how_it_works) [<https://perma.cc/YV74-3TB5>]; *Got Questions? We've Got Answers*, STARTENGINE, <http://help.startengine.com/hc/en-us> [<https://perma.cc/5Q4H-9H8L>].



curities Act gives it the power to impose additional requirements on crowdfunding intermediaries “for the protection of investors and in the public interest.”<sup>250</sup> Section 4A(b)(5) gives the SEC similar power to impose additional requirements on issuers.<sup>251</sup> Providing an arbitration remedy for fraud is, without a doubt, consistent with investor protection, and I have explained in this Article why such a remedy is in the public interest.<sup>252</sup> Thus, the SEC could mandate an arbitration remedy with all of the features described in this Article. The question is whether it should.

The problem with an SEC mandate is that it would lock all crowdfunding intermediaries into a single dispute-resolution model that would require notice-and-comment rulemaking to change. Securities crowdfunding is new, and the best way to ensure its long-term success is to encourage experimentation by crowdfunding platforms to see what does and does not work. If the SEC does not require a particular form of dispute resolution for all crowdfunding intermediaries, one of those intermediaries might develop an even more effective solution to the fraud problem.

On the other hand, an SEC-mandated remedy might reach more broadly than an arbitration requirement imposed voluntarily by the crowdfunding platforms. To this point, I have been assuming that the dispute will be solely between the issuer and defrauded investors. That will not necessarily be the case. Section 4A(c) of the Securities Act,<sup>253</sup> the crowdfunding liability provision, imposes liability on parties other than the issuer. The issuer’s directors, partners, principal executive officer, principal financial officer, and controller or principal accounting officer are also potential defendants.<sup>254</sup> The statute also imposes liability on anyone else who “offers or sells” the issuer’s securities in the crowdfunded offering,<sup>255</sup> this probably covers anyone who solicits the purchase for the issuer or for their own financial benefit.<sup>256</sup> It is unclear if these other defendants would be liable for

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250. Securities Act of 1933 § 4A(a)(12), 15 U.S.C. § 77d-1(a)(12) (2012).

251. *Id.* § 4A(b)(5), 15 U.S.C. § 77d-1(b)(5).

252. *See supra* Part V.

253. *Id.* § 4A(c), 15 U.S.C. § 77d-1(c).

254. Section 4A(c)(2) only makes issuers liable, but section 4A(c)(3) defines “issuer” to include not only the company issuing the securities but these other parties as well. *See id.* § 4A(c)(2), (3), 15 U.S.C. § 77d-1(c)(2)-(3).

255. *Id.* § 4A(c)(3), 15 U.S.C. § 77d-1(c)(3). It is unclear if the other listed defendants must be involved in offering or selling the security to be liable. *See Bradford, The New Federal Crowdfunding Exemption, supra* note 17, at 211.

256. *See Pinter v. Dahl*, 486 U.S. 622, 647 (1988) (defining identical language in section 12 to encompass anyone who solicits a purchase “motivated at least in part by a desire to serve his own financial interests or those of the securities owner”); *see also Bradford, The*

the issuer's fraud or only for their own fraudulent statements,<sup>257</sup> but those other defendants clearly could be liable to defrauded investors in at least some cases.

That poses a problem for a voluntarily imposed arbitration remedy. Crowdfunding intermediaries could obtain the issuer's consent to arbitrate as a condition of listing the offering on the intermediary's site, but the other potential defendants would not be bound by the issuer's consent. Those other parties could be required to arbitrate only if they individually agreed to do so. The issuer is not their agent, and nonsignatories "cannot be bound to arbitrate in the absence of a full showing of facts supporting an articulable theory based on . . . contract law or . . . agency law."<sup>258</sup>

The intermediary could require all of the defendants listed in section 4A(c) to agree to arbitrate, but that would be cumbersome. Some of the potential defendants will not even be identifiable at the time of the listing; the intermediary cannot know in advance who will be offering or selling the securities. Also, if one of the named officers refuses to sign the arbitration agreement, the issuer would either have to replace the officer with someone more compliant or find another crowdfunding platform that does not require such an agreement. The effect of trying to expand liability would be to push issuers towards platforms that provide less effective remedies.

It is unclear, however, if an SEC mandate would solve this problem. The SEC certainly has the power to impose an arbitration remedy on the issuer and the crowdfunding intermediary.<sup>259</sup> But nothing in section 4(a)(6) or section 4A gives the SEC the power to impose requirements on anyone else. Perhaps the SEC's authority to impose requirements on the issuer could be read liberally to extend to the issuer's principals and others acting on the issuer's behalf in the offering. If so, an SEC mandate would be much more effective than an intermediary-imposed arbitration requirement because it could force the other potential defendants to arbitrate. Even if the SEC lacks the power to force those other defendants to arbitrate, however, providing investors with an arbitration remedy limited to the issuer is still better than the status quo.

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*New Federal Crowdfunding Exemption*, *supra* note 17, at 211 (noting that the *Pinter* definition would presumably apply to section 4A(c)).

257. See Bradford, *The New Federal Crowdfunding Exemption*, *supra* note 17, at 211-12; Bradford, *Shooting the Messenger*, *supra* note 83, at 396-97.

258. *Sarhank Grp. v. Oracle Corp.*, 404 F.3d 657, 662 (2d Cir. 2005); see also *Westmoreland v. Saudox*, 299 F.3d 462, 466 (5th Cir. 2002) (holding that an agent cannot compel arbitration merely because his principal is a signatory to the arbitration agreement).

259. See *supra* text accompanying notes 250-51.

One possible defendant deserves special mention. Crowdfunding intermediaries might fall within the “offers or sells” language in section 4A(c).<sup>260</sup> If so, in many cases, they might be the only defendant capable of paying an arbitration award.<sup>261</sup> This presents two problems. First, their potential liability gives them an incentive not to offer an arbitration remedy, or at least not one that applies to them. Second, an unbiased forum is a crucial element of the online arbitration process.<sup>262</sup> If intermediaries offer an arbitration remedy that includes themselves as potential defendants, they have an incentive to tilt the arbitration procedures in favor of defendants.<sup>263</sup>

It is uncertain if crowdfunding intermediaries would ordinarily be liable to investors for fraud by the issuer.<sup>264</sup> But, until that uncertainty is resolved, the mere risk of liability could skew intermediaries’ incentives. An SEC mandate avoids this conflict of interest.

#### VIII. INTERACTION WITH OTHER REFORM PROPOSALS

Other suggestions have been offered to deal with the problem of crowdfunding fraud. The unilateral arbitration remedy proposed in this Article will not interfere with any of those proposed solutions. In fact, it may be necessary to make some of them work.

One possibility is to make the litigation remedy under section 4A(c) more favorable to small investors. For instance, David Mashburn proposes that the prevailing party be awarded his or her attorneys’ fees.<sup>265</sup> Then, according to Mashburn, “[i]nstead of being deterred by the limited size of the award, attorneys could concentrate on the likelihood of success because they would receive adequate compensation if they won on the merits at trial.”<sup>266</sup> The additional

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260. See Bradford, *Shooting the Messenger*, *supra* note 83, at 391-95.

261. Palmiter, *supra* note 112, at 426.

262. See, e.g., Perritt, *supra* note 182, at 678; see also Bordone, *supra* note 244, at 206 (“[I]t is important to be vigilant and ensure that the system operators do not impose too powerfully in shaping the dispute design model such that it tilts it in favor of the system operator’s own rather than the general Cybercommunity’s interests and needs.”).

263. See Palmiter, *supra* note 112, at 375 (“Arbitration, predictably, would be designed by, for and of securities firms and the new crowdfunding portals—the repeat players in the game. Certainly, there is reason for caution given the way customer-broker arbitration has been captured by brokerage firms.”); see also Hang, *supra* note 185, at 861 (arguing that one potential problem is that businesses will draft online arbitration clauses to suit their needs).

264. See Bradford, *Shooting the Messenger*, *supra* note 83, at 382 (asserting that crowdfunding intermediaries are unlikely to be liable for issuer fraud under Rule 10b-5); *id.* at 388 (explaining that intermediaries who do not recommend the offering or the particular securities might not be liable for issuer fraud under sections 4A(c) and 12(a)(2) of the Securities Act).

265. Mashburn, *supra* note 89, at 171.

266. *Id.* at 171-72.

liability for attorneys' fees would also serve a deterrence function by increasing the cost of engaging in fraud.<sup>267</sup>

It is not clear if Mashburn's proposal would work. The prospect of recovering attorneys' fees could encourage strike suits against even nonfraudulent issuers, increasing the cost of raising capital for all issuers.<sup>268</sup> On the other hand, Mashburn's proposal imposes an additional risk on investors—if they are unable to convince a court that the offering was fraudulent, they would have to pay the defendant's attorneys' fees, not just their own. This risk could deter even meritorious claims.

In any event, nothing in my proposal would affect Mashburn's proposal or any other solution that attempts to improve an investor's chances in litigation. Since the proposed arbitration remedy is unilateral, investors would not be bound to arbitrate. If litigation becomes a viable option, a unilateral arbitration remedy would not prevent investors from suing.

Others believe that the role of crowdfunding intermediaries should be strengthened. The SEC Investor Advisory Committee, for example, has argued that crowdfunding intermediaries should take a more active role in policing offerings for fraud and other problems.<sup>269</sup> Nothing in the proposed arbitration remedy would preclude a more active enforcement role on the part of intermediaries. An adequate remedy would still be needed for fraudulent offerings that slip through the intermediary's screening.

A similar response can be made to suggestions that investor disclosure be strengthened.<sup>270</sup> Even if additional disclosure makes fraud less likely, investors would still need a remedy for the cases where fraudulent offerings nevertheless succeed.

Alan Palmiter suggests another alternative: insurance.<sup>271</sup> Either crowdfunding intermediaries or independent insurers could offer insurance against fraudulent offerings. Investors who suffered losses due to fraud could recover on the insurance policy instead of suing the fraudulent issuer. The insurance company would have an incen-

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267. *Id.* at 172.

268. To reduce the possibility of strike suits, Mashburn proposes to amend section 4A(c) to make scienter, rather than negligence, the standard of care. *Id.* at 169. This increased burden of proof would make it harder for plaintiffs to recover, and discourage litigation even against fraudulent issuers, so the net effect of Mashburn's two proposals is indeterminate.

269. SEC INVESTOR ADVISORY COMMITTEE, *supra* note 87.

270. See Cody R. Friesz, Note, *Crowdfunding & Investor Education: Empowering Investors to Mitigate Risk & Prevent Fraud*, 48 SUFFOLK U. L. REV. 131, 149 (2015).

271. Palmiter, *supra* note 112, at 426.

tive to act as a gatekeeper, identifying and shutting down potentially fraudulent offerings before they close.<sup>272</sup>

Among other things, this would eliminate the problem of enforcing a judgment or arbitration award against an absent or judgment-proof fraudster.<sup>273</sup> The deep-pocketed insurance company would replace the issuer as the defendant. But insurance does not eliminate the need for an effective dispute resolution mechanism; it merely shifts the focus to a different defendant. Investors would still have to prove that the offering was fraudulent in order to collect on the insurance, with all the same problems involved in claims against issuers. An arbitration remedy like the one proposed in this Article could be used to pursue claims against the insurers.

### IX. CONCLUSION

Crowdfunding has great potential as a way for small businesses to raise capital, but it also poses a significant risk of fraud. Some of the requirements of the crowdfunding exemption—for example, disclosure requirements, the required use of a neutral intermediary, and the restrictions on off-platform communications—should reduce the incidence of fraud. But no regulatory requirements can eliminate *all* fraud.

When crowdfunding fraud occurs, investors need access to a simple, low-cost remedy that will allow them to pursue the wrongdoers. Given the small amounts of money involved, neither individual lawsuits nor class actions are likely. The online arbitration remedy proposed in this Article is designed to make it easier for defrauded investors to recover. The proposed remedy will not only help compensate those investors for their losses, it will also help to deter fraud in the first place.<sup>274</sup> The online arbitration remedy is not perfect; in particular, collection is still an issue. But it is significantly better than any existing options available to defrauded investors.

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272. *Id.*

273. *See supra* text accompanying notes 236-40.

274. *See Galves, supra* note 143, at 47 (“[T]he presence of a reliable [online dispute resolution] system will likely lead to fewer cases of fraud or misrepresentation because sellers will know that they will be held legally responsible for the transaction.”).

## APPENDIX A

## A SIMPLE ONLINE ARBITRATION CLAIM FORM

**WARNING: You have a right to sue in court. If you file this form, you will lose your right to sue in court. Do not file this arbitration claim form if you intend to bring a lawsuit.**

**Your name:**

**Name of company in which you invested:**

**Name of crowdfunding platform:**

**Amount you invested:**

**Approximate date of your purchase:**

**Statement or statements you claim are fraudulent:**

(Provide as much detail as possible, including when the statement was made, where it was posted, who made the statement, and the exact language of the statement that you believe was fraudulent.)

**Why you think the statement was false or misleading when it was made:**

(Provide as much detail as possible. What have you learned that makes you believe the statement was fraudulent, and where did you find that information? If your belief is based on something on the Internet, please provide the URL of your source. If your belief is based on something published in print, please give as much detail about the publication as possible.)

**Anything else you wish to say in support of your claim:**

*You may also attach any additional material you wish to submit in support of your claim.*

## APPENDIX B

## AN EXAMPLE OF A SIMPLE ARBITRATION FINDING

**Arbitrator:** Anne Arbitrator

**Name of Complainant(s):** Jane Smith

**Name of Issuer:** Dazzle, LLC

**Amount of Complainant's Investment:** \$10,000

**Other Respondents:** None

**Award:** Dazzle is ordered to pay Jane Smith \$10,000.

**Fraud Alleged:** Smith alleged two fraudulent statements:

1. Dazzle stated in its posted disclosure: "We already have 1,000 orders for our product."
2. In a post on the intermediary's communications channel, Dazzle's CEO, Ernie Entrepreneur, stated: "We believe there's a strong market for our product."

**Findings:**

1. The first statement was false. At the time of the disclosure, Dazzle had no firm orders for its product. It had received approximately 1,000 inquiries from potential customers, but only two customers had already placed orders.
2. Dazzle knew the statement was false.
3. This false statement was material. There is a substantial likelihood that a reasonable investor would consider it important in deciding whether to invest in Dazzle.
4. Dazzle has not shown that all or part of Smith's loss results from something other than the false statement.
5. Dazzle has not shown that Smith knew or should have known the statement was false when she purchased her interest in Dazzle.
6. The second statement was not materially false. It reflected the honest, good-faith belief of Dazzle's principals at the time, and they were unaware of any information indicating there was not a strong market for their product. In fact, the inquiries they had received about their product reasonably led them to believe that there was a strong interest in their product.

/s/ Anne Arbitrator

Date: January 15, 20xx