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Far from the Maddening Crowd: Does the Jobs Act Provide Meaningful Redress to Small Investors for Securities Fraud in Connection with Crowdfunding Operations

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Abstract: Title III of the Jumpstart Our Business Startups (“JOBS”) Act provides a “crowdfunding” exemption from securities registration for small issuers to publicly offer up to $1 million in equity securities during a twelve-month period. Issuers will conduct crowdfunding offerings through online social networks as a means of reaching a myriad of potential investors. Although Title III requires crowdfunding issuers to disclose information about the startup’s business and the securities being offered, many small investors will lack the financial sophistication to understand their investments and bear a higher risk of becoming victims of fraudulent offerings. In the likely event of issuer fraud, the economic incentives of crowdfunding make the class action vehicle a virtual prerequisite for small investors seeking to recoup their lost investments. The procedural hurdles erected by the Private Securities Litigation Reform Act of 1995 (the “PSLRA”), however, would eliminate the efficacy of Title III’s private right of action and thus impede, if not entirely prevent, small defrauded crowdfunding investors from adequate redress. Yet class actions brought by small crowdfunding investors would not implicate the policy concerns that prompted the passage of the PSLRA. In order to create a truly viable crowdfunding exemption, Congress should carve out an exception to the PSLRA for class action lawsuits alleging fraud in connection with crowdfunding offerings.
If the country is to flourish, capital must be invested in enterprise. But those who seek to draw upon other people's money must be wholly candid regarding facts on which the investor's judgment is asked.

—Franklin D. Roosevelt

INTRODUCTION

Signed into law by President Barack Obama on April 5, 2012, the Jumpstart Our Business Startups ("JOBS") Act seeks to afford startups access to previously unavailable capital in order to grow the American economy. Title III of the JOBS Act amends Section 4(a)(6) of the Securities Act of 1933, as amended (the "Securities Act"), to allow startups to offer up to $1 million worth of their securities to the public during a twelve-month period. These "crowdfunding" offerings would, in theory, allow startups to solicit potential investors through online social networks and grant startups access to a previously untapped well of capital. Although lending and donation-based crowdfunding websites have experienced tremendous success in raising capital for small enterprises, Title III goes a step further in allowing investors to purchase an equity stake in the startup itself.

Although Title III could provide marginalized startups with a much-needed capital injection through crowdfunding offerings, potential crowdfunding investors may face serious hazards. Purchasing a startup's securities may expose small unsophisticated investors to unknown financial risks and higher incidents of issuer fraud. Small un-

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1 President Franklin Roosevelt, Message to Congress (May 27, 1933), in 2 Public Papers and Addresses of Franklin Delano Roosevelt 214 (Samuel I. Roseman ed., 1938).


3 Id.


The problem is that in the guise of job creation, this legislation rolls back important investor protections and transparency requirements that are fundamental to our capital markets. Under the legislation the House has sent us,
sophisticated investors generally lack the necessary financial acumen to understand the nuances of investing—especially concepts related to financial risk, portfolio management, and limiting exposure. Crowd-funding investors lacking financial know-how stand to gain little from Title III’s requirement that startups issuing securities provide disclosures to investors. Additionally, many startups will not have done enough business to have generated sufficient financial information to disclose to potential investors. Furthermore, assuming that crowd-funding investors understood the information disclosed by the issuer, even seasoned investors would find evaluating and verifying the quality of that information difficult. Finally, small investors lacking financial acumen are unlikely to have sufficient investable assets to withstand a loss of their entire investment in the event of fraud.

Although Title III affords crowdfunding investors a private right of action in the event of issuer fraud, small investors may—in practice—lack the ability to sue crowdfunding issuers for securities fraud. Investors bringing suit under Title III’s private right of action may only recover up to the amount invested, which for small investors may amount to less than the cost of bringing suit in the first place. Given the economic disincentives for bringing a securities fraud action against a crowdfunding issuer, a class action lawsuit is the only economically fea-

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8 Bradford, supra note 5, at 112.
14 See JOBS Act, at sec. 302(b), § 4A(c) (codified at 15 U.S.C. § 77d-1(c)); see also Hazen, supra note 4, at 1759 ("[A] relatively small crowdfunding effort will result in relatively modest potential damages, thus raising questions regarding the economics of bringing such a claim and the adequacy of the economic incentives to plaintiff’s law firms to bring suit . . . .").
Possible option for small individual investors. Unfortunately, the Private Securities Litigation Reform Act of 1995 (the “PSLRA”) would effectively prevent classes of small defrauded crowdfunding investors from the advantages of Title III’s private right of action. The PSLRA, which operates to prevent manufactured plaintiff classes from bringing meritless securities fraud suits against issuers seeking settlement, would require classes of small defrauded crowdfunding investors to plead scienter as well as loss causation with particularity. Because many fledgling startups are unlikely to have generated much financial information (e.g., tax returns or audited financial statements), defrauded crowdfunding investors would find that meeting the PSLRA’s heightened pleading requirements difficult, if not impossible. The PSLRA’s heightened pleading requirements could, therefore, effectively eliminate plaintiffs’ already limited remedies under Title III’s private right of action, creating “litigation-proof” offerings.

Despite the federal interest in deterring meritless class action securities fraud lawsuits, the PSLRA should not curb classes of small defrauded crowdfunding investors from seeking redress under Title III’s private right of action. Because the perceived abuses of the class action vehicle in securities fraud litigation would likely be absent from crowdfunding securities litigation, such a lawsuit would not implicate the public policy goals underlying the PSLRA. For example, startups raising capital through crowdfunding offerings lack large asset bases by definition, giving plaintiff classes no incentive to shake down issuers for lucrative settlements without regard to culpability. Similarly, Title III prevents individual investors from recovering anything in excess of “the consideration paid for such security with interest thereon,” which in

15 See Diamond, supra note 13, at 1840.
17 Id. § 78u-4(b) (2)(A), (b)(4) (imposing heightened burdens on class action securities fraud suits).
18 See Taku, supra note 10, at 3.
19 See Diamond, supra note 13, at 1838.
20 See id.; see also § 78u-4(b) (imposing heightened burdens on class action securities fraud suits).
21 See H.R. Rep. No. 104-369, at 31 (1995) (Conf. Rep.). Congress was particularly concerned with vexatious litigation that targeted deep-pocketed defendants such as accountants, underwriters, and individuals who may have large insurance policies. Id. None of these individuals, however, are common in small startups. See Abraham J.B. Cable, Fending for Themselves: Why Securities Regulations Should Encourage Angel Groups, 13 U. Pa. J. Bus. L. 107, 120 (2010) (noting that startups typically lack sufficient sources of funding after they have exhausted personal resources and before attracting venture capital funds).
22 See id. (indicating that deep pockets may incentivize meritless litigation).
turn would prevent plaintiff classes from seeking extortionate sums from crowdfunding issuers.\textsuperscript{23} As such, Congress should carve out class action lawsuits brought under Title III’s private right of action from coverage by the PSLRA.\textsuperscript{24}

Part I of this Note examines the need for legislation addressing the financing difficulties of startups and Title III’s disclosure requirements geared towards investor protection.\textsuperscript{25} Part II discusses whether such requirements sufficiently protect small unsophisticated crowdfunding investors from issuer fraud.\textsuperscript{26} Part III then examines whether Title III’s private right of action provides small defrauded investors with economically feasible recourse in the event of issuer fraud and concludes that the PSLRA effectively precludes small investor redress by way of the class action vehicle.\textsuperscript{27} Finally, Part IV argues that class action lawsuits brought by small defrauded investors against crowdfunding issuers would not undermine the policies on which the PSLRA rests.\textsuperscript{28} As such, this Note suggests that Congress should carve out a crowdfunding exception in the PSLRA in order to create a workable crowdfunding exemption.\textsuperscript{29}

\textbf{I. CROWDFUNDING AND FEDERAL SECURITIES LAWS}

In the wake of the 2008 financial crisis and ensuing credit crunch, small business startups continue to face mounting challenges in locating scarce capital needed to grow and stay solvent.\textsuperscript{30} Frequently, startups will not qualify for loans from traditional institutional investors, such as banks, because of the risks associated with emerging growth.\textsuperscript{31} Similarly, smaller startups tend not to attract the attention and benevo-

\textsuperscript{25} See infra notes 30–87 and accompanying text.
\textsuperscript{26} See infra notes 88–154 and accompanying text.
\textsuperscript{27} See infra notes 155–216 and accompanying text.
\textsuperscript{28} See infra notes 217–258 and accompanying text.
\textsuperscript{29} See infra notes 242–258 and accompanying text.
\textsuperscript{30} See generally Tanya Prive, What Is Crowdfunding and How Does It Benefit the Economy, FORBES, Nov. 27, 2012, http://www.forbes.com/sites/tanyaprive/2012/11/27/what-is-crowdfunding-and-how-does-it-benefit-the-economy/ (noting that, to obtain capital in the post-recession world, startups have increasingly turned to online crowdfunding platforms such as Kiva and RocketHub).
\textsuperscript{31} Bradford, supra note 5, at 5.
lence of “angel investors” or venture capital funds. These challenges force startups to solicit relatives and friends for funding, which is usually insufficient to support the majority of emerging businesses.

In the absence of traditional seed money, small startups have recently seized upon donation-based crowdfunding as a low-cost means of locating potential investors and raising capital. The term “crowdfunding” refers to the solicitation of capital from many individual investors in small amounts over the Internet—a process that offers startups access to capital that they might not otherwise receive through traditional channels. Donation-based crowdfunding, in particular, has connected startups to a nearly unlimited well of untapped capital through preexisting online social networks. The proliferation of online social networks within the past five years has allowed startups to access millions of potential investors in real time, with no incremental cost. For example, peer-to-peer lending websites such as Kickstarter and Kiva allow startups to seek funding from donors around the world, usually in the form of small gifts. Larger, well-publicized ventures may receive substantial donations of several million dollars. One scholar has estimated that peer-to-peer lending alone has raised an estimated $1 billion in funding for small businesses and will likely exceed $5 billion by the end of 2013.

Donation-based crowdfunding websites offer sufficient funding to artists, musicians, and the like, but donations alone are unlikely to pro-

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33 Id. at 27. Mingling friends and family into the already tense atmosphere that pervades most business startups also tends to increase stress on the business management and by extension decrease the likelihood of long-term success. Id.


35 Bradford, supra note 5, at 5.

36 Hazen, supra note 4, at 1736–37.


38 Bradford, supra note 5, at 10. The “peer-to-peer model” commonly involves temporary loans from contributors, with or without interest, subject to immediate repayment. Id.

39 See, e.g., Cease and Desist Order, Securities Act Release No. 9216, 2011 WL 2246317 (June 8, 2011) (illustrating how five million people contributed a total of $200 million to two advertising executives seeking to purchase Pabst Brewing Co.).

40 Bradford, supra note 5, at 11.
vide the level of investments necessary for business startups.\footnote{See id. at 12, 16. Although crowdfunding has experienced tremendous popularity in its use in the entertainment industry, none of the prominent crowdfunding sites used by businesses and entrepreneurs actually use the donation model. See id.} One method of solving this problem would be to offer investors a stake in the startup’s future earnings, which would likely encourage more consistent investment and lead to more startup success.\footnote{See id. at 24.} This paradigm would allow startups to collect small amounts of money from many investors who would share in business returns.\footnote{Id. at 22.}

Although offering investors equity in a startup helps solve the problem of attracting and maintaining sufficient capital for long-term growth, such offerings likely would implicate federal securities laws.\footnote{See Stuart R. Cohn, The New Crowdfunding Registration Exemption: Good Idea, Bad Execution, 64 Fla. L. Rev. 1433, 1435 (2012).} Unlike donations, which do not offer returns to the donor, crowdfunding equity securities would likely fall within the meaning of “investment contracts.”\footnote{Hazen, supra note 4, at 1740. Investment contracts are construed broadly to include any contract, arrangement, or scheme in which an individual invests money in a “common enterprise” with the expectation of profit from the efforts of others. See SEC v. W.J. Howey Co., 328 U.S. 293, 298–99 (1946) (noting that the term “security” is defined in § 77b(a)(1) of the Securities Act by way of a non-exhaustive list, which includes investment contracts, stocks, bonds debentures, evidences of indebtedness, and options).} As a result, they would constitute securities for purposes of the registration requirements of the Securities Act and the periodic disclosure requirements of the Securities Exchange Act of 1934, as amended (the “Exchange Act”).\footnote{See Securities Exchange Act of 1934, 15 U.S.C. § 78l(b) (2012) (requiring all securities traded on the securities exchanges to be registered under Sections 12(a) and 12(b) of the Exchange Act); Securities Act of 1933, 15 U.S.C. § 77b(a)(1) (2012) (including investment contracts within the definition of “security”). Under Section 5 of the Securities Act, prospect issuers must file forms with the SEC prior to offering securities in a process known as “registration.” See Registration Under the Securities Act of 1933, U.S. SEC. & EXCH. COMM’N, http://www.sec.gov/answers/regist33.htm (last modified Sept. 2, 2011). These forms, which include the registration statement and prospectus, include information for investors such as a description of the issuer’s properties and business as well as a description of the securities being offered, information about the issuer’s management, and audited financial statements. See id.} The costs associated with observing applicable securities regulations, in particular registration under Section 5 of the Securities Act, would likely exceed the financing available to startups through a public offering.\footnote{Joan MacLeod Hemingway & Sheldon Ryan Hoffman, Proceed at Your Peril: Crowdfunding and the Securities Act of 1933, 78 Tenn. L. Rev. 879, 910 (2011). Section 5 of the Securities Act requires offerors to both register their offerings with the SEC and to file disclosure documents. Id. These processes entail a litany of fees for underwriters, legal
This Part describes the manner in which the JOBS Act addresses the capital needs of startups by creating a crowdfunding exemption from securities registration and the subsequent problems this may generate for small, unsophisticated investors.\footnote{See infra notes 51–87 and accompanying text.} Section A examines the substance of Title III in relation to federal securities laws’ overarching concern with investor protection.\footnote{See infra notes 51–60 and accompanying text.} Section B then discusses the scheme of mandatory issuer disclosures set forth in Title III and questions their efficacy.\footnote{See infra notes 61–87 and accompanying text.}

A. The JOBS Act: What Is It and How Does It Work?

In the absence of any viable preexisting Securities Act registration exemptions, the JOBS Act sought to allow startups to easily raise capital in the capital markets.\footnote{See Jumpstart Our Business Startups Act of 2012, H.R. 3606, 112th Cong. (2012), available at http://www.gpo.gov/fdsys/pkg/BILLS-112hr3606rh/pdf/BILLS-112hr3606rh.pdf (“A bill to increase American job creation and economic growth by improving access to the public capital markets for emerging growth companies.”).} Noting the correlation between the declining number of initial public offerings (“IPO”) and stagnant job creation,\footnote{H.R. Rep. No. 112-406, at 7 (2011) (noting that, according to the President’s Council on Jobs and Competitiveness, 90% of jobs created by startup companies are created after their IPO).} Congress sought to stimulate the domestic job market by reinvigorating the domestic IPO market.\footnote{See id. Congress observed that in 2010, U.S. capital markets raised only 15% of global IPO proceeds, in contrast to 28% over the past decade, and further emphasized that 10% of U.S. companies that did go public in 2010 did so outside of the United States. Id.} Without easy access to capital, startups that might have otherwise gone public were unable to do so, failing to create needed jobs.\footnote{Id.}

Title III of the JOBS Act directly addresses the dearth of funding options for startups by creating a new registration exemption for crowd-
Title III amends Section 4(6) of the Securities Act to allow for unregistered offerings of up to $1 million during a twelve-month period. At the same time, Title III limits the maximum amount an individual can invest in a crowdfunding offering based on the investor’s financial status. An investor with either an annual income or net worth exceeding $100,000 may invest up to $10,000 annually. Conversely, an investor whose net worth or annual income is less than $100,000 is limited to investing up to $2000 annually. Furthermore, investors may not resell the securities purchased in connection with a crowdfunding offering within one year of the date of purchase absent limited circumstances, making any crowdfunding securities highly illiquid.

B. Disclosure Requirements Under the JOBS Act

To effectively protect investors from fraud, a crowdfunding exemption must compel issuers to disclose sufficient information with which investors can make informed investments. Investor protection is paramount among policy considerations underlying federal securities laws. The Securities Act assumes that full and fair disclosure best protects investors from securities fraud. Armed with the requisite knowl-
edge, the individual investor stands to make the best decision about whether to purchase the security.\textsuperscript{64}

In keeping with the Securities Act’s emphasis on investor protection through adequate information, Title III requires issuers to provide investors with certain disclosures and to file them with the Securities Exchange Commission (SEC).\textsuperscript{65} In addition to the issuer’s name, physical address, and URL address, Title III requires the issuer to provide information about the nature of the startup, including the names of the directors and a description of the issuer’s ownership and capital structure.\textsuperscript{66} The issuer must also disclose a description of the current business, the anticipated business plan, a description of the stated purpose and intended use of the proceeds of the offering sought by the issuer, and the target amount of funding sought from the offering.\textsuperscript{67} Furthermore, the issuer must disclose its financial condition, which may include income tax filings and audited financial statements.\textsuperscript{68}

Title III additionally compels the issuer to disclose information about the securities being offered.\textsuperscript{69} Before any crowdfunding offering, the issuer must disclose either the public price of the security or the means of determining that price.\textsuperscript{70} Required information includes the number of classes of the security and their respective rights, as well as how the security’s terms may be modified.\textsuperscript{71} The issuer must further disclose the identities of current shareholders who control greater than twenty percent of any class of the issuer’s outstanding securities as well as a description of how the exercise of the controlling shareholders’ rights could negatively impact the purchasers of the securities to be offered.\textsuperscript{72} For companies not subject to the Exchange Act’s periodic re-

\textsuperscript{64} Id.
\textsuperscript{66} Id. at sec. 302(b), § 4A(b)(1)(A)–(B).
\textsuperscript{67} Id. at sec. 302(b), § 4A(b)(1)(C), (E)–(F).
\textsuperscript{68} Id. at sec. 302(b), § 4A(b)(1)(D).
\textsuperscript{69} Id. at sec. 302(b), § 4A(b)(1)(G)–(H).
\textsuperscript{70} Id. at sec. 302(b), § 4A(b)(1)(G).
\textsuperscript{72} Id. at sec. 302(b), § 4A(b)(1)(H)(ii)–(iii). The issuer must also disclose the risks to purchasers of the securities relating to minority ownership in the issuer and the risks associated with corporate actions, including additional issuances of shares, a sale of the issuer or of assets of the issuer, or transactions with related parties. Id. at sec. 302(b), § 4A(b)(1)(H)(v).
porting requirements, Title III nonetheless requires issuers to annually file with the SEC and report its financial status to investors.\footnote{73}{Id. at sec. 302(b), § 4A(b)(4). Publicly traded companies are required to file, inter alia, an annual report, quarterly reports, and additional reports for material events. \textit{Form 10-K}, U.S. SEC. & EXCH. COMM’N, http://www.sec.gov/answers/form10k.htm (last modified June 6, 2009). The deadlines for these filings depend on the size of the filer’s “public float,” i.e., the amount of a company’s freely tradable public shares. Id.}

Title III further requires issuers to conduct crowdfunding offerings through an intermediary.\footnote{74}{JOBS Act, at sec. 302(b), § 4A(a).} Under Section 4(6) of the Securities Act, as amended by Title III, either a registered broker or a “funding portal” may qualify as an intermediary.\footnote{75}{Id. at sec. 302(b), § 4A(a)(1). The Exchange Act defines a funding portal as “any person acting as an intermediary in a transaction involving the offer or sale of securities for the account of others, solely pursuant to section 4(6).” Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(80) (2012).} Because funding portals are classified separately from brokers, the Exchange Act imposes more exacting restrictions on their allowable activities.\footnote{76}{15 U.S.C. § 78c(a)(80)(A)–(E). Unlike brokers, funding portals may not offer investment advice or recommendations to investors nor directly solicit transactions in the securities offered on their websites. Similarly, funding portals may not handle investor funds or the issuer’s securities themselves. Id.} Funding portals are not, however, required to register with the SEC as broker-dealers; instead, they must register with a self-regulatory organization.\footnote{77}{Id. § 78c(a)(80)(h)(1)(A). Funding portals must register with a national securities organization registered under Section 15A of the Exchange Act, which may regulate the funding portal with such rules that are “written specifically for registered funding portals.” Id. § 78c(a)(80)(h)(1)(B). As of this time, because the only national 15A registered self-regulatory organization is the Financial Industry Regulatory Authority, all registered funding portals will be required to register with it. Thomas V. Powers, \textit{SEC Regulation of Crowdfunding Intermediaries Under Title III of the JOBS Act}, 31 BANKING & FIN. SERVICES POL’Y REP. 1, 3 (2012).}

Bearing in mind the Securities Act’s emphasis on investor protection, Title III imposes investor understanding and education requirements on intermediaries.\footnote{78}{JOBS Act, Pub. L. No. 112-106, sec. 302(b), § 4A(a)(4), 126 Stat. 306 (2012) (codified at 15 U.S.C. § 77d-1(a)(4) (2012)).} Before investing, investors must review educational materials prepared by the crowdfunding intermediary according to the standards to be set forth by the SEC.\footnote{79}{Id. at sec. 302(b), § 4A(a)(4)(A).} Because of the risks inherent to startups and the abstract nature of securities, the intermediary must affirm that investors appreciate the risk of losing their entire investment.\footnote{80}{Id. at sec. 302(b), § 4A(a)(4)(B).} In addition to reviewing educational materials, potential crowdfunding investors must also answer questions pertaining to their
understanding of the startup and the securities being offered.81 Finally, intermediaries must take measures to reduce the risk of fraud, although what those measures will consist of remains subject to further SEC rulemaking.82

Despite the apparent stringency of these investor protections, Title III simultaneously eases restrictions on solicitation.83 Although the amended Section 4A(b) prohibits the issuer or others acting on its behalf from advertising the terms of the offering, the issuer may direct investors to the intermediary conducting the offering.84 The issuer may further compensate third parties for promoting the offering “through communication channels provided by the intermediary,” provided the issuer discloses the compensation in accordance with SEC requirements.85 Easing the restrictions on directing potential investors to crowdfunding offerings allows crowdfunding issuers to leverage online social networks to attract sufficient investor interest that would have been otherwise impossible under existing regulations.86 Given the multitude of online social network participants, however, online crowdfunding offerings may attract many novice investors.87

II. CROWDFUNDING AND SECURITIES FRAUD

Federal securities laws have historically rested on two policy cornerstones: (1) the requirement that issuers tell the truth about securities prior to the offering; and (2) that failure to tell the truth results in

81 Id. at sec. 302(b), § 4A(a) (4)(C)(i)–(iii). Investors must demonstrate that they have: “(i) An understanding of the level of risk generally applicable to investments in startups, emerging businesses, and small issuers; (ii) an understanding of the risk of illiquidity; and (iii) an understanding of such other matters as the Commission determines appropriate, by rule.” Id.
82 Id. at sec. 302(b), § 4A(a) (5). The provision includes limited guidelines for intermediary risk reduction including obtaining a background and a securities enforcement regulatory history check on each officer, director, and person holding more than twenty percent of the outstanding equity of every issuer whose securities are offered by such person. Id.
83 See id. at sec. 302(b), § 4A(b)(2).
85 Id. at sec. 302(b), § 4A(b)(3).
86 See generally Hemingway & Hoffman, supra note 47 (noting that small businesses could not bear the costs imposed by existing exemptions from registration under the unamended Securities Act). See JOBS Act, at sec. 302(b), § 4A(b)(3) (easing restrictions on the solicitation of investors).
87 Diamond, supra note 13, at 1840 (noting that by directing investors directly towards the offering without apprising them of the offering’s terms upfront, issuers may attract more unsophisticated investors).
a serious penalty. As such, adequate “front-end” protection for investors requires both that information be made available to potential investors and that investors be able to understand that information to make reasonable investment decisions. Without access to necessary information, investor trust in the capital markets will wane and the true capital formation and economic growth sought by the drafters of the Jumpstart Our Business Startups (“JOBS”) Act cannot flourish.

The likelihood of issuer fraud in online crowdfunding offerings, however, magnifies the probability that potential investors, especially small unsophisticated investors, will lose all or part of their investment. Fraud is endemic to the securities industry, and no exemption to registration, no matter how carefully crafted, will wholly prevent individuals from committing securities fraud. Even registration requirements, from which Title III exempts crowdfunding offerings, would not entirely protect investors from fraud. Nonetheless, the SEC has repeatedly stressed the importance, and perhaps even primacy, of investor protection over efficient capital raising through crowdfunding offerings.

This Part discusses the likelihood of issuer fraud in connection with online crowdfunding securities offerings. Section A examines securities fraud in the Internet era and the myriad of hazards facing

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89 Heath Abshure, President, N. Am. Sec. Adm’rs Ass’n, Keynote Address at the SIMFA Compliance and Legal Society Annual Meeting (Mar. 19, 2012) [hereinafter Abshure Keynote Address], available at http://www.nasaa.org/21946/nasaa-president-heath-abshures-keynote-address-at-simfa-compliance-and-legal-society-annual-meeting/ (“It is important that investors understand the risk involved and . . . that investors . . . have access to information about the issuer . . . .”); see also Manuel A. Utset, Fraudulent Corporate Signals: Conduct as Securities Fraud, 54 B.C. L. Rev. 645, 647 (2013) (noting how recent changes in federal securities law aim to make companies more transparent).
90 Luis A. Aguilar, Comm’r, Sec. & Exch. Comm’n, Address at the Harvard Law School Forum on Corporate Governance and Financial Regulation: Investor Protection Is Needed for True Capital Formation (Mar. 25, 2012) [hereinafter Aguilar Address] (“True capital formation and economic growth require investors to have both confidence in the capital markets and access to the information needed to make good investment decisions.”).
91 See Heath Abshure, President, N. Am. Sec. Adm’rs Ass’n, Remarks at NASAA SEC 19(d) Conference (Apr. 26, 2013) [hereinafter Abshure Remarks].
92 Cohn & Yadley, supra note 37, at 72 (“[N]o amount of technical exemption requirements will hinder the fraud artists from their endeavors.”).
93 Bradford, supra note 5, at 112.
94 Aguilar Address, supra note 90 (“[The JOBS Act] would seriously hurt investors by reducing transparency and investor protection and, in turn, makes securities enforcement more difficult.”).
95 See infra notes 98–154 and accompanying text.
unsuspecting investors.\textsuperscript{96} Bearing in mind that many members of the investing “crowd” lack financial sophistication, Section B concludes that the issuer disclosures required by Title III of the JOBS Act would do little in practice to ensure investor protection from issuer fraud.\textsuperscript{97}

A. The Prospect of Issuer Fraud in Crowdfunding Offerings

The impersonal nature of the Internet may increase the likelihood of fraud in connection with crowdfunding offerings, thus warranting more stringent investor protections.\textsuperscript{98} Since its creation and widespread popularity, the Internet has afforded securities fraudsters bountiful targets, especially by way of online social networks.\textsuperscript{99} In particular, the Internet has proved highly adaptable to tried and true methods of microcap securities fraud existing before the Internet.\textsuperscript{100} Spam e-mail and online message posting have replaced cold calling from “boiler rooms” as well as “pump-and-dump” schemes, offering fraudulent issuers access to a larger audience.\textsuperscript{101} The ease with which these schemes are perpetrated is inversely proportional to the amount of information available about the security or the issuer, making crowdfunding offerings all the more fertile territory for securities fraud.\textsuperscript{102}

Unsurprisingly, unsophisticated investors are more likely to be victims of fraudulent crowdfunding offerings.\textsuperscript{103} Due to their lack of financial acumen, these investors are ideal targets for repeated crowdfunding frauds because they may not be able to discern legitimate offerings from scams or even recognize when they have been defrauded.\textsuperscript{104} Title III compounds this problem by failing to explicitly set forth how funding portals will function in practice, thus creating additional difficulty for potential investors in distinguishing between legiti-

\textsuperscript{96} See infra notes 98–117 and accompanying text.

\textsuperscript{97} See infra notes 118–154 and accompanying text.

\textsuperscript{98} Hazen, supra note 4, at 1766; see Fisch, supra note 11, at 80; Internet Fraud, U.S. SEC. & EXCH. COMM’N (Feb. 1, 2011), http://www.sec.gov/investor/pubs/cyberfraud.htm.

\textsuperscript{99} Hazen, supra note 4, at 1767; see Internet Fraud, supra note 98.


\textsuperscript{101} Hazen, supra note 4, at 1768. “Boiler rooms” are high-pressure sales operations, whereas “pump-and-dump” schemes entail aggressive sales or withholding of a worthless security from the market to boost its value before “dumping” the security into the market and thereby causing its value to plummet. Id. at 1767–68.

\textsuperscript{102} Microcap Stock: A Guide for Investors, supra note 100 (“It’s easier for fraudsters to manipulate a stock when there’s little or no information about the company.”).

\textsuperscript{103} Hazen, supra note 4, at 1766.

\textsuperscript{104} See id.
mate crowdfunding offerings and scams. Furthermore, if unsophisticated investors behave similarly to average investors—e.g., by spending only a fraction of their total investments on fraud detection services—these paltry sums will be insufficient to effectively investigate potential fraud, putting their investments at greater risk.

A larger than average potential for fraud and self-dealing exists in startups than in more established companies, adding to the already high risk of failure inherent in startups. As evident from the abuse of the penny-stock market in the 1980s, startups make investors vulnerable to a disproportionate risk of fraud. Given the relative ease of perpetrating securities fraud through the Internet and online social networks, it follows that crowdfunding offerings made through online funding portals will breed similar abuses. Already, the North American Securities Administrators Association (“NASAA”) has placed crowdfunding securities fraud at the top of their annual investment scams list.

Securities fraud in crowdfunding offerings may manifest itself in several ways. Fraudsters may pose as registered funding portals, a prospect made more daunting by the recent spike in the number of registered domain names styling themselves as crowdfunding intermediaries.

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106 Nate C. Hindman, Post-JOBS Act, Investors Brace for Startup Scam Artists, HUFFINGTON POST, (Apr. 18, 2012, 11:31 AM) http://www.huffingtonpost.com/2012/04/18/jobs-act-2012-fraud-investors-scam_n_1432842.html. Investors on average spend a mere 0.1 percent of their total investment on fraud detection services. Id. Applying this average to Title III’s $2000 investment limitation, a small investor is only likely to spend two dollars on average investigating the offered securities prior to purchase assuming the investor spends the maximum amount. Id.

107 Bradford, supra note 5, at 105.

108 Id.

109 See Karen E. Klein, Crowdfunding Sites Launch a Preemptive Strike on Fraud, BLOOMBERG BUSINESSWEEK, Apr. 9, 2012, http://www.businessweek.com/articles/2012-04-09/crowdfunding-sites-launch-a-preemptive-strike-on-fraud. According to a former general counsel for the Troubled Asset Relief Program (TARP) Congressional Oversight Panel, there is “‘concern that scammers will descend on the fledgling market and mine it in fraud.’” Id. In addition, “‘There will be unregistered people cropping up [to offer small business equity investments] and the SEC will spend a lot of time shutting them down.’” Id. (alteration in original).


111 Taku, supra note 10, at 4.
ies. Alternatively, fraudsters may directly solicit unwitting investors with fraudulent crowdfunding offerings through a legitimate funding portal by way of spam e-mail, message board postings, and social media platforms such as Facebook and Twitter.

Although the SEC has not completed rules governing equity-based crowdfunding offerings, frauds have already been exposed in connection with donation-based crowdfunding. For example, one crowdfunding website, Gittip.com—which connects charitable endeavors to potential donors—discovered that the website’s platform was being used to launder money from stolen credit cards. In addition, in August of 2012, the Massachusetts Securities Division formally charged a Lowell resident for defrauding twenty investors of $153,396 in connection with a crowdfunding scam involving a gaming website. The ease with which donors are defrauded of their simple donations demonstrates the ease with which unsophisticated investors could be defrauded through vastly more complex equity securities.

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112 Eileen Ambrose, *New Law Allows Entrepreneurs to Sell Securities via Crowdfunding: Consumer Advocates Fear Crowdfleeing*, Balt. Sun (Apr. 14, 2012, 7:45 PM), http://www.baltimoresun.com/business/money/bs-bz-ambrose-crowdfunding-20120414,0,6798661.story?page=1 (“No question, fraud will occur. If con artists can send you emails that look as if they come from your bank, they will be able to set up counterfeit sites that appear to belong to authentic groups raising capital.”). Another commentator has suggested: “The number of entities already out there pitching themselves as crowdfunding entities online has risen in a significant fashion . . . . Just look at the web domain names: it has gone from a couple hundred to well over 1,600 in the past year. They are staking a position to enter [the] crowdfunding market. There will be a lot more to come on this.”

Gladstone, supra note 110 (quoting NASAA Enforcement Section Chair Matt Kitzi).

113 See Taku, supra note 10, at 4; *Internet Fraud*, supra note 98.


115 See id.


117 See Letter from William F. Galvin, Sec’y of the Commonwealth of Mass., to Elizabeth M. Murphy, Sec’y, U.S. Sec. & Exch. Comm’n (Aug. 8, 2012). (“[C]rowdfunding may also serve as a new channel that fraud promoters can use to distribute penny stocks widely to the public. Such promoters could later manipulate the stocks if they begin to trade in an over-the-counter market.”).
B. The Implications of Online Crowdfunding Offerings for Small Unsophisticated Investors

Given federal securities laws’ underlying concern with telling the truth about securities, meaningful investor protection must arise from adequate information about crowdfunding issuers and their securities, as well as the investor’s ability to understand that information.\textsuperscript{118} Although no amount of regulation can completely eliminate the investment risks present in any securities offering, Title III of the JOBS Act may not provide meaningful safeguards for unsophisticated investors in crowdfunding offerings.\textsuperscript{119} Crowdfunding investors may not be able to protect themselves by choosing not to purchase a startup’s securities because many of them may lack the necessary financial acumen or information about the startup to make that choice.\textsuperscript{120}

Investors may be further ensnared by the fact that many startups seeking to take advantage of crowdfunding offerings will not understand the difference between lawfully promoting their products online and priming the market for their securities in violation of Title III.\textsuperscript{121} As a threshold matter, Title III allows crowdfunding securities issuers to lead investors to the funding portal or broker.\textsuperscript{122} By directing potential investors directly towards the offering without apprising them of the offering’s terms upfront, issuers may attract more unsophisticated investors.\textsuperscript{123} The issuer may, and will have to, provide notice to prospective investors directing them to the issuer’s funding portal or intermediary.\textsuperscript{124} The Act fails, however, to define what constitutes “notice” or to provide any examples for prospective issuers.\textsuperscript{125} Although Title III pur-

\textsuperscript{118} Abshure Keynote Address, supra note 89 ("It is important that investors understand the risk involved and . . . that investors . . . have access to information about the issuer . . . . ").

\textsuperscript{119} See Bradford, supra note 5, at 112. Compare JOBS Act, Pub. L. No. 112-106, sec. 302(b), § 4A(b), 126 Stat. 306 (2012) (codified at 15 U.S.C. § 77d-1(b) (2012)) (imposing disclosure requirements on issuers), with Hazen supra note 9, § 1.2 (indicating that many investors will likely lack the financial acumen to understand their investments).

\textsuperscript{120} See Hazen supra note 9, § 1.2.

\textsuperscript{121} Thaya Brook Knight et al., A Very Quiet Revolution: A Primer on Securities Crowdfunding and Title III of the JOBS Act, 2 Mich. J. Private Equity & Venture Cap. L. 135, 141–42 (2012).

\textsuperscript{122} JOBS Act, at sec. 302(b), § 4A(b)(2) (indicating that issuers may “not advertise the terms of [an] offering, except for notices which direct investors to [a] funding portal or broker”).

\textsuperscript{123} Diamond, supra note 13, at 1838–39.

\textsuperscript{124} JOBS Act, at sec. 302(b), § 4A(b)(2).

\textsuperscript{125} See generally id. (codified in scattered sections of 15 U.S.C.) (failing to provide guidance on the issue of “notice”).
ports to forbid issuers from advertising the terms of the offering, the distinction between “notice” and “advertising” means little to startups that may engage in advertising and cast a wider net ensnaring unsophisticated investors.\(^\text{126}\)

Although Title III directly addresses the issue of investor education and financial acumen by delegating responsibilities to funding portals, these demands may not adequately protect small unsophisticated investors.\(^\text{127}\) Under Title III, funding portals must provide potential investors with educational materials and disclosures related to the security being offered.\(^\text{128}\) Additionally, funding portals must ensure investors read the aforementioned material, understand the nature of the investment (and the possibility of losing all or part of the investment), and demonstrate their knowledge pertaining to the risks associated with the investment.\(^\text{129}\) Thus far, the SEC has offered scant guidance on how funding portals will operate.\(^\text{130}\) Providing the requisite disclosures to investors will require funding portals to undertake their own due diligence, which may in turn require the assistance of legal counsel at considerable ex-

\(^{126}\) See Diamond, supra note 13, at 1840. According to the President of NASAA, under the JOBS Act, “We’re opening the door to broad solicitation and advertising of these [small securities offerings].” Id. As a result, he predicts that “[t]he lies are going to be easy to disseminate.” Id.


\(^{128}\) Id. at sec. 302(b), § 4A(a)(3) (indicating that funding portals must “provide such disclosures, including disclosures related to risks and other investor education materials, as the Commission shall, by rule, determine appropriate”).

\(^{129}\) JOBS Act, at sec. 302(b), § 4A(a)(4). The JOBS Act requires funding portals to

- (4) ensure that each investor
  - (A) reviews investor-education information, in accordance with standards established by the Commission, by rule;
  - (B) positively affirms that the investor understands that the investor is risking the loss of the entire investment, and that the investor could bear such a loss; and
  - (C) answers questions demonstrating—
    - (i) an understanding of the level of risk generally applicable to investments in startups, emerging businesses, and small issuers;
    - (ii) an understanding of the risk of illiquidity;
    - (iii) an understanding of such other matters as the Commission determines appropriate, by rule . . . .

\(^{130}\) Powers, supra note 77, at 3.
pense.\textsuperscript{131} Furthermore, it is unclear how funding portals would ensure that potential unsophisticated investors have understood the nature of their investment.\textsuperscript{132} Although the required educational material will likely not make unsophisticated investors sophisticated, merely alerting potential investors that some risk exists is insufficient.\textsuperscript{133}

The relative lack of financial understanding held by unsophisticated investors creates a greater need for increased investor protection.\textsuperscript{134} Although federal securities laws are predicated on the full and fair disclosure of information, unsophisticated investors, who by definition have a limited grasp on finance, will not be able to use the information to make meaningful investment decisions.\textsuperscript{135} Members of the so-called “crowd” generally have limited understanding of basic finance, much less capital markets and investing.\textsuperscript{136} A 2010 financial literacy study prepared for the Financial Crisis Inquiry Commission noted a marked disconnect between the average individual’s perception of their financial and mathematical knowledge and their responses to questions measuring financial and mathematical comprehension.\textsuperscript{137} For example, although thirty-eight percent of respondents rated their own financial knowledge as “very high,” fewer than ten percent of respondents answered each question correctly.\textsuperscript{138} Furthermore, forty-two percent of the respondents who described themselves as very risk averse incorrectly answered a question about risk and diversification—concepts that these types of investors should presumably know about.\textsuperscript{139} If such a large percentage of the “crowd” lacks even basic knowledge of general financial principles, these potential investors will not likely appreciate the complicated statements released in connection with a crowdfunding offering.\textsuperscript{140} 

Even assuming that potential crowdfunding investors understood the information provided by the issuer, it would be challenging for any investor to evaluate and verify the quality of that information, regard-

\textsuperscript{131} Id. at 4.
\textsuperscript{132} See Bradford, supra note 5, at 139 (suggesting that funding portals educate investors by way of a short instructional video, but conceding that there is no simple means to ensure that investors actually watch these videos); see also JOBS Act, at sec. 302(b), § 4A(a)(4) (mandating that funding portals ensure investor competency).
\textsuperscript{133} Bradford, supra note 5, at 138.
\textsuperscript{134} Bradford, supra note 12, at 2.
\textsuperscript{135} See Hazen, supra note 9, § 1.2.
\textsuperscript{136} Bradford, supra note 5, at 112.
\textsuperscript{137} Annamaria Lusardi, Americans’ Financial Capability 15 (2010).
\textsuperscript{138} Id.
\textsuperscript{139} See id. at 16.
\textsuperscript{140} See Bradford, supra note 5, at 112.
less of competency. Unlike large public companies, whose periodic SEC reports are scrutinized by professional analysts, small startups possess limited hard information. New startups are unlikely to have generated enough business to provide sufficient information for potential investors to make a meaningful investment decision, a problem known as “information asymmetry.” The balance of information about the business startup weighs heavily in favor of the entrepreneur, preventing investors from discerning promising investments from busts.

Finally, and perhaps most importantly, the risk of failure inherent to business startups is substantially greater than that of established companies, which ultimately translates into a more hazardous investment. Small business startups lack the larger capitalization of more established companies and are thus less likely to survive downturns, competition, and other market pressures. In addition, the majority of critical business decisions that will ultimately determine the startup’s success or failure have yet to be made at the time of funding. Despite elaborate business plans, most startups lack a proven track record of success. Nearly eighty percent of business startups fail within five to seven years of formation typically because of insufficient managerial

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141 Fisch, supra note 11, at 78; see also Statement of Sen. Levin, supra note 7 (expressing concern that without sufficient investor protection in the form of meaningful disclosure, investors may not be able to discern legitimate crowdfunding offerings from frauds).

142 Taku, supra note 10, at 3. One commentator has noted:

As a practical matter, many early-stage startup companies that are considering crowdfunding may have only been recently incorporated and have not yet filed tax returns. Furthermore, many startup companies may not yet have engaged independent public accountants, nor have audited financial statements at the time they wish to raise funds.

Id.

143 See Fisch, supra note 11, at 78 (noting that informational asymmetries make it difficult for small businesses to raise capital); see also Ilan L. Moscovitz & John Maxfield, Submitted Commentary on JOBS Act Title III 1 (June 27, 2012), http://www.sec.gov/comments/jobs-title-iii/jobstitleiii-98.pdf (“[T]he opportunities for misuse and abuse are enormous due to the inherently speculative nature of start-ups, as well as what will certainly be weaker accounting scrutiny and corporate governance.”).

144 Cable, supra note 21, at 122.

145 Bradford, supra note 5, at 105.

146 See Fisch, supra note 11, at 60 (noting that the primary cause of startup failure, after management mistakes, is insufficient capitalization).

147 Cable, supra note 21, at 122.

148 Bradford, supra note 5, at 106; see also Ronald J. Gilson, Engineering a Venture Capital Market: Lessons from the American Experience, 55 Stan. L. Rev. 1067, 1076–77 (2003) (“Virtually all of the important decisions bearing on the company’s success remain to be made, and most of the significant uncertainties concerning the outcome of the company’s efforts remain unresolved.”).
experience, limited access to capital, or an unwanted product or service.\textsuperscript{149} This tendency towards quick collapse makes an already unattractive investment opportunity even more treacherous to first time and unsophisticated startup investors.\textsuperscript{150}

Even though crowdfunding fills a necessary funding gap for startups seeking needed capital, Title III creates a host of fresh concerns for small unsophisticated investors.\textsuperscript{151} Given the lack of financial acumen for small investors and the corresponding inadequacies of Title III’s disclosure requirements, issuer fraud in connection with online crowdfunding offerings is likely.\textsuperscript{152} Even without adequate “front-end” protection at the time of the initial purchase, however, crowdfunding investors retain a private right of action against an issuer on the “back-end” in the event of securities fraud under Title III.\textsuperscript{153} Nonetheless, the landscape of federal securities regulation may effectively eviscerate small investors’ ability to seek adequate redress under Title III’s private right of action.\textsuperscript{154}

III. SMALL CROWDFUNDING INVESTORS LACK AN ECONOMICALLY VIABLE FORM OF REDRESS FOR SECURITIES FRAUD

Although Title III of the Jumpstart Our Business Startups (“JOBS”) Act provides defrauded investors with a private right of action against crowdfunding issuers, this remedy may provide little comfort to small

\textsuperscript{149} U.S. Gov’t Accountability Office, GAO/GGD-00-190, SMALL BUSINESS: EFFORTS TO FACILITATE EQUITY CAPITAL FORMATION 19 (2000).

\textsuperscript{150} See Bradford, supra note 5, at 105.

\textsuperscript{151} See Cohn, supra note 44, at 1438.

\textsuperscript{152} See Daniel Isenberg, Submitted Commentary on JOBS Act Title III 1 (Apr. 15, 2012), http://www.sec.gov/comments/jobs-title-iii/jobstitleiii-70.pdf (noting that equity investors in crowdfunding ventures will suffer because they “simply cannot know enough about the highly risky ventures or the highly complex venture investing process to make informed investment decisions”).

\textsuperscript{153} Abshure Keynote Address, supra note 89. According to the President of NASAA:

\textit{If efforts to promote access to investment capital for small businesses are to be successful, investors need to be confident that they are reasonably protected from fraud and undisclosed risk. This means that investors must have access to information about the issuer and, where there is wrongdoing, adequate civil recourse.}

\textit{Id.}

\textsuperscript{154} Diamond, supra note 13, at 1840 (arguing that class action lawsuits are the only viable means for small investors to seek redress for crowdfunding fraud and expressing concern that existing federal legislation may impede upon investors’ ability to sue crowdfunding issuers as a class).
unsophisticated investors. Given that small investors may only purchase crowdfunding securities in limited amounts, and that Title III’s private right of action limits defrauded investors to recovering only the amount invested, the cost of bringing an individual action would inevitably exceed the benefits provided by a successful verdict. As such, the economic utility of Title III’s private right of action virtually requires small unsophisticated investors to join together in a class action lawsuit.

Plaintiffs having purchased securities from a crowdfunding offering are entitled to bring an action under § 77d-1(c) of the Securities Act of 1933, as amended (the “Securities Act”) in the event of issuer fraud. Title III’s private right of action is unique insofar as plaintiffs need not prove that the alleged fraud caused their loss, as is required by the Private Securities Litigation Reform Act of 1995 (the “PSLRA”). Instead, section 77d-1(c) shifts the burden of proving loss causation to the defendant by incorporating by reference § 77l(b) of the Securities Act. According to § 77l(b), the defendant may avoid liability by proving that the security depreciated in value for a reason distinct from the alleged fraud. Title III’s evidentiary burden is also distinguishable from the PSLRA because it does not require plaintiffs to prove that defendants

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156 Abshure Remarks, supra note 91 (“The losses in single instances of fraud are unlikely to be sufficient to support a private legal action by a single victim.”).

157 See id.

158 Securities Act of 1933, 15 U.S.C. § 77d-1(c) (2)(A) (2012). The new liability provision levies penalties on issuers for false or misleading statements if the issuer:

[B]y any means of any written or oral communication, in the offering or sale of any security in a transaction exempted by the provisions of section 77d(6) of this title, makes an untrue statement of a material fact or omits 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.

Id. (emphasis added).

159 Bradford, supra note 12, at 13. Compare JOBS Act, sec. 302(b), § 4A(c)(1)(B) (providing a private right of action that does not require plaintiffs to prove that an alleged fraud caused their loss), with Private Securities Litigation Reform Act (PSLRA) of 1995, 15 U.S.C. § 78u-4(b)(4) (2012) (“In any private action arising under this chapter, the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages.”).


acted with scienter. Defendants may, however, avoid liability by showing that they “did not know, and in the exercise of reasonable care could not have known, of such untruth or omission.”

Despite the private right of action provided for in Title III, a potential roadblock may exist for defrauded investors seeking to bring a class action lawsuit against a crowdfunding issuer. The PSLRA, which erects procedural hurdles for plaintiff classes alleging securities fraud, would effectively void the efficacy of Title III’s private right of action. The PSLRA requires plaintiffs to plead scienter as well as loss causation with particularity, a daunting prospect given the scant information that will be available about most startups. Thus, small unsophisticated investors seeking redress for securities fraud in connection with crowdfunding offerings may lack viable recourse by way of Title III’s private right of action.

Given the risks associated with crowdfunding offerings, this Part examines whether the private right of action in Title III of the JOBS Act affords defrauded small crowdfunding investors adequate redress. Section A suggests that Title III’s private right of action would, as a practical matter, require small defrauded investors to sue a crowdfunding issuer as a class. Section B argues that, despite the necessity of the class action vehicle, the procedural impediments of the PSLRA will likely frustrate the efforts of small investors seeking redress for securities fraud under Title III’s private right of action.

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163 JOBS Act, at sec. 302(b), § 4A(c)(2)(B). Because the same language appears in § 77l(a)(2) of the Securities Act, it is fair to assume that courts will interpret the language of Title III in the same way—denying recovery to plaintiffs who were aware of the misstatement or omission. Bradford, supra note 12, at 13; see 15 U.S.C. § 77l(a)(2).

164 Diamond, supra note 13, at 1839–40 (illustrating the fears of Heath Abshure, President of NASAA, that existing federal legislation such as the PSLRA may effectively preclude defrauded investors from suing an issuer as a class).


166 See PSLRA § 78u-4(b)(2)(A), (b)(4); Taku, supra note 10, at 3 (noting that most startups seeking to take advantage of crowdfunding may have just recently incorporated and have yet to file tax returns or engage professional auditors, all of which limit the information available about the startup to investors).

167 See Diamond, supra note 13, at 1840.

168 See infra notes 171–216 and accompanying text.

169 See infra notes 171–181 and accompanying text.

170 See infra notes 182–216 and accompanying text.
A. The Economic Utility of Title III’s Private Right of Action for Small Unsophisticated Investors

The difficulties present in Title III’s private right of action with respect to investor redress for securities fraud would bear most heavily on small investors because they have the most to lose.\(^{171}\) Although Title III’s limitations on investments minimize the exposure of potential small investors to bad investments, this cap on spending may preclude small investors from successfully recouping their losses in the event of issuer fraud.\(^{172}\) Title III allows small investors to invest up to $2000 per year in crowdfunding offerings, an amount that exceeds what many individuals can bear to lose in the event of issuer fraud.\(^{173}\) A troubling prospect for small investors is the fact that legal fees to bring an action against the issuer would inevitably exceed the $2000 maximum investment.\(^{174}\) An individual plaintiff who can only afford to invest $2000 will likely be unable to afford to retain an attorney.\(^{175}\) Representation on contingency is similarly unlikely as the damages are limited by the small size of the initial investment and thus inadequate to compel representation.\(^{176}\)

Because of the economic disadvantages that individual small investors face in bringing a securities fraud action against a crowdfunding issuer, a class action lawsuit presents the only feasible remedy.\(^{177}\) Following the filing of a class action lawsuit, a federal court decides whether to certify the suit in accordance with Rule 23 of the Federal Rules of Civil Procedure.\(^{178}\) The PSLRA requires the court to approve a “Lead Plain-

\(^{171}\) Abshure Remarks, supra note 91 (noting that a class action lawsuit is a virtual prerequisite for small, defrauded investors because the JOBS Act limits the amount of money an individual small investor may invest, and a single instance of fraud may affect dozens of similarly situated investors).

\(^{172}\) See id.


\(^{174}\) See Abshure Keynote Address, supra note 89 (“The losses in instances of fraud are unlikely to be sufficient to support a private legal action by a single [fraud] victim.”).


\(^{176}\) Id. ; see JOBS Act, sec. 302(b), § 4A(c)(1) (limiting plaintiff’s recovery to “the consideration paid for such security with interest thereon,” in the event of issuer fraud); Hazen, supra note 4, at 1759; see also Diamond, supra note 13, at 1840 (“an investor in that offering, acting individually, is never going to find an attorney’ Abshure continued. ‘It’s $1,000. Which attorney is going to take a securities fraud case with the chance to win $330? It’s got to be a class action . . . .”).

\(^{177}\) See Diamond, supra note 13, at 1840.

tiff” or “Co-Lead Plaintiffs” to represent the class’s interests. Class actions allow individuals to aggregate their otherwise paltry claims into a larger judgment, making the suit economically advantageous to bring. As a result, class actions are especially popular in the securities litigation arena.

**B. The PSLRA Will Bar Classes of Small Unsophisticated Investors from Suing Under Title III’s Private Right of Action**

Before bringing a class action lawsuit alleging securities fraud against a crowdfunding issuer, plaintiff classes must consider whether other federal securities regulations impede such a suit. The PSLRA, enacted in 1995, imposes heightened pleading requirements on plaintiff classes alleging securities fraud. Plaintiffs must first specify the issuer’s particular misleading statements or omissions as well as supporting reasons. When basing their allegations on information and belief, plaintiffs must furthermore state “with particularity all facts on which that belief is formed.” Finally, plaintiffs must allege scienter, stating “with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind.” If plaintiffs fail to meet PSLRA’s pleadings requirements, defendants can move to dismiss the action during which time discovery is stayed. Because of this heightened pleading standard, the PSLRA might have the effect of precluding class action lawsuits brought under Title III.

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180 Amchem Prods., Inc. v. Windsor, 521 U.S. 591, 617 (1997) (quoting Mace v. Van Ru Credit Corp., 109 F.3d 388, 344 (7th Cir. 1997)) (“The policy at the very core of the class action mechanism is to overcome the problem that small recoveries do not provide the incentive for any individual to bring a solo action prosecuting his or her rights.”).

181 Press Release, Cornerstone Research, Despite Record Low Number of Settlements in 2012, Securities Class Action Settlements Increase from 2011 (Mar. 20, 2013) (noting that the average reported settlement of a class action suit increased in excess of 150% from $21.6 million in 2011 to $54.7 million in 2012).

182 See Abshure Remarks, supra note 91.

183 See Abshure Remarks, supra note 91.

184 See Diamond, supra note 13, at 1839–40.
1. The PSLRA and the Problem of “Strike Suits”

Congress enacted the PSLRA in order to rein in the apparent exploitation of private class actions alleging securities fraud.\textsuperscript{189} Despite the class action lawsuit’s utility in the realm of securities fraud litigation for groups of small investors, several unintended consequences arose from the use of the class action vehicle for more nefarious purposes.\textsuperscript{190} Chief among these was the “strike suit,” a meritless action filed for the sole purpose of extorting a settlement from a defendant issuer.\textsuperscript{191} Because the possibility of having to pay an exorbitant judgment is likely in cases of securities fraud, defendant issuers often choose to settle rather than risk going to trial.\textsuperscript{192} The coercive pressure facing issuers to settle strike suits consequently creates a perverse incentive for plaintiffs’ attorneys to bring vexatious litigation in response to any dip in the issuer’s stock price, regardless of culpability.\textsuperscript{193} Even with issuers happy to settle with plaintiff’s attorneys, neither have a strong incentive to protect the actual plaintiffs forming the class.\textsuperscript{194}

Congress enacted the PSLRA as a means of discouraging abusive and often meritless class action lawsuits alleging securities fraud against technology issuers.\textsuperscript{195} In doing so, Congress sought to effectuate several goals: to reduce the external costs of non-meritorious suits on capital markets, to reduce litigation risk for technology companies disproportionately targeted by strike-suits, and to avoid suits filed on the basis of the issuer’s stock depreciating without any pre-filing investigation of

\begin{footnotesize}


\textsuperscript{191} H.R. Rep. No. 105-803, at 13 (1998) (Conf. Rep.). “Strike suits” are actions designed to “extract a sizable settlement from companies that are forced to settle, regardless of the lack of merits of the suit, simply to avoid the potentially bankrupting expense of litigation.” \textit{Id.}

\textsuperscript{192} Gorsuch & Matey, \textit{supra} note 190, at 2 (quoting \textit{In Re Rhone-Pulec Roer, Inc.}, 51 F.3d 1293, 1294 (7th Cir. 1995)) (noting that between “stak[ing] their companies on the outcome of a single jury trial, or be[ing] forced by fear of the risk of bankruptcy [into settling] even if they have no legal liability,” companies accused of securities fraud prefer the latter course).

\textsuperscript{193} 114 Cong. Rec. E1384-85 (July 22, 1998) (statement of Rep. John Boehner) (“If the stock went down, even briefly, the trial lawyers sued the companies and harassed them.”).

\textsuperscript{194} Gorsuch & Matey, \textit{supra} note 190, at 3.

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underlying fraud. The PSLRA seeks to curb strike suits by heightening the standards as to what constitutes securities fraud, giving plaintiffs more control over their attorneys, and compelling judges to impose mandatory sanctions on attorneys for filing vexatious claims.

2. The PSLRA’s Procedural Hurdles Applied to Crowdfunding

Given that the PSLRA covers private class action lawsuits alleging securities fraud, classes of small investors will have substantial obstacles to clear. Heath Abshure, President of the North American Securities Administrators Association (“NASAA”), echoed this sentiment, expressing concerns that the PSLRA’s pleading restrictions could impede investors seeking redress for crowdfunding securities fraud. The PSLRA’s heightened pleading requirements could effectively eliminate plaintiffs’ already limited remedies under Title III’s private right of action, precluding small investors from recouping their lost investments and creating “litigation-proof” offerings.

The PSLRA requires plaintiff classes to show the defendant issuer’s state of mind. This concept, known as “scienter,” refers to the defendant’s requisite mental state indicating intent to deceive, manipulate, or defraud. The burden of showing the defendant crowdfunding issuer’s mental state is, however, conspicuously absent from Title III’s private right of action.

Plaintiff classes would have difficulty meeting the PSLRA’s scienter requirement, especially in cases where the defendant issuer allegedly acted recklessly. The PSLRA increases the standard of proving defendant’s state of mind under FRCP 9(b), requiring plaintiffs to “state

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198 See id. One commentator suggests otherwise. See Hazen, *supra* note 4, at 1758 (“[A] class action involving securities that are not widely publicly traded may not be subject to the heightened pleading standards of the [PSLRA].”).

199 See *Diamond, supra* note 13, at 1839–40.

200 See *id.*

201 PSLRA § 78u-4(b)(2)(A).


204 See *Knight et al., supra* note 121, at 141–42.
with particularity facts giving rise to a *strong inference* of scienter.\textsuperscript{205} The "strong inference" language precludes plaintiffs from merely inferring the misstatement and intent elements of a claim.\textsuperscript{206} Scienter includes instances of reckless conduct—extreme departures from the standards of ordinary care.\textsuperscript{207} Take for example the likelihood that crowdfunding issuers may inadvertently prime the market through advertising the terms of the offering as prohibited by Title III.\textsuperscript{208} Unwary investors who purchase securities from the offering may be frustrated later on in their attempt to sue the issuer as a class because of the difficulty in showing that, prior to discovery, the defendant issuer’s conduct rose to the level of recklessness.\textsuperscript{209}

Additionally, the PSLRA requires plaintiff classes to prove that the defendant issuer caused plaintiff’s loss prior to undertaking discovery.\textsuperscript{210} Although Title III shifts the burden of proving loss causation to the defendant, the PSLRA denies plaintiff this convenience.\textsuperscript{211} The United States Supreme Court recently increased the plaintiff’s burden to prove loss causation in 2005, holding in *Dura Pharmaceuticals, Inc. v. Broudo* that a plaintiff class may not meet the PSLRA’s loss causation burden solely by pleading that they purchased a security at a price inflated by an issuer’s misrepresentations.\textsuperscript{212}

Reading the PSLRA to hold plaintiff classes to a higher evidentiary standard, however, puts the cart before the horse because of the scant

\textsuperscript{205} Compare Private Securities Litigation Reform Act (PSLRA) of 1995, 15 U.S.C. § 78u-4(b)(2)(A) (2012) ("[T]he complaint shall, with respect to each act or omission alleged to violate this chapter, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."), with Fed. R. Civ. P. 9(b) ("In alleging fraud or mistake, a party must state with particularity the circumstances constituting fraud or mistake.").

\textsuperscript{206} PSLRA § 78u-4(b)(2)(A). In the 2007 United States Supreme Court case *Tellabs, Inc. v. Makor Issues & Rights Ltd.*, the Court decided that a "strong inference" must be "cogent" and "at least as compelling as an opposing inference on non-fraudulent intent." 551 U.S. 308, 324 (2007).

\textsuperscript{207} Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033, 1045 (7th Cir. 1977) (noting that reckless conduct is that which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it).

\textsuperscript{208} Knight et al., supra note 121, at 141–42.

\textsuperscript{209} See id.

\textsuperscript{210} PSLRA § 78u-4(b)(4).

\textsuperscript{211} Compare JOBS Act, Pub. L. No. 112-106, sec. 302(b), § 4A(c)(2)(B), 126 Stat. 306 (2012) (codified at 15 U.S.C. § 77d-1(c)(2)(B) (2012)) (requiring the defendant to disprove loss causation), with Private Securities Litigation Reform Act (PSLRA) of 1995, § 78u-4(b)(4) (2012) ("In any private action arising under this chapter, plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages.").

\textsuperscript{212} See 544 U.S. 336, 342 (2005).
information available concerning the issuer. In contrast to large publicly traded companies, against whom strike-suits are typically filed, startups are unlikely to have generated enough business to provide sufficient information upon which to make meaningful investment decisions. Without such information from defendant issuer’s disclosures, plaintiff classes would be hard-pressed to plead loss causation with particularity prior to discovery. As such, small investors suing as a class may face unique challenges in recouping their losses in the event of issuer fraud.

IV. A Workable Crowdfunding Exemption Must Allow Small Investors to Seek Redress for Securities Fraud

An exception to the heightened pleading requirements of the Private Securities Litigation Class Action Reform Act of 1995 (the “PSLRA”) should be made for investors that sue crowdfunding issuers for securities fraud as a class. Without an exception, classes of small crowdfunding investors will face substantial difficulties in curbing issuer fraud, and future investors may be reluctant to purchase crowdfunding securities. In addition, none of the policy goals underlying the PSLRA would be served were the statute used to preclude classes of defrauded small investors from bringing suit against a crowdfunding issuer. Applying the PSLRA to bar crowdfunding class actions would run counter to the second of the two primary goals of the landscape of federal securities laws: that failure to tell the truth results in a serious penalty for issuers.

213 See Taku, supra note 10, at 3 (noting that most early-stage business startups have not yet filed tax returns or engaged independent public accountants to create audited financial statements).

214 See id.

215 See PSLRA § 78u-4(b)(1) (requiring plaintiff to “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind”); Abshure Keynote Address, supra note 89 (noting that the riskiest startups typically lack a proven business track record).

216 Abshure Remarks, supra note 91.

217 See infra notes 218–258 and accompanying text.

218 See Diamond, supra note 13, at 1840; see also Aguilar Address, supra note 90 (noting that confidence in U.S. capital markets perpetuates and sustains the growth of those markets).

219 Diamond, supra note 13, at 1840 (providing the president of the NASAA’s observations that class action lawsuits brought by small crowdfunding investors are not likely to be strike suits designed to shake out settlements from issuers that the PSLRA was designed to protect); see Private Securities Litigation Reform Act (PSLRA) of 1995, 15 U.S.C. § 78u-4 (2012).

(“JOBS”) Act unequivocally affords that right to defrauded investors—and there it should remain.221

To serve as an effective crowdfunding exemption, Title III of the JOBS Act must simultaneously allow startups easier access to capital markets and protect investors from fraudulent offerings.222 Small unsophisticated investors merit the most stringent protections because they have the most to lose.223 Although Title III’s private right of action offers classes of crowdfunding investors the ability to recoup their losses in the event of fraud, the heightened pleading standards contained in the PSLRA would irreparably hamstring plaintiff classes.224

In this Part, Section A argues that the PSLRA should not preclude small defrauded investors from suing crowdfunding issuers as a class in instances of fraud because such lawsuits would not implicate the policies underlying PSLRA.225 Section B suggests that any change in the law must come from Congress and proposes that Congress carve out an exception for crowdfunding offerings in the PSLRA itself.226

A. The Public Policies Underlying the PSLRA Cut Against Preclusion of Class Action Lawsuits Brought by Small Investors

In passing the PSLRA, one of Congress’s chief goals was to prevent class action securities fraud suits from targeting deep-pocketed defendants without regard to actual culpability.227 This scenario, however, is highly improbable with respect to crowdfunding offerings because of the limited capital held by most startups.228 Small startups seeking capital through crowdfunding offerings lack the larger capitalization of

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222 See Aguilar Address, supra note 90 (“True capital formation and economic growth require investors to have both confidence in the capital markets and access to the information needed to make good investment decisions.”).

223 See Abshure Remarks, supra note 91 (acknowledging that increasing procedural and evidentiary burdens on investor class actions in the era of crowdfunding “presents a particular risk to small investors”).

224 See Abshure Keynote Address, supra note 89 (arguing that heightened procedural and evidentiary burdens will have particularly profound effects on small investors in the crowdfunding era).

225 See infra notes 227–241 and accompanying text.

226 See infra notes 242–258 and accompanying text.


228 See Cable, supra note 21, at 120 (“It is a widely held belief that startup companies do not have sufficient funding sources.”).
more established companies by definition and would thus not have a large asset base with which to settle.\textsuperscript{229} If small business startups pursuing crowdfunding offerings lack the necessary capital to hire accountants and underwriters necessary to register in the traditional initial public offering process, it stands to reason that they also do not have enough capital to attract nuisance suits.\textsuperscript{230} Thus, attorneys filing strike suits against crowdfunding issuers would lack any financially well-endowed targets to make settlement a viable option.\textsuperscript{231}

Furthermore, the very language of Title III’s private right of action would prohibit a plaintiff class from shaking down issuers for large settlements.\textsuperscript{232} Title III prevents individual investors from recovering anything in excess of the cost of purchasing the securities at issue, including interest.\textsuperscript{233} Without the prospect of the plaintiff class seeking exorbitant damages, the issuer assumes no chance of risking the solvency of their companies on a jury trial, or being coerced into settling for fear of bankrupting the startup.\textsuperscript{234}

In addition, the PSLRA sought to end the abuse of the class action securities fraud lawsuit by targeting the misbehavior of plaintiffs’ attorneys, not the plaintiffs themselves.\textsuperscript{235} The financial gains to be had from a successful class action lawsuit targeting a crowdfunding for securities fraud would not, however, entice even the most unscrupulous at-

\textsuperscript{229} See id.
\textsuperscript{230} See Hemingway & Hoffman, supra note 47, at 908–09.
\textsuperscript{231} Compare H.R. Rep. No. 369, at 31 (1995) (Conf. Rep.) (describing Congress’s concern with meritless securities fraud action lawsuits targeting deep-pocketed issuers), with Cable, supra note 21, at 120 (noting that the majority of startups lack sufficient funding sources).
\textsuperscript{232} See JOBS Act, Pub. L. No. 112-106, sec. 302(b), § 4A(c)(1)(A), 126 Stat. 306 (2012) (codified at 15 U.S.C. § 77d-1(c)(1)(A) (2012)) (limiting the recovery of plaintiffs to little more than their initial investments); see also Diamond, supra note 13, at 1840 (providing the president of the NASAA’s observations that class action lawsuits brought by defrauded investors against crowdfunding issuers are not likely to be strike suits seeking to shake out a settlement).
\textsuperscript{233} JOBS Act, at sec. 302(b), § 4A(c)(1)(A).
\textsuperscript{234} Compare Gorsuch & Matey, supra note 190, at 2 (quoting In Re Rhone-Pulec Roer, Inc., 51 F.3d 1293, 1294 (7th Cir. 1995)) (noting that between “stak[ing] their companies on the outcome of a single jury trial, or be[ing] forced by fear of the risk of bankruptcy [into settling] even if they have no legal liability,” companies facing potentially overwhelming damages preferred the latter course), with Hazen, supra note 4, at 1759 (noting that small crowdfunding offerings will likely yield modest damages).
\textsuperscript{235} H.R. REP. No. 369, at 31 (1995) (Conf. Rep.) (illustrating that that one of Congress’s concerns prompting passage of the PSLRA was the manipulation of plaintiff classes by lawyers motivated by personal gain).
Attorney to bring a strike suit.\textsuperscript{236} Crowdfunding issuers accused of securities fraud will have no incentive to settle to avoid risking a potentially unfavorable jury decision because of Title III’s limitation on damages and because those issuers will, by definition, lack a sufficient asset base with which to settle.\textsuperscript{237} Furthermore, Title III prohibits issuers from selling securities in amounts exceeding $1 million per crowdfunding offering.\textsuperscript{238} Because Title III’s private cause of action only entitles successful plaintiffs to receive the consideration paid in exchange for the securities purchased, the entire judgment for a class action could not exceed $1 million.\textsuperscript{239} As class action lawyers on contingency have traditionally taken twenty to thirty percent of the recovery in legal fees, an attorney would only stand to make $300,000, assuming that the issuer sold the maximum amount of securities allowed by Title III and that each investor joined the class.\textsuperscript{240} Without financial incentives, plaintiffs’ lawyers will have little motivation to act as principles, rather than as agents working on behalf of the plaintiff class.\textsuperscript{241}

B. Congress Must Reconsider the PSLRA to Create a Workable Crowdfunding Exemption

Despite having been signed into law in April 2012, the actual implications of Title III of the JOBS Act have yet to be truly felt and measured.\textsuperscript{242} Although the JOBS Act compels the Securities and Exchange Commission (SEC) to make rules expanding upon certain provisions within 270 days of passage, the SEC missed the deadline and gave no

\textsuperscript{236} See Hazen, supra note 4, at 1759 (“[A] relatively small crowdfunding effort will result in relatively modest potential damages, thus raising questions regarding the economics of bringing such a claim and the adequacy of the economic incentives to plaintiff’s law firms to bring suit . . . .”).

\textsuperscript{237} Compare Gorsuch & Matey, supra note 190, at 2 (illustrating how companies facing potentially overwhelming damages in securities fraud litigation prefer to settle), with JOBS Act, at sec. 302(b), § 4A(c) (2) (A) (codified at 15 U.S.C. § 77d-1(c) (2)(A)) (capping damages available to plaintiff classes in crowdfunding securities fraud litigation), and Hazen, supra note 4, at 1759 (noting that small crowdfunding offerings will likely yield modest damages), and Cable, supra note 21, at 120 (indicating that crowdfunding issuers are modestly capitalized and will therefore lack a sufficient asset base with which to settle).


\textsuperscript{239} See id. ($1 million offering limit); id. at sec. 302(b), § 4A(c) (1) (A) (recovery limit).

\textsuperscript{240} See Perino, supra note 196, at 918 (discussing the contingency fee basis of class action lawyers for securities fraud suits).

\textsuperscript{241} See Hazen, supra note 4, at 1759.

\textsuperscript{242} Traeger et al., supra note 6, at 215.
timeframe for when such regulations would be completed.\textsuperscript{243} Notwithstanding the SEC’s delay, Congress limited the scope of the SEC’s regulatory revision to provisions of the JOBS Act not including the private right of redress.\textsuperscript{244} Short of revising the other anti-fraud provisions of the Securities Act of 1933, as amended (the “Securities Act”), and the Securities Exchange Act of 1934, as amended (the “Exchange Act”), the SEC cannot directly address the issue of remedies, especially with regard to the PSLRA.\textsuperscript{245}

Similarly, state securities regulators or legislatures cannot offer defrauded small crowdfunding investors any relief from PSLRA coverage.\textsuperscript{246} Securities sold under Title III are “covered,” meaning federal legislation preempts state securities laws.\textsuperscript{247} That states retain the right to investigate crowdfunding issuers for securities fraud provides little comfort for defrauded small crowdfunding investors.\textsuperscript{248}

Starting from the premise that “the best defense is a good offense,” Congress should carve-out an exception for crowdfunding offerings in the PSLRA itself.\textsuperscript{249} Including a carve-out in federal securities legislation is hardly a novel concept; the Securities Litigation Uniform Standards Act provides limited circumstances in which a shareholder may bring an action under the statutory or common law of an issuer’s state of incorporation.\textsuperscript{250} Similarly, the PSLRA could conceivably contain a provision exempting certain class action lawsuits brought by defrauded crowdfunding investors from coverage.\textsuperscript{251}

An exemption to PSLRA coverage for class action lawsuits brought by defrauded crowdfunding investors would, ideally, render the


\textsuperscript{244} See Bradford, supra note 12, at 39–41.

\textsuperscript{245} See id.


\textsuperscript{247} See id.

\textsuperscript{248} See id. at sec. 305(b) (2).

\textsuperscript{249} See infra notes 250–258 and accompanying text.


\textsuperscript{251} See id. § 78bb(f)(3)(A).
PSLRA’s procedural impediments inapplicable to such suits prior to the discovery stage.\textsuperscript{252} Classes of defrauded crowdfunding should be able to infer the misstatement and intent elements of a claim rather than plead them with particularity.\textsuperscript{253} Similarly, an exemption to PSLRA coverage should preserve Title III’s loss causation burden-shifting scheme, placing the onus of proving loss causation to the defendant crowdfunding issuer.\textsuperscript{254} Given the limited information available about most startups, plaintiff classes would be hard-pressed to plead loss causation with particularity.\textsuperscript{255}

A class action lawsuit brought by small defrauded crowdfunding investors will not undermine the public policy goals underlying the PSLRA.\textsuperscript{256} The perceived abuses of the class action vehicle in securities fraud litigation would likely be absent from crowdfunding securities fraud class action litigation.\textsuperscript{257} As such, the PSLRA should not hinder classes of small defrauded investors in pursuing otherwise meritorious

\textsuperscript{252} Compare Private Securities Litigation Reform Act (PSLRA) of 1995, 15 U.S.C. § 78u-4(b)(2)(A), (b)(4) (2012) (setting forth the heightened pleading standards for plaintiff classes with respect to defendant’s state of mind and loss causation), with Taku, supra note 10, at 3 (noting that most early-stage business startups have not yet filed tax returns or engaged independent public accountants to create audited financial statements).

\textsuperscript{253} See Abshure Keynote Address, supra note 89 (advocating against legislative impediments to class actions by way of amendments to federal law that would permit private lawsuits for fraud associated with small offerings).

\textsuperscript{254} Compare PSLRA § 78u-4(b)(1) (requiring plaintiff to “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind”), with JOBS Act, Pub. L. No. 112-106, sec. 302(b), § 4A(c)(2)(B), 126 Stat. 306 (2012) (codified at 15 U.S.C. § 77d-1(c)(2)(B) (2012)) (requiring the defendant to disprove loss causation), and Taku, supra note 10, at 3 (illustrating that there is very limited information available regarding startups), and Abshure Keynote Address, supra note 89 (illustrating that the heightened requirements of the PLSRA effectively vitiate the private right of action provided by Title III, causing crowdfunding investors to be without meaningful recourse in the event of securities fraud).

\textsuperscript{255} Compare PSLRA § 78u-4(b)(1) (requiring plaintiff to “state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind”), with Taku, supra note 10, at 3 (noting that most early-stage business startups have not yet filed tax returns or engaged independent public accountants to create audited financial statements).

\textsuperscript{256} See Diamond, supra note 13, at 1840 (providing the president of the NASAA’s observations that class action lawsuits brought by small crowdfunding investors are not likely to be strike suits designed to shake out settlements from issuers that the PSLRA was designed to protect).

\textsuperscript{257} See id.; see also Abshure Keynote Address, supra note 89 (noting that the PSLRA was passed in response to abusive class actions brought against large publicly traded companies, not small companies).
claims against crowdfunding issuers through Title III’s private right of action.\textsuperscript{258}

**CONCLUSION**

In the academic debate regarding crowdfunding, the primary tension lays between the need for small businesses to easily access capital and the concern for the protection of investors. Like any two sides of the same coin, however, these goals are not mutually exclusive; in fact, they cannot exist without one another. State and federal securities regulators agree that investors will not contribute capital to a marketplace in which they cannot protect themselves. Without investor confidence in the capital markets, true capital formation and subsequent economic growth cannot flourish.

Although market for crowdfunding offerings has yet to take shape, it is not too early to consider the inevitable effects of fraud on future offerings. Conceptually, crowdfunding relies on a myriad of small injections of capital to fund the larger product, but small investors will not flock to crowdfunding offerings without the prospect of recouping their investments in the event of fraud. For crowdfunding to be successful, potential investors must be able to rely on class action relief before fraud occurs.

Just as one cannot consider eased capital raising in a vacuum, one cannot consider Title III’s crowdfunding exemption without reference to the entire landscape of federal securities regulation. Without Congressional action, the PSLRA could deny class action relief to small crowdfunding investors in the event of fraud. Because a class action lawsuit is the only economically viable means for small, defrauded investors to pursue redress against crowdfunding issuers for securities fraud, the PSLRA ought not to preclude otherwise meritorious class action securities fraud lawsuits brought by small crowdfunding investors. Failure to make an exception for crowdfunding offerings in the PSLRA would conflict with the principles underlying the statute and, in the long term, discourage crowdfunding investment.

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\footnotesize{258} See Diamond, \textit{supra} note 13, at 1839–40 (expressing Heath Abshure’s concern that existing federal legislation such as the PSLRA should not create litigation-proof offerings by precluding defrauded small investors from suing a crowdfunding issuer as a class).