

The Future of Dispute Resolution for Crowdfunding Websites

BY HUU NGUYEN, BRIAN HALBERG, AND PETER M. BEAN

I. Popularity of Crowdfunding Websites

Online crowdfunding websites are a fast growing FinTech phenomenon on which not just accredited, but also non-accredited investors may invest in businesses, subject to certain restrictions that govern the use of crowdfunding and responsibilities of intermediaries. For example, the authors are aware of potentially over one hundred crowdfunding websites in the real estate space.¹ Setting aside the issue of whether a large number of potential real estate crowdfunding investors may create Real Estate Investment Trust (“REIT”) problems for these real estate crowdfunding websites, it is good practice for crowdfunding websites in general to put in place arbitration and anti-class action terms of use, along with practices and mechanisms to improve the terms of uses’ enforceability, and to the extent possible under the crowdfunding websites’ business model, avoid being investment advisers.

II. Crowdfunding Under the JOBS Act

The Securities and Exchange Commission (“SEC” or “Commission”) recently promulgated the so-called Reg A+ rules²

for Title IV of the *Jumpstart Our Business Startups Act* (“JOBS Act”).³ These rules provide various exemptions from registrations, permissions for certain non-accredited investor participations, and other limits on crowdfunding websites. However, rules for Title III of the JOBS Act that will provide more flexibility for crowdfunding websites, called “funding portals” under the Act, have yet to be promulgated.⁴

Under Title III of the JOBS Act, Congress sought to spur crowdfunding by adding section 6 to 15 U.S.C. § 77d (the Securities Act of 1933),⁵ which provides certain exemptions. Specifically, the statute provides that:

(a) The provisions of section 77e of this title shall not apply to—

...

(6) transactions involving the offer or sale of securities by an issuer (including all entities controlled by or

CONTINUED ON PAGE 3

Article REPRINT

Reprinted from the FinTech Law Report. Copyright © 2015 Thomson Reuters. For more information about this publication please visit legalsolutions.thomsonreuters.com



THOMSON REUTERS

© 2015 Thomson Reuters. This publication was created to provide you with accurate and authoritative information concerning the subject matter covered, however it may not necessarily have been prepared by persons licensed to practice law in a particular jurisdiction. The publisher is not engaged in rendering legal or other professional advice, and this publication is not a substitute for the advice of an attorney. If you require legal or other expert advice, you should seek the services of a competent attorney or other professional.

For authorization to photocopy, please contact the Copyright Clearance Center at 222 Rosewood Drive, Danvers, MA 01923, USA (978) 750-8400; fax (978) 646-8600 or West's Copyright Services at 610 Opperman Drive, Eagan, MN 55123, fax (651)687-7551. Please outline the specific material involved, the number of copies you wish to distribute and the purpose or format of the use.

For subscription information, please contact the publisher at: west.legalworkspublications@thomson.com

Editorial Board

EDITORS-IN-CHIEF:

JAMES SIVON
Counsel
Squire Patton Boggs

AARON KLEIN
Director, Financial Regulatory Reform Initiative
Bipartisan Policy Center

KATIE WECHSLER
Counsel
Squire Patton Boggs

CHAIRMAN:
DUNCAN B. DOUGLASS
Partner & Head, Payment Systems Practice
Alston & Bird LLP
Atlanta, GA

MEMBERS:
DAVID L. BEAM
Partner
K & L Gates LLP
Washington, DC

DAVID M. BIRNBAUM
Financial Services Consultant
(Legal Risk & Compliance)
San Francisco, CA

JEANETTE HAIT BLANCO
Senior Regulatory Counsel
PayPal
San Jose, CA

ROLAND E. BRANDEL
Senior Counsel
Morrison & Foerster LLP
San Francisco, CA

RUSSELL J. BRUEMMER
Partner & Chair, Financial Institutions Practice
Wilmer Hale LLP
Washington, DC

CHRIS DANIEL
Partner & Chair, Payment Systems Practice
Paul Hastings LLP
Atlanta, GA

RICHARD FRAHER
VP & Counsel to the Retail Payments Office
Federal Reserve Bank
Atlanta, GA

GRIFF GRIFFIN
Partner
Sutherland Asbill & Brennan LLP
Atlanta, GA

PAUL R. GUPTA
Partner
Reed Smith LLP
New York, NY

ROB HUNTER
Executive Managing Director & Deputy
General Counsel
The Clearing House
Winston-Salem, NC

SYLVIA KHATCHERIAN
Managing Director
Legal Department
Morgan Stanley

MICHAEL H. KRIMMINGER
Partner
Cleary, Gottlieb, Steen & Hamilton
Washington, DC

JANE E. LARIMER
Exec VP & General Counsel
NACHA—The Electronic Payments Assoc
Herndon, VA

KELLY MCNAMARA CORLEY
Sr VP & General Counsel
Discover Financial Services
Chicago, ILL

VERONICA MCGREGOR
Partner
Hogan Lovells US LLP
San Francisco, CA

C.F. MUCKENFUSS III
Partner
Gibson, Dunn & Crutcher LLP
Washington, DC

MELISSA NETRAM
Senior Public Policy Manager and Counsel
Intuit
Washington, DC

ANDREW OWENS
Partner
Davis Wright Tremaine
New York, NY

R. JASON STRAIGHT
Sr VP & Chief Privacy Officer
UnitedLex
New York, NY

DAVID TEITALBAUM
Partner
Sidley Austin LLP
Washington, DC

RICHARD M. WHITING
Executive Director
American Association of Bank Directors

DAMIER XANDRINE
Senior Counsel
Wells Fargo & Co
San Francisco, CA

Fintech Law Report
West LegalEdcenter
610 Opperman Drive
Eagan, MN 55123

© 2015 Thomson Reuters
One Year Subscription ■ 6 Issues ■ \$820.00
(ISSN#: XXXX)

For authorization to photocopy, please contact the Copyright Clearance Center at 222 Rosewood Drive, Danvers, MA 01923, USA (978) 750-8400; fax (978) 646-8600 or West's Copyright Services at 610 Opperman Drive, Eagan, MN 55123, fax (651) 687-7551. Please outline the specific material involved, the number of copies you wish to distribute and the purpose or format of the use.

This publication was created to provide you with accurate and authoritative information concerning the subject matter covered. However, this publication was not necessarily prepared by persons licensed to practice law in a particular jurisdiction. The publisher is not engaged in rendering legal or other professional advice, and this publication is not a substitute for the advice of an attorney. If you require legal or other expert advice, you should seek the services of a competent attorney or other professional.

Copyright is not claimed as to any part of the original work prepared by a United States Government officer or employee as part of the person's official duties.

CONTINUED FROM PAGE 1

under common control with the issuer), provided that—

- (A) the aggregate amount sold to all investors by the issuer, including any amount sold in reliance on the exemption provided under this paragraph during the 12-month period preceding the date of such transaction, is not more than \$1,000,000;
- (B) the aggregate amount sold to any investor by an issuer, including any amount sold in reliance on the exemption provided under this paragraph during the 12-month period preceding the date of such transaction, does not exceed—
 - (i) the greater of \$2,000 or 5 percent of the annual income or net worth of such investor, as applicable, if either the annual income or the net worth of the investor is less than \$100,000; and
 - (ii) 10 percent of the annual income or net worth of such investor, as applicable, not to exceed a maximum aggregate amount sold of \$100,000, if either the annual income or net worth of the investor is equal to or more than \$100,000;
- (C) the transaction is conducted through a broker or funding portal that complies with the requirements of section 77d-1 (a) of this title; and
- (D) the issuer complies with the requirements of section 77d-1 (b) of this title.⁶

To take advantage of Title III, a crowdfunding website must comply with the following:

- (80) Funding portal. The term “funding portal” means 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) of the Securities Act of 1933 (15 U.S.C. 77d (6)), that does not —
- (A) offer investment advice or recommendations;

- (B) solicit purchases, sales, or offers to buy the securities offered or displayed on its website or portal;
- (C) compensate employees, agents, or other persons for such solicitation or based on the sale of securities displayed or referenced on its website or portal;
- (D) hold, manage, possess, or otherwise handle investor funds or securities; or
- (E) engage in such other activities as the Commission, by rule, determines appropriate.⁷

While the SEC has promulgated rules concerning certain parts of the JOBS Act that affect crowdfunding websites, the SEC has not yet promulgated rules for Title III of the JOBS Act.⁸ There are both opportunities and risks for crowdfunding websites under the current and expected rules. One of the challenges is in how a crowdfunding website might benefit from the various rules, limit their risks by requiring arbitration and prohibiting class action litigation because of the large number of potential accredited and non-accredited investors, and not run afoul of potential arbitration restrictions as discussed below.

III. Arbitration

One of the ways that crowdfunding websites may limit their risks with respect to customer and investor disputes is to require arbitration under the websites’ terms and agreements. By avoiding protracted and expensive court proceedings, arbitration may limit both monetary and reputational damages.

The courts, including the United States Supreme Court, have generally been favorable to the enforcement of arbitration clauses, including the prohibition of class action suits under arbitration. For example, in *American Express Co. v. Italian Colors Restaurant*,⁹ the Supreme Court held that the Federal Arbitration Act (“FAA”) does not permit courts to invalidate a contractual waiver of class arbitration simply because a plaintiff’s cost of individually arbitrating a federal statutory claim exceeds the potential recovery.¹⁰ In so holding, the Court upheld the “overarch-

ing principle that arbitration is a matter of contract,” and thus may not be easily disturbed by courts.¹¹ The Court in *Italian Colors* concluded that the courts must “‘rigorously enforce’ arbitration agreements according to their terms.”¹² Such enforcement is necessary even for claims alleging a violation of a federal statute, “unless the FAA’s mandate has been overridden by a contrary congressional command.”¹³

While the effectiveness of particular online arbitration terms is beyond the scope of this article, we note that it is common practice for the Financial Industry Regulatory Authority’s (“FINRA”) and FinTech websites to require arbitration terms. For example, FINRA’s proposed funding portal rules require funding portals registered with the organization to implement arbitration under FINRA Rule 12000 Series (Code of Arbitration Procedure for Customer Disputes), FINRA Rule 13000 Series (Code of Arbitration Procedure for Industry Disputes), and FINRA Rule 14000 Series (Code of Mediation Procedure).¹⁴

AngelList, one of the most well-known crowdfunding websites, has the following arbitration provision in its terms of use:

Users have waived the right to bring suit in a court and/or to participate in “class action” suits. Instead, we will use binding arbitration with each party in the event of a dispute.¹⁵

Crowdfunding website Fundersclub includes arbitration provisions in its terms of use, with a prohibition on class action suits:

This Agreement (and any further rules, policies or guidelines incorporated by reference herein) shall be governed by and construed in accordance with the laws of the State of Delaware, without giving effect to any principles of conflicts of law. Unless otherwise agreed in writing by User and FundersClub, any dispute arising out of or relating to the Agreement, or the breach hereof, shall be finally resolved by arbitration administered by the American Arbitration Association (“AAA”) under its Commercial Arbitration Rules. If parties

are unable to select an arbitrator then AAA shall select the arbitrator. Judgment on any award entered by the arbitrator may be entered in any court having jurisdiction thereof. User agrees that it may bring claims against FundersClub only in an individual capacity and not as a plaintiff or class member in any purported class or representative proceeding.¹⁶

Another Crowdfunding website, Circleup, also includes similar arbitration provisions:

This Agreement (and any further rules, policies or guidelines incorporated by reference herein) shall be governed by and construed in accordance with the laws of the State of Delaware, without giving effect to any principles of conflicts of law. Unless otherwise agreed in writing by User and CircleUp, any dispute arising out of or relating to the Agreement, or the breach hereof, shall be finally resolved by arbitration administered by the American Arbitration Association (“AAA”) under its Commercial Arbitration Rules. If parties are unable to select an arbitrator then AAA shall select the arbitrator. Judgment on any award entered by the arbitrator may be entered in any court having jurisdiction thereof. User agrees that it may bring claims against CircleUp only in an individual capacity and not as a plaintiff or class member in any purported class or representative proceeding.

FINRA BrokerCheck Hotline - The Financial Industry Regulatory Authority, Inc. offers investors information and education through the FINRA BrokerCheck Hotline at 800-289-9999 and FINRA website at www.finra.org.¹⁷

As common practice, websites also often require users to affirmatively agree to their terms of use. For example, in a recent case, the United States District Court, Eastern District of New York found that online retailer Amazon’s mandatory

arbitration provision on its website was enforceable.¹⁸ Specifically, the court held that:

Given (1) the conspicuous placement of the hyperlink to the current Conditions of Use on the checkout page, (2) the express warning at checkout that his purchases were subject to the terms of the current Conditions of Use, and (3) the fact that he expressly agreed, when signing-up for an Amazon.com account, to be bound by the terms of the Conditions of Use (including a provision notifying him that the conditions are subject to change), this Court concludes that Plaintiff assented, each time he made a purchase on Amazon.com, to be bound to the terms of the then-current Conditions of Use. Thus, he is bound to the mandatory arbitration clause and class action waiver contained in the 2012 Conditions of Use.¹⁹

In the context of crowdfunding websites, such sites should consider making their terms, including arbitration terms, conspicuous; warn investors that their use of the crowdfunding website is subject to the terms of use; and expressly require potential investors to agree to terms before they can sign up.

IV. Restrictions on Arbitrations Under the Dodd-Frank Act

One potential law that might limit arbitration for crowdfunding websites can be found in the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (“Dodd-Frank Act”).²⁰ The Dodd-Frank Act permits the SEC to restrict mandatory pre-dispute arbitration of customers or clients of any broker, dealer, or municipal securities dealer. The language of the Act reads, in relevant part:

Subtitle B—Increasing Regulatory Enforcement and Remedies

SEC. 921. AUTHORITY TO RESTRICT MANDATORY PRE-DISPUTE ARBITRATION.

(a) AMENDMENT TO SECURITIES EXCHANGE ACT OF 1934.—Section 15 of the Securities Exchange Act of 1934 (15 U.S.C. 78o), as amended by this title, is further amended by adding at the end the following new subsection:

“(o) **AUTHORITY TO RESTRICT MANDATORY PRE-DISPUTE ARBITRATION.**—The Commission, by rule, may prohibit, or impose conditions or limitations on the use of, agreements that require customers or clients of any broker, dealer, or municipal securities dealer to arbitrate any future dispute between them arising under the Federal securities laws, the rules and regulations thereunder, or the rules of a self-regulatory organization if it finds that such prohibition, imposition of conditions, or limitations are in the public interest and for the protection of investors.”.

(b) AMENDMENT TO INVESTMENT ADVISERS ACT OF 1940.—Section 205 of the Investment Advisers Act of 1940 (15 U.S.C. 80b– 5) is amended by adding at the end the following new subsection:

“(f) **AUTHORITY TO RESTRICT MANDATORY PRE-DISPUTE ARBITRATION.**—The Commission, by rule, may prohibit, or impose conditions or limitations on the use of, agreements that require customers or clients of any investment adviser to arbitrate any future dispute between them arising under the Federal securities laws, the rules and regulations thereunder, or the rules of a self-regulatory organization if it finds that such prohibition, imposition of conditions, or limitations are in the public interest and for the protection of investors.”.²¹

The SEC has not yet promulgated rules for Section 921.²² However, regulators may have

increasing appetite for regulating arbitration to the extent they have authority to do so. For example, the Consumer Financial Protection Bureau (“CFPB”) recently published its *Arbitration Study*²³ as required under Section 1028 of the Dodd-Frank Act, which is similar to Section 921 but in the context of consumer financial products or services.²⁴ In the study, the CFPB engaged in an empirical analysis of the value, economic and otherwise, of restricting pre-dispute arbitration. The results and analysis of this study are still being reviewed by industry experts.

V. Potential Applicability of Dodd-Frank Act Arbitration Restrictions to Crowdfunding Websites

The threshold inquiry concerning whether the Dodd-Frank Act might be used by the SEC to limit arbitration for a particular crowdfunding website is whether the crowdfunding website is an investment adviser under the Investment Advisers Act of 1940, which defines “investment adviser” in the following manner:

(11) “Investment adviser” means any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities ...²⁵

However, an investment adviser does not include:

(D) the publisher of any bona fide newspaper, news magazine or business or financial publication of general and regular circulation.²⁶

The JOBS Act does not require that a crowdfunding website be an investment adviser, and it is not completely clear if the JOBS Act’s prohibition against funding portals offering investment

advice or recommendation²⁷ will necessarily mean that the funding portal will or will not be considered an investment adviser under the Investment Advisers Act. The question of whether a crowdfunding website is an investment adviser under the Investment Advisers Act, and thus the potential arbitration restriction under the Dodd-Frank Act, is likely very fact specific. However, it is significant to note that AngelList,²⁸ Funderclub,²⁹ and Circleup³⁰ and/or their related companies are registered as investment advisers with the SEC.

The potential rules discussed in this article will affect more than crowdfunding websites. However, the proposed rules may have particularly acute effects on crowdfunding websites, which, because of the large number of investors, could expose these websites to class action lawsuits – a result that crowdfunding websites’ various arbitration provisions seek to prevent.

With the Dodd-Frank Act’s focus on the protection of investors and the SEC’s concern about abuse of crowdfunding, the SEC may look more favorably upon enacting aggressive rules prohibiting arbitration with respect to investment advisers in general, and may consider crowdfunding websites, to the extent they fall under the definition of investment advisers, to be subject to the arbitration restrictions.

NOTES

1. See *Updated List of Real Estate Crowdfunding Sites – May 2015*, Model for Success – The REFM Blog (May 20, 2015), https://www.getrefm.com/blog/crowdfunding/updated-list-of-real-estate-crowdfunding-sites-may-2015/?utm_source=feedburner&utm_medium=email&utm_campaign=Feed%3A+RealEstateFinancialModelingModelForSuccess+%28Model+For+Success+by+Real+Estate+Financial+Modeling%29.
2. See Amendments for Small and Additional Issues Exemptions under the Securities Act (Regulation A), Exchange Act Release Nos. 33-9741, 34-74578, 39-2501, 80 Fed. Reg. 21806 (Apr. 20, 2015) (to be codified at 17 C.F.R. parts 200, 230, 232, 239, 240, 249, and 260), available at <http://www.sec.gov/rules/final/2015/33-9741.pdf> (*Title IV A+ Rules*).
3. See Jumpstart Our Businesses Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012), available at <http://www.gpo.gov/fdsys/pkg/PLAW->

- [112publ106/pdf/PLAW-112publ106.pdf](#) (JOBS Act).
4. See Crowdfunding, Exchange Act Release Nos. 33-9470, 34-70741, 78 Fed. Reg. 66428 (Nov. 5, 2013), available at <https://www.sec.gov/rules/proposed/2013/33-9470.pdf> (Title III Proposed Rules).
 5. 15 U.S.C. § 77d (2012).
 6. *Id.* § 77d(a)(6) (emphasis added).
 7. See 15 U.S.C. § 78c(a)(80) (emphasis added)
 8. See *supra* note 3.
 9. 133 S. Ct. 2304 (2013).
 10. *Id.* at 2304, 2306, 2312.
 11. *Id.* at 2309 (citing *Rent-A-Center West, Inc. v. Jackson*, 561 U.S. 63, 69 (2010)).
 12. *Id.* (citing *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213, 221 (1985)).
 13. *Id.* (citing *CompuCredit Corp. v. Greenwood*, 132 S. Ct. 665, 668 (2012)).
 14. See Regulatory Notice, Financial Industry Regulatory Authority, FINRA Requests Comment on Proposed Funding Portal Rules and Related Forms, Attachment A (Oct. 2013), available at <http://www.finra.org/sites/default/files/Notice-Attachment/p369763.pdf>.
 15. See Angellist, *Terms of Service*, available at <https://angel.co/terms>.
 16. See Funders Club, *Terms and Conditions*, available at <https://fundersclub.com/terms-of-use/>.
 17. See Circleup, *Terms of Use*, available at <https://circleup.com/terms/>.
 18. See *Nicosia v. Amazon.com, Inc.*, No. 14-cv-4513 (SLT) (MDG), 2015 U.S. Dist. LEXIS 13560, at *24 (E.D.N.Y. Feb. 4, 2015), available at <http://www.gpo.gov/fdsys/pkg/USCOURTS-nyed-14-cv-04513/pdf/USCOURTS-nyed-14-cv-04513-0.pdf>.
 19. *Id.*
 20. See generally Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010), available at <http://www.gpo.gov/fdsys/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf>.
 21. See *id.* at 1841; see also 15 U.S.C. §§ 78o(r); 80b-5(f).
 22. See Implementing Dodd-Frank Wall Street Reform and Consumer Protection Act — Pending Action available at <https://www.sec.gov/spotlight/dodd-frank/dfactivity-upcoming.shtml>.
 23. Arbitration Report, Consumer Financial Protection Bureau (March 2015), available at http://files.consumerfinance.gov/f/201503_cfpb_arbitration-study-report-to-congress-2015.pdf (CFPB 2015 Arbitration Report).
 24. See *Dodd-Frank Act*, 124 Stat. 1376, 2003; see also 12 U.S.C. § 5518(a).
 25. See 15 U.S.C. § 80b-2(11)(A).
 26. *Id.* § 80b-2(11)(D).
 27. See 15 U.S.C. § 78c(a)(80) (emphasis added)
 28. See Securities and Exchange Commission, *Investment Adviser Search Results*, available at <http://www.adviserinfo.sec.gov/IAPD/Firm/167700>.
 29. See Securities and Exchange Commission, *Investment Adviser Search Results*, available at <http://www.adviserinfo.sec.gov/IAPD/Firm/166518>.
 30. See Securities and Exchange Commission, *Investment Adviser Search Results*, available at <http://www.adviserinfo.sec.gov/IAPD/Firm/173380>.