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Protecting Investor-Victims: Entrepreneurial Capital Remedies Across India and The Us

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Abstract

The article makes a comparative analysis of the remedial options that are available to the investor-victim in entrepreneurial capital markets in India and the United States. With the proliferation of startup ecosystems and enterprises supported by startup capital, cases of founder fraud, misleading disclosure, and fiduciary breaches have highlighted a significant disconnect between the protection of investors' rights under investor protection law and its enforcement. Based on statutory provisions, regulatory structure, and case law in both jurisdictions, this article outlines the civil, criminal, and regulatory remedies available to displeased investors in private and early-stage capital markets. Compares the Securities and Exchange Board of India Act, the Companies Act 2013, and the regulations for startups with the U.S. Securities Exchange Act of 1934, the Securities Act of 1933, the SEC enforcement mechanisms, and the common law fraud doctrines in the state. The article highlights structural asymmetries, such as information inequalities, contractual lock-in provisions, and illiquidity, which systematically disadvantage investor-victims in entrepreneurial contexts. It claims that the investor protection systems of both jurisdictions have not yet been fully adjusted to the vulnerabilities of entrepreneurial capital markets and outlines a series of harmonized reforms that will enhance the possibilities of deterrence and access to remedies and meaningful accountability. This comparative study adds to the scholarship in the areas of securities law, entrepreneurship law, and comparative corporate governance.

Keywords*:* Investor Protection, Entrepreneurial Capital Markets, Securities Fraud, SEBI, SEC, Comparative Law, Venture Capital, Startup Law, India, United States, Fiduciary Duty

Introduction

Over the last 20 years, an extraordinary growth of entrepreneurial capital markets has taken place around the world. Venture capital firms, angel groups, and crowdfunding platforms have invested trillions of dollars into startups, leading to groundbreaking innovation and, inevitably, investor harm. The failure of big businesses such as Theranos in the U.S. or fraudulent startup schemes that were exposed by the Enforcement Directorate in India has exposed serious weaknesses in legal systems designed to safeguard the investors of such ventures. In entrepreneurial markets, the investor-victim is in a unique and poorly theorized role in securities and corporate law.

The retail investor in the public markets enjoys mandatory disclosure, robust secondary markets, and robust regulatory and enforcement infrastructure, but the investor in a privately held startup does not. The investor-victim has no other means of redressing the situation other than to seek a remedy through the courts, and the court system she faces is not properly equipped to address her situation. How to protect investors in securities markets has been the sole subject of existing scholarship, and that scholarship has been overwhelmingly concerned with the public securities markets. Comparative studies of investor protection in the Indian and U.S. markets for entrepreneurs are almost non-existent, and there is little literature on private market investor protection.

This article begins by filling that gap by systematically comparing the remedial landscape for investor victims in two of the world's most important startup ecosystems. The core argument in this article is that neither India nor the United States has modified its investor protection regime to consider the unique structural weaknesses of entrepreneurial capital markets. Legacy structures based on public securities markets fail to address key issues in private placement transactions, in companies supported by venture capital, and in crowdfunded transactions. Targeted reforms, tailored to the comparative strengths of each jurisdiction, must fill those gaps.

This article proceeds as follows: Part 2 provides an overview of the legal frameworks in both jurisdictions. Part 3 makes a comparative and empirical study of investor remedies. Part 4 presents a policy critique of rules in place. In Part 5, concrete changes are suggested. Part 6 considers the implications for business law and entrepreneurship in the future, and Part 7 concludes.

Background and Legal Framework

The U.S. has its basic laws for investor protection because of the stock market crash in 1929. The Securities Act of 1933 mandated the disclosure of information for public offerings, while the Securities Exchange Act of 1934 established the Securities and Exchange Commission (SEC) and extended antifraud provisions to all securities transactions. Private securities fraud litigation now focuses on the Exchange Act and Rule 10b-5, which the Exchange Act adopted. Later, the Private Securities Litigation Reform Act of 1995 (PSLRA) made it harder to bring class actions to discourage frivolous ones. The private placement exemption framework was expanded under the Jumpstart Our Business Startups Act of 2012 (JOBS Act), and equity crowdfunding was added, which presents new investor-protection issues. The Securities Act offers the most important safe harbour for private placements to accredited investors in the form of Rule 506(b) and Rule 506(c). State Blue Sky laws, such as the Minnesota Securities Act (Minn.), provide independent federal anti-fraud measures and private rights of action in Stat. §§ 80A.40-80A.87.

The statutory framework in India that safeguards investors is based on the Securities and Exchange Board of India Act, 1992 (SEBI Act), the Securities Contracts (Regulation) Act, 1956 (SCRA), and the Companies Act, 2013. The definition of securities under the SCRA and the definition of the term ‘fraudulent’ under the SEBI (Prohibition of Fraudulent and Unfair Trade Practices Relating to Securities Markets) Regulations, 2003, make securities within the jurisdiction of SEBI, and the regulations prohibit any fraudulent conduct in connection with securities transactions. Most of the investments of startups are conducted as private placements under Section 42 of the Companies Act, 2013, which has a set of procedures, but lesser disclosure requirements as compared to public placements. Section 447 of the Companies Act makes a broad-based offense of fraud, and Section 245 provides for a class action mechanism in the National Company Law Tribunal (NCLT). The Serious Fraud Investigation Office (SFIO) under Section 211 investigates corporate fraud, and the Enforcement Directorate (ED) has jurisdiction under the Prevention of Money Laundering Act, 2002 (PMLA).

Launched in 2016, the Startup India initiative of India provides fiscal benefits to investor-victims, but it does not significantly enhance their private law remedies. The evolution of investor protection law in both jurisdictions shows a similar pattern: investor protection laws for public markets have been gradually expanded to private markets, with a lack of structure. The history of the Acts of 1933-34, the PSLRA, the Sarbanes-Oxley Act of 2002, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, and the JOBS Act of 2012 are all examples of market failure reactions.

The evolution of securities laws in India from pre-independence to the SEBI Act to the Companies Act 2013 and the Insolvency and Bankruptcy Code 2016 is also incremental rather than a wholesale overhaul of the existing private capital market framework. Materiality, scienter, reliance, and loss causation are key doctrinal concepts that are applicable to both jurisdictions: Materiality is the threshold of significance that a misrepresentation must satisfy to meet the materiality requirement. Scienter is the mental state required for a misrepresentation to constitute fraud; Reliance is the causal connection between the misrepresentation and the investment decision, and loss causation is the connection between the fraudulent conduct and the investor’s economic loss. These doctrines are particularly relevant to the context of startup investment transactions and are at the heart of the analysis in this article.

Comparative and Empirical Analysis

There is no private securities fraud enforcement system like the one in the United States. Rule 10b-5: private securities litigation actions, contingency fee securities litigation bars, and the class action device allow claims from investor-victims to be aggregated into economically viable litigation units. In private market cases where the documentary evidence is solely with the defendant, the PSLRA's increased pleading requirements and automatic discovery stay, which are intended to discourage frivolous litigation, are burdensome to investor-victims.

Securities Act Section 12(a)(2) imposes strict liability for material misstatements in private offering documents and is more readily available when scienter is difficult to establish. With an SEC enforcement budget of more than $2 billion per year, the agency can maintain a strong presence in the private markets, and recent enforcement activity against the founders of startups, including the DOJ prosecution of Theranos founder Elizabeth Holmes, which led to conviction for wire fraud and conspiracy in 2022, demonstrates that the agency is ready to hold the wrongdoers responsible for entrepreneurial fraud. Administered by the Dodd-Frank Act, the Fair Fund mechanism provides disgorged funds to be distributed to investor victims, but often the funds are not returned in a timely manner.

The Indian remedial system exhibits fragmentation and complexity. Investor-victims in early-stage companies with dispersed cap tables essentially cannot use the Companies Act's class action mechanism, which demands at least one hundred members representing at least ten percent of the issued share capital. Restrictions on contingency fees, long judicial delays before the Commercial Courts and the NCLT, and the lack of a plaintiff's securities litigation bar, like that in the U.S., pose challenges for individual civil claims under the Indian Contract Act for misrepresentation and the tort of deceit, which tracks the elements of common law fraud. SFIO investigations have led to prosecutions in high-profile cases of startup fraud, but limited investigative capacity has led to prosecutions in only a fraction of the cases of investor harm.

The ED's jurisdiction over proceeds of crime is an excellent tool for asset recovery where the assets may have been diverted, but the relationship between the PMLA confiscation proceedings and civil restitution claims is a complex one. Empirical evidence highlights the extent of the issue in both jurisdictions. According to the latest report by DPIIT, the Indian startup ecosystem (with more than 84,000 startups registered as of 2022) received around $38.5 billion in venture and private equity investment, compared to more than $238 billion in VC investments in the U.S. market in 2021. Investors have been affected by both ecosystems—the SEC has seen a material rise in investor damage due to private company fraud between 2018 and 2023, and the SFIO and ED have witnessed a significant surge in startup-related investigations during the same timeframe in India.

Case studies show that in the U.S., the Theranos investor-victims have been able to partially recover some of their losses through DOJ criminal forfeiture proceedings, but that in India, investor-victims in similar situations often discover that they are unable to recover anything in civil proceedings because of asset dissipation and procedural hurdles. Other jurisdictions shed light on alternative approaches to regulation. The Financial Services and Markets Act 2000 of the United Kingdom (UK) has set up a single regulatory system for financial services under the Financial Conduct Authority. This law also gives claimants a private right of action for breach of statutory duty, which could be a model for the Indian and U.S. jurisdictions to follow. The fiduciary duty doctrine has grown in Delaware corporate law to cover startup governance and is applicable to most U.S. venture-backed companies. The Court of Chancery's more robust scrutiny of conflict-of-interest transactions and its entire fairness review in investor-victim transactions offer valuable protections that are not available in India, where the judicial development of the fiduciary duty doctrine in the venture capital context is still in its early stages.

Policy Analysis and Critique

Both are fundamentally flawed in their design, as investor protection law is designed for the public markets and then adopted for the private markets. The private placement exemptions under Regulation D were not intended to provide a safe haven for unethical behaviour, but rather to make it easier to raise capital. But the net impact of decreased disclosure requirements and limited regulation and liquidity in the private markets is that investor harm can be inflicted and remain unnoticed for long periods.

The PSLRA's increased pleading requirements are consistent with the pleading standards in public market litigation, but they are especially onerous for plaintiffs in the private market who do not have access to the company's books before the discovery stay is lifted. The accredited investor definition, based on wealth rather than financial sophistication, presumes self-sufficiency, but this presumption is often inaccurate and does not reliably capture the ability to sustain investor harm. India's disjointed jurisdictional framework causes transaction costs that systematically discourage investor-victims from filing claims, as SEBI, the NCLT, civil courts, SFIO, and the ED have overlapping and sometimes conflicting jurisdiction. Professional conduct rules in India that limit contingency fee arrangements are another factor that reduces the economic rationales of individual claim pursuit, eliminating the incentive for private attorneys to spend resources on investor protection litigation.

The unintended consequence of the high threshold requirements in Section 245 of the Companies Act (which were designed to ensure that only serious claims are litigated) is that it excludes legitimate claims by minority investors in start-up businesses. The burdensome regulation that slows innovation from an entrepreneurial point of view lowers investor and regulatory confidence in the market and increases the cost of capital. Both jurisdictions are still in the process of tuning the balance to an entrepreneurial market. The lack of investor protection in entrepreneurial capital markets has economic and social consequences that go beyond the damage done to the investors. If sophisticated investors are cheated with no effective remedy, they will expect to receive a higher risk premium on their next investments, which will increase the cost of equity capital for all startups, even those that are honest.

Reputational externalities of high-profile entrepreneurial fraud cases like Theranos in the United States or several cases of fund diversion in India lead to a regulatory response, which then has a broad impact on the startup ecosystem through compliance costs. Society's losses because of entrepreneurial fraud are therefore systematically greater than the losses suffered by investor-victims. A normative critique of the law in place must also consider the power imbalances that are inherent in the venture capital contract. Negotiated shadow markets include preferred stock arrangements, anti-dilution provisions, drag-along rights, and information rights. There is a wide gap between the sophistication of the contract terms of institutional VCs and individual angel investors. The contracts created in these markets are presumed enforceable, and neither system of law provides sufficient scrutiny as to whether the conditions of genuine informed consent were met. An effective investor protection regime should not only consider the consequences of damage but also the underlying system in which it is likely to happen.

Proposed Reforms or Solutions

This article suggests that the PSLRA’s automatic discovery stay in cases involving private market fraud should be modified to allow earlier discovery of documents in a case where the documents are solely in the possession of the defendant company, but with the requirement of a heightened pleading standard to prevent frivolous litigation, as in *Cyan, Inc. v. Beaver County Employees Retirement Fund*, 138 S. Ct. (ii) a legislative clarification that federal court is the exclusive venue for securities fraud claims arising from private capital market transactions, to avoid forum-shopping uncertainty created by *Cyan, Inc. v. Beaver County Employees Retirement Fund*, 138 S. Ct. The final rules include the following changes to the definition of accredited investor: (i) clarifying that the definition of accredited investor would include the presence of genuine sophistication requirements beyond wealth, such as professional qualifications and investment experience; and (ii) expanding the disclosure and investor protection requirements for issuers offering under the $1061 (2018) limit to non-accredited investors, including additional mandatory disclosures of risk factors, conflicts of interest, and use of proceeds.

The article suggests the following for India: (i) a minimum disclosure regime for companies that have raised funds from non-promoter investors mandating that the companies provide audited annual financial statements to the Registrar of Companies within prescribed time-lines; (ii) a uniform private capital market investor protection panel within the NCLT regime with a comprehensive mandate over investor fraud cases, avoiding the current multi-forum fragmentation of the investor protection regime between SEBI, civil courts, SFIO, and ED; and (iii) the statutory conferral of minimum information rights on the investors holding a stake above a prescribed threshold, such as periodic financial statements, access to books of account on notice, and the right to appoint a nominee director, instead of relying on contractual negotiations.

For both jurisdictions: enhanced cooperation between SEBI and SEC in enforcing securities laws, including through a bilateral agreement that would expand the scope of evidence sharing and coordination of enforcement efforts and include mutual recognition of disgorgement and restitution orders, should be formalized. The IOSCO Multilateral Memorandum of Understanding offers a basis but needs to be strengthened for the entrepreneurial capital market environment. Good practices for entrepreneurs include the use of model term sheets that include mandatory investor information rights, model subscription agreement antifraud representations, and voluntary governance codes for venture-backed companies that exceed certain capital thresholds. These changes have implications for business law practitioners in terms of the revised due diligence process to address the information asymmetry in the private markets and representation and warranty provisions to reflect the risk profiles of startup transactions.

The political economy of both jurisdictions supports these reforms. The Indian government has shown consistent legislative and regulatory efforts to increase access to entrepreneurial capital markets, as has the U.S. government. These proposed reforms are aimed at making sure that such expansion doesn't result in the compromise of investor protection, a key ingredient in sustainable growth of the market. Finally, credible investor protection lowers the cost of capital to the honest founders by lowering the risk premium that investors require in markets where there are information asymmetry and limited legal recourse.

Future Implications for Business Law and Entrepreneurship

Investor protection frameworks will have a lasting impact on the entrepreneurial ecosystem in India and the United States. Over time, rational investors will require higher risk premiums or will not invest in private markets in markets where investor-victims have little or no recourse. On the other hand, jurisdictions that build strong, accessible, and affordable remedies for investor damages in private capital markets will make it more appealing to invest in them, decrease the cost of equity financing for honest entrepreneurs, and set the stage for sustainable development of entrepreneurial ecosystems.

In particular, the Indo-U.S. start-up corridor, which is becoming a significant technology corridor, has brought a sense of urgency to the bilateral enforcement cooperation reforms proposed in this article. Both jurisdictions' existing frameworks are inadequate to address emerging technologies' investor protection issues. The rise of tokenized securities, decentralized finance (DeFi) platforms, and investment mechanisms based on the blockchain makes it difficult to distinguish between securities transactions and non-regulated financial activities. The SEC's Howey test application to cryptocurrency offerings and SEBI's new regulatory framework for virtual digital assets are both steps towards regulatory oversight of these new instruments, but the investor protection aspects of truly decentralized entrepreneurial financing have yet to be explored.

The role of an information intermediary to an investor-victim is shaped by new types of AI-powered investment platforms and algorithmic investor matching in both jurisdictions, which need new doctrinal analysis. Future research should focus on: the efficacy of the proposed class action reforms in India in comparison to the enforcement record of the post-reform Indian class action regime; the best fit of the discovery stay in PMLA proceedings for private market plaintiffs; the interplay between PMLA asset recovery proceedings and civil investor claims in India; and the cross-border investor protection implications of the expanding Indo-U.S. startup corridor. The behavioural law and economics approach to investor decision-making in information-asymmetric private markets is a promising framework for empirical research and analysis into the impact of legal interventions on investor behaviour, the behaviour of founders, and the efficiency of the capital markets.

This study is a major methodological contribution in this field, as comparative metrics to measure the effectiveness of investor protection are not only formal legal rules but also the enforcement intensity and accessibility of the procedure and its remedial adequacy.

Conclusion

This article has contended that the law in India and the United States alike systematically under protects investor-victims in entrepreneurial capital markets, even though the law is rooted in the context of public securities markets and has been adapted to the context of private capital markets. Both have extensive investor protection laws and have created a degree of enforcement capacity, albeit with varying effectiveness. Neither has fully recognized the structural asymmetries of entrepreneurial finance (severe information gaps, forced illiquidity, and governance by the founder) for the development of effective remedial frameworks.

The reforms proposed in this article, which aim at minimizing the fragmentation of jurisdiction in India, optimizing access to collective redress mechanisms in both countries, improving mandatory disclosure and information rights for private market investors, and optimizing enforcement cooperation between the two countries, are based on the comparative strengths of each system and tailored to the specific vulnerabilities of entrepreneurial capital market investors. These are not intended to be all of the answers to the complex issue of startup market integrity but rather a series of interventions targeted to the most important structural shortcomings found in this comparative analysis.

This article adds to the scholarship discourse on securities law, entrepreneurship law, and comparative corporate governance by providing a systematic comparison of the remedial regimes in private capital markets for the investor-victim in both India and the United States. A comparison shows that there are real opportunities to learn from each other in both directions: the U.S. could learn about class action mechanisms and the SEC's capacity to enforce the laws in India, and India could learn about the U.S. emerging mandatory disclosure regime for private companies. Protecting investor-victims in entrepreneurial capital markets is not just a legal obligation; it's a prerequisite for the sustainable development of the high-growth, innovative enterprises that both countries are working towards.

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