Regulating Ponzi Schemes

Raj Rani Bhalla
Partner
Link Legal

Introduction

A Ponzi Scheme is a fraudulent investment maneuver. It promises extraordinarily high returns or consistent returns which are provided not from any profit making activity conducted by the Company or the individual with whom the investment has been made but from the money raised from the investors themselves and the new investors. This scam yields the promised returns to earlier investors, who have invested in the early stage of the scheme, as long as new investors continue to invest in the Scheme. Therefore it is also popularly known as "*rob Peter to pay Paul*" Scheme. These schemes usually collapse for want of new investors. There are no underlying assets or business activities for which the money is collected from the investors.

Definition of 'Ponzi Scheme'

Investopedia defines Ponzi Scheme as "A fraudulent investing scam promising high rates of return with little risk to Investors". The Scheme is named after Charles Ponzi from United States, who tricked many investors in the 1920s, into investing in a speculation of postage stamps which could be sold at different prices in different countries. Though these schemes were in existence before he came to prominence but the magnitude of his scale of operation and the amount of money that he generated, gave the scam his name.

Features of a Ponzi Scheme

Many Ponzi Schemes share some common characteristics which are as follows:

- These Schemes offer **high investment returns with little or no risk** despite the well known premise that every investment carries some degree of risk, and high yielding investments involve high degree of risk. There are **overly consistent returns** even though normal investments tend to go up and down over time, especially those seeking high returns. These Schemes tend to generate regular and positive returns **regardless of overall market conditions**.
- Such investments are usually **unregistered** with any of the regulators, like RBI, SEBI etc. . Registration is important because it provides investors with access to key information about the Company's management, products, services, and finances which can help build trust and reliability.
- The seller firms or individuals of ponzi schemes are **unlicensed** even though our securities laws require investment professionals and their firms to be licensed or registered with the relevant authority.
- They have **secretive and/or complex strategies** which a common investor does not understand.
- **In these schemes, there are issues with paperwork** as the perpetrators of the Schemes normally do not allow review of information about an investment in writing and only assure guaranteed returns etc. by word of mouth of highly commissioned agents.
- **There is difficulty in receiving payments** as the promoters sometimes encourage participants to "roll over" promised payments by offering even higher investment returns on the retained amounts.

One of the most important elements of the schemes is to gain trust of more and more investors. For that purpose the initial investors are usually paid their promised returns in the earlier stages of the scheme, if not something better. This gives the investors the encouragement to re-invest their money in the scheme as well and also motivate others to do so.

Ponzi scheme and Pyramid scheme: The Ponzi Scheme has, at times, been confused with the Pyramid Scheme. Ponzi and Pyramid Schemes have similarities like they both involve paying long-standing members with money collected from new participants, instead of actual profits or gains from investing or selling products or carrying out any business activity. However, there are some differences between the two:

1. In a Pyramid Scheme the investors are lured into earning high profits by making a single payment coupled with an obligation of finding a set of other investors who become the distributors of the product, whereas in a Ponzi Scheme investors are told that high investment returns with little or no risk can be earned by simply handing over their money.
2. There is no interaction with the original Promoter in the Pyramid Scheme but in a Ponzi Scheme the Promoter usually remains in a direct or personal contact with the investors.
3. Again, in a Pyramid Scheme, the source of payment is always disclosed, that is, "From the new participants" whereas in a Ponzi Scheme it is not disclosed to the investors even though the source remains the same.

One of the most important elements of the schemes is to gain trust of more and more investors. For that purpose the initial investors are usually paid their promised returns, if not something better. This gives the investors the encouragement to re-invest their money in the scheme as well.

Ponzi Schemes in India

India has not been able to stay away from the clutches of the Ponzi Schemes. To name a few examples from the past are the Plantation Companies, the Emu and Goat Farms, the Real Estate Schemes giving Annual Assured Returns, the Holiday Membership Plans, the Potatoes Purchase Schemes and the sale and purchase of Mavros-currency like units, etc. Data presented in Parliament this year shows 669 companies being probed by SEBI for violation of Collective Investment Schemes (CIS) regulations. Between them these companies had together collected Rs 7,435 Crores. Of these, 552 companies were prosecuted and convictions were secured in 124 cases. Another 75 wound up their business and refunded the money back to their investors.

Major concern is that, many a times, these defrauding Companies are backed by commendable infrastructure to gain interest as well as trust of investors. For example, Companies like Golden Forests, PGFL and Anubhav Plantations Limited were duly incorporated entities with offices, staff and commission agents all over the country. In and around 1996-97 a lot of **plantation companies** mushroomed all over India, promising unrealistic returns to investors by sale of a plot of land and planting of some teak trees which were not demarcated in favour of any investor, with a promise of buy back after a few years. They offered returns in the range of 24 to 36% backed by reliable ownership in teak trees. Most of their prey were retired army officers who invested their life savings into the scheme leading many of them to the brink of bankruptcy.

This is similar to the **real estate schemes** which assure fixed returns to the purchasers, with added features of leasing properties on behalf of the investors and the option of buying back after a certain term.

Similarly, contract farming of Emu (the flightless birds of Australia), had all the ingredients of a Ponzi Scheme from the beginning. In 2006, M.S. Guru, hailing from Perundurai, founded Susi Emu Farms and introduced a buy-back scheme that promised lucrative returns. For an initial investment of Rs. 1.5 Lakhs, he promised a return of Rs. 3.34 Lakhs within two years. The operation soon spread throughout India, luring thousands of investors. When the scheme collapsed, total losses were estimated to be as high as $50 million. Investors realised that Emu farming was a scam, only when payments from **Susi Emu Farms** dried up, leaving hundreds of investors in financial ruin and abandoning of more than 12,000 exotic birds, which are now being auctioned off by the government to livestock traders for meat. Like any typical Ponzi Scheme, the company had paid the early investors promptly at the end of two years so that others would grab the bait.

Citizens of the Jammu and Kashmir were recently advised by SEBI to steer clear from the **Sheep Husbandry Department (SHD)**, a private company which was advertising 2% to 3% monthly returns from an investment in goat-rearing farms.

In the case of **Saradha Group**, many lost their life savings in a fraudulent Scheme in the State of West Bengal and the other North-East States which was similar to a chit-fund investment which was held by SEBI to be a CIS.

Another model of raising funds through unregistered entities is that of M/s Rose Valley Companies. M/s. Rose Valley have allegedly raised Rs 1006.70 Crores from the public up till February 2012 through launch of a scheme titled **Rose Valley Holiday Membership Plan** ("HMP") in the year 2010. Under the HMP, an investor could book a holiday package through payment of monthly installments and upon maturity or completion of tenure for monthly installments, such investor can either avail the facilities i.e. room accommodation and services or opt for maturity payment i.e. a return on the investment with annualized interest.

In another instance, SEBI came across an advertisement dated September 11, 2012, in a local newspaper in Kolkata, issued by Sumangal Industries Limited ('SIL'), whereby funds were solicited from the public under '**Potato Purchase Scheme(s)'.** SEBI examined all the relevant information/documents issued by company to the investors and held that SIL was carrying on the activities of a CIS, thus attracting the provisions of Sections 12(1B) of the Securities and Exchange Board of India Act, 1992 ('the SEBI Act') and SEBI (CIS) Regulations, 1999 ('CIS Regulations').

Challenges and remedies in Regulation:

The regulation of collective investment schemes that come under SEBI's scanner has also left much to be desired. The definition of "CIS" was inserted in the SEBI Act vide the Securities Laws (Amendment) Act, 1999 with effect from February 22, 2000. According to the definition, CIS means any scheme or arrangement which satisfies the conditions specified in Section 11AA of the SEBI Act, which provides as under:

"*11AA. (1) Any scheme or arrangement which satisfies the conditions referred to in sub section (2) shall be a collective investment scheme.*

(2) Any scheme or arrangement made or offered by any company under which,

(i) the contributions, or payments made by the investors, by whatever name called, are pooled and utilized solely for the purposes of the scheme or arrangement;

(ii) the contributions or payments are made to such scheme or arrangement by the investors with a view to receive profits, income, produce or property, whether movable or immovable from such scheme or arrangement;

(iii) the property, contribution or investment forming part of scheme or arrangement, whether identifiable or not, is managed on behalf of the investors;

(iv) the investors do not have day to day control over the management and operation of the scheme or arrangement."

SEBI issued the CIS Regulations and instructed the companies who qualified under Section 11AA to get themselves registered under the said Regulations. However, till date there is only one scheme which was found fit for registration from amongst 600 odd such companies operating all over India without registration. The only company to be so registered is Gift Collective Investment Management Co., a Gujarat Government PSU which is building the International Financial City in the Ahmedabad–Gandhinagar region. SEBI has launched criminal prosecutions against the unregistered companies, their promoters and directors and also debarred them from accessing Capital Market for certain periods.

Further, SEBI had a restrictive mandate under Section 11AA which contains exemptions for institutions such as chit funds, nidhis and cooperative societies.

With the promulgation of Ordinance dated July 18, 2013, now SEBI has been empowered to deal with all kinds of investment schemes involving pooling of funds totaling Rs 100 Crores or more.

Under a **fragmented regulatory system**, as in our country, hazy lines of work exist between financial regulators, the Central Government and State Governments which creates problems of jurisdiction which eventually has led to the problem of **under policing.** Anything which does not fall squarely within the lines tends to pass unnoticed under the radar of regulation. For example, in the case of Saradha Group, "its activities could be argued to fall under any of the following categories: running a collective investment scheme (regulated by SEBI); running a chit fund (regulated by the State Government); a private company taking deposits for its business (regulated by the Registrar of Companies); and taking public deposits as a non-banking financial company (regulated by RBI). The Saradha Group chose to seek permission from none of these".

Looking forward, the draft Indian Financial Code (IFC) framed by the Financial Sector Legislative Reforms Commission (FSLRC) presents a comprehensive solution to address the problem of under-regulation. The FSLRC has recommended a clearer and more comprehensive regulatory architecture as compared to what we currently have - RBI would regulate banking and payments, and a Unified Financial Authority (UFA) would cover all other financial services and products. Within this structure, there would be no scope for confusion about who should regulate a Saradha or MMM India as this responsibility would clearly vest with the UFA. This will also bring about more consistency in the regulatory treatment of a range of institutions undertaking similar activities, irrespective of the institution-type.

The FSLRC's draft law offers a viable solution in terms of conferring the duty of regulating all investment schemes on a single regulatory body that will be fully accountable for this task. The complete, principles-based framework of definitions, that can adapt over the years, will also help minimise regulatory gaps.

Another challenge is inconsistency in the manner and extent of regulation of financial institutions performing similar activities. For instance, 265 non-banking financial companies and 18 housing finance companies are allowed to take public deposits, but they do not enjoy the same deposit insurance protection that is available to banks. If the main rationale for deposit insurance is to protect depositors from the risk of a financial institution becoming unable to make good on its promise to refund public deposits, should the same logic not apply to all deposit takers?

Further, differences in enforcement levels across States have resulted in some States becoming more prone to ponzi schemes.

Another drawback is that the regulators like RBI and SEBI do not have enough powers, infrastructure and staff to enforce the regulations resulting in lack of effective implementation of the regulations.

After Saradha, SEBI stepped up its investigation against these alleged Ponzi schemes. With an aim to regulate these schemes under CIS Regulations the Government promulgated an ordinance on July 18, 2013 for amendment of the Securities Laws, i.e. the SEBI Act, SCRA and the Depositories Act. To prevent the companies claiming that they do not come under the purview of SEBI Collective Investment Scheme regulations, SEBI has now been empowered to deal with all kinds of investment schemes involving pooling of funds totaling Rs 100 Crores or more. After the promulgation of the ordinance the scope has been enlarged and any investment scheme floated by a 'person' and not necessarily a 'company' has been brought under SEBI's jurisdiction for CIS activities.

Besides, the Government has also provided SEBI with direct powers to conduct search and seizure with authorization from its Chairman. Earlier it could conduct search and seizure only after the approval from the Chief Metropolitan Magistrate, but this provision was often seen to delay proceedings and hamper the confidential nature of probe.

The ordinance also seeks to bring all kinds of ponzi schemes, which are thriving in various semi urban and rural areas at the expense of gullible investors, under SEBI's oversight, which itself has been made much more effective to safeguard investors from being defrauded.

Last of the challenges is the low level of awareness among the investors. However, both RBI and SEBI are having investor education campaigns.

Recently, in the wake of the Ponzi Schemes, the RBI Governor has stated that although schemes like chit funds and multi-level marketing companies do not fall under the jurisdiction of the Reserve Bank, it had, as a public policy measure undertaken to create awareness about these schemes.

RBI has, for instance, published in 13 languages, frequently asked questions (FAQs) about non-banking financial companies. RBI has also stressed on the need to sensitize the police officials on this issue so that they give priority to these complaints and urged the State Government to help the RBI in ramping up publicity about such fraudulent schemes through its district machinery.

Since the public is generally unaware about who regulates what, the RBI has announced that the public could complain to any regulator and all regulators would coordinate resolution of complaints among themselves.

Lastly, it is felt that, there is a **need to fast track the disposal of seized assets of the fraudsters.** Vide the ordinance referred to above, SEBI has been empowered **to attach and sell defaulting person's movable and immovable assets in case of non-compliance.**

<u>Recommendations:</u>

In the end, it can be concluded that the government should create effective mechanisms so that no investment goes unregistered and unregulated which in my view, can be obtained through the following steps:

- Make the public at large more financial literate.
- As far as possible, prevent political patronage for particular schemes.
- Ensure regulator itself has officers of high integrity.
- Provide conditions for financial mainstream activities across all regions and places in India.
- To set up a central data information cell which is connected with all the law making agencies

Let us hope that these steps would prevent the fraudsters from creating difficulties in the life of the investors and win their confidence back.