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EVERYTHING THAT CHIT FUNDS CAN DO: ANOTHER PONZI SCHEME TOWARDS TOTAL BANKRUPTCY

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1. INTRODUCTION

Financial markets are so intrinsic and complex that they refuse to go against the ambit of being a strongly held, closely connected and loosely monitored lattice structure. We could relate it to greed, the lure of making quick money, or the necessity to climb the social ladder through any means – fraudulent and cynical, more often than we rather think. It is amazing to figure out that a currency has so much value that it undermines the extent to which savings, sweat earned investments and family future plans are tarnished by misrepresentation, fraud, coercion and undue influence, the four key ingredients of not gaining free consent. Whether it is an engaging case on the stock markets by Harshad Mehta[1] in the 1990s, the number of scams emerging in the media on a regular basis due to misappropriation of accounts, double taxation and avoidance of the same, hoarding black money in Swiss bank accounts and like, are now in everyday parlance. It is not new, and never will be in a world of modern capitalism. As *Justice Holmes* said, such issues are the price we pay for making ourselves a civilization. However, the true economics of such cases is the complex economics itself, not to mention clever investment decisions, shrewd marketing plans, hoodwinked assignments and harsh reality crashing when the accused get caught without any defence for explaining such contingent dubious associations. This paper attempts to look at our legislation and the recent case in point that erupted in West Bengal namely the *Saradha Group Case* and what measures can be taken by the state to avoid such bankruptcy and safeguard innocent citizens.

2. SARADHA GROUP CASE

April 2013 saw a gust of hatred wind, combined with murders, incessant strikes, call for action from the police, appeal for *suo motu* action by the tax authorities and a proposal to seek a thorough enquiry by the Central Bureau of Investigation (CBI) when the Corporate Affairs Ministry announced a detailed probe. Ponzy scheme Saradha Group was run by Sudipta Sen who apportioned public money by way of seeking chit funds in West Bengal and other Eastern and North Eastern states, even though the suspected entities were not actually registered as chit funds. The Saradha group allegedly utilised a consortium of companies with multiple cross linkages to set in motion an elaborate Ponzi scheme. The scheme was touted as a realty business and there were frequent changes in its operational strategy in an attempt to avoid scrutiny by regulatory authorities. In addition to the Saradha group, it is suspected that several companies are currently running fraudulent chit fund schemes in West Bengal. Apart from the Saradha group firms, various other inter-connected entities from such as Rose Valley, Icore E-Services and Sunshine India Land Developers were also involved. Fourteen Saradha group entities including Saradha Realty India, Saradha Agro Development, Saradha Exports, Saradha Construction Company and Saradha Garden Resorts and Hotels are under the scanner. Besides, nine entities from the Sunshine India Land Developers group, 11 from the Icore E-Services Ltd group and 19 from Rose Valley group are being investigated.

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[1] Complete study of the case is available here: http://www.bullrider.in/harshad-mehta-stock-scam/

Meanwhile, an Inter-Ministerial Group is working on comprehensive set of guidelines to tackle the mushrooming illegal money-pooling activities or ponzi schemes[2]. The Telegraph had reported on August 19 that a total of 17.39 lakh applications was submitted to the commission probing the scam and 83 per cent of the applicants — around 14.43 lakh — had deposited Rs 10,000 or less. Back-of-the-envelope calculations reveal that the state will require a minimum of Rs 720 crore if the average deposit was Rs 5,000. The payout requirement will go up to Rs 1,010 crore if the average deposit was Rs 7,000. In short, this is nothing short of a 3,000 crore scam by one company.

3. MODUS OPERANDI

How did these schemes escape the regulator, or SEBI's, glare? SEBI bans collective investment schemes such as, say, buying a stake in a plantation, which is typically what Ponzi players offer to do. So, Ponzi players offer 'time-shares' on promise of return on surrender of membership. For instance, a depositor could be buying into comfortable hotel accommodation for a few days in a year, somewhat like a club membership. These do not qualify as financial schemes. To entice more deposits, those operating these schemes promised to pay not just high returns (18-20 per cent) but a hefty commission (Rs 30-35 on Rs 100 collected) on deposit money mobilised by the depositor/his recruits. Huge numbers of people turned up at the doorstep of Saradha and its ilk. As the cash registers started ringing, Ponzi owners opened plush offices in Kolkata. They generated no less than half the advertisement revenue for vernacular TV channels; some even bought into large media houses. The trend was strengthened with the transfer of political power to the Mamata Banerjee-led Trinamool Congress. The public discourse and media space was overwhelmed by entertainment, news, football and 'chit funds'. The Chief Minister's presence at newspaper launches by Saradha; the open support of her Government to the media house; involvement of top party leaders in the affairs of the group; and alleged participation of ground level activists to mobilise funds for Saradha, boosted Saradha's reputation and credibility. The Saradha Group was forced to regulate collections following the launch of the Serious Fraud Investigation Office (SFIO) in 2012.

According to available estimates, the Group may have collected over Rs 20,000 crore of deposit — all in cash — through approximately 100-odd companies. Investigations so far, however, traced transactions worth a couple of hundred crores. Lakhs of investors from West Bengal and the rest of the Eastern and North Eastern region are demanding justice. At least two persons have committed suicide. Even the West Bengal Protection of Depositors Interests in Financial Institutions, 2003 to ensure preventive action through district level vigilance failed to tackle this issue. The Saradha episode is a foretaste of more closures to come[3]. It would be easy to dismiss the Saradha chit fund debacle now playing out in West Bengal as just another instance of avaricious investors throwing caution to the winds when tempted with high returns only to cry foul when the gamble failed. But this incident is also a pointer to systemic deficiencies in the way the Indian financial sector is being regulated today. Even as the Reserve Bank of India (RBI), Securities and Exchange Board of India (SEBI) and the Ministry of Corporate Affairs (MCA) formulate elaborate rules for registered mutual funds, banks and listed companies, there are many entities out there who are able to raise vast amounts of public money by operating in a no-man's land, where these regulators are oblivious to the goings-on or, if aware, are wary of treading.

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[2] *SFIO submits interim report on Saradha scam*, Economy & Policy, Business Standard, August 28, 2013

[3] A Ponzi empire crumbles in Bengal, The Hindu Business Line, Opinion, April 23, 2013

4. CHIT FUNDS: WHO HAS THE MONEY?

Chit fund is a traditional financial scheme carried out based on trust between operators and members, which prevailed even before formal banking began. Unregistered chit funds, whose chit value exceeds Rs. 100, are illegal in India[4]. In Bangalore, there are 193 registered chit fund operations under the Chit Funds Act 1982, with a turnover of about Rs. 4,000 crore per annum. However, the number of unregistered chit operators is estimated to be at least 100 times that. In other words, investors are sitting on a powder keg that can blow up any time. "Chit funds are overregulated but less governed, and regulations on chit funds are more stringent than banking regulations. Simplification of the Act will solve many hurdles and prevent people from being attracted towards unregistered chit fund operators," says T.S. Sivaramakrishnan, general secretary of All Indian Association of Chit Funds, while pointing out that Saradha Group of West Bengal, which is still making news following the collapse of its ponzi scheme, was not registered to operate chit funds. Penal provisions for operating an unregistered chit fund are too soft. They should be changed to ensure longer imprisonment with higher penalty amount of at least Rs. 5 lakh from the Rs. 5,000 now, he said and added that that the Registrar of Chits has, perhaps, never used his power to raid an illegally operated chit fund firm/operator.[5]

A study by the Institute for Financial Management and Research (IFMR), Chennai, found that 96 per cent of chit fund members surveyed had commented that participation in registered chit fund operations as "safe". The results from this study underscore the importance of chit funds as a savings and borrowing vehicle for the poor and lower income households in India. The data collected from the Chit Fund Registrars of Andhra Pradesh, Tamil Nadu, Karnataka, Kerala and Delhi for the first time estimates the size of the registered chit fund industry. The report stated that the total amount of capital lent per year through registered chit funds is between 10 per cent and 50 per cent of all priority-sector lending which is extended by regular banks in these same States. The study also pointed out that though chit funds are an important source of finance for small businesses and low-income households, there has been a general exodus of low value chit fund schemes from the registered chit fund market. "This is mainly because registered chit funds find it less lucrative to serve the poor due to the increased cost of operating such schemes imposed by the regulators. Most registered chit funds have moved away from smaller chit fund schemes and mainly offer large schemes. These developments make it very difficult for the poor to participate in chit fund schemes and often leave them without any institutional savings options," said the report.

Then the big question arises: Why do people risk dealing with unregistered operators? There are three main reasons: there is no need for any document to participate in chit fund schemes, unlike in the case of registered companies; flexibility in borrowing, and an easy way to invest unaccounted for money. And how do unregistered chit operators flourish despite cases of cheating against many of them? The main reasons are: non-implementation of preventive measures as prescribed in the Chit Funds Act to prosecute unregistered chit operators; lack of stringent provisions in law to check their operations and third, many unregistered operators adopt dubious methodology to ensure that their schemes are slightly different from the chit fund scheme as defined in the Act, to avoid registration. Overregulation and the multilayered

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[4] *Chit funds or cheat funds?*, The Hindu, May 21, 2013

[5] *Ibid.*

procedures to get a chit fund registered under the Act also are a deterrent for people to go the legal way.

Such funds are governed by central Chit Funds Act 1982[6] as well as specific Chit Fund Acts enacted by different states. As regulation of chit funds is a State subject, both RBI and SEBI exclude chit funds from the purview of their regulations for deposit-taking finance companies or collective investment schemes. But these very exclusions allow chit funds to collect public money without any of the controls or checks imposed on regulated firms — capital adequacy norms, risk controls or even basic financial disclosures. But the increasing incidence of such scams and the quantum of public money involved in it, suggests that it may now be time for regulators to shed their reservations about treading on each other's toes, and make a collective effort to expand the regulatory net by pushing for legislative changes. If this results in some overlap of jurisdictions, so be it. After all, such overlaps exist even now with listed banks accountable to SEBI for their dealings with shareholders and to RBI, on depositor protection. The Saradha incident also provides ammunition for policymakers to lean on the State governments to tweak their chit fund laws, to grant SEBI or RBI powers to seek information and inspect the books of chit funds. Financial institutions, as a class, are prone to the risk of 'contagion'. Not only can the operational failure of an entity be transmitted to others, bad reputation too can fasten on just as well to other entities, to the detriment of the industry as a whole.

But there is another aspect to this episode. If people with limited means or those running small businesses flock to unorganised entities for their credit needs despite the latters' exorbitant costs, it is also because they find it difficult to access the formal financial system. Making banks and NBFCs more accessible to them will certainly help wean them away from such spurious operators of chits or other mutual benefit schemes. The technology today available in the form of the mobile communications network and electronic payment systems, has made it possible for banks to track the status of their borrowers and facilitate transactions at a fraction of the costs they used to incur earlier. It is time they used this reach to take banking services to the small customers' doorstep[7].

5. STATE'S RESPONSE TO SARADHA INVESTORS

The West Bengal government seems to have found a way out to disburse cash from the Rs 500-crore fund meant to help the poorest of poor depositors affected by the Saradha Group scandal. A proposal is being considered to enact legislation under Article 282 of the Constitution to dole out the benefit the chief minister had promised on April 24 to all the aggrieved investors. The article allows the Union or a state to make grants for any public purpose. Earlier, the state government's efforts to create the fund had hit a roadblock as there was no provision in the budgetary rules. Although the constitutional provision may spare the government legal hassles, the proposed Rs 500-crore kitty — around Rs 150 crore would come from higher tax on tobacco products, the chief minister had said — may not be enough. The state government is set to issue a fresh notification delegating the power of attaching properties of the Saradha Group and use the fund to repay the poor investors. Till now, the special investigation team has found over 450 bighas linked to Saradha in Bengal and other states, besides over 500 bank accounts and nearly 100 vehicles and over 220 properties[8]. The Enforcement Directorate (ED) is at the helm of this recovery operation.

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[6] Full Act can be read here: http://www.lawzonline.com/bareacts/chit-funds/chit-funds-act.html
[7] *Case of oversight*, The Hindu, April 23, 2013
[8] *Public purpose plan to unlock Saradha fund*, The Telegraph, August 2, 2013

In an effort to understand this debacle it is imperative to understand what the law mandates and the fine line interprets. The offence under the Prevention of Money Laundering Act may be committed at three stages: placement, layering and integration. If a person diverts the investments and even deposits the amount so collected in a bank, it would amount to placement. In this case, the accused had gathered deposits from investors but instead of using it for the proposed purpose, diverted the funds to purchase properties. This would also amount to placement. At the second stage (layering), the money launderer engages in a series of continuous conversions or movement of funds within a financial/banking system through several accounts with an objective to conceal the true origin of proceeds. At the third stage, to evade detection, the accused employs multiple means to show the proceeds of crime as part of money generated through legal sources of income and goes on to invest in business ventures, real estate and other avenues[9]. While the ED prepares to take further action in the Saradha Group case, once the adjudicating authority under the Prevention of Money Laundering Act would approve provisional attachment, the properties so identified would be attached by the agency pending further procedures.

6. THE EMERGENCE OF SERIOUS FRAUD INVESTIGATION OFFICE (SFIO)

The SFIO was established in 2003, as a body of the Ministry of Corporate Affairs, on the basis of the recommendations in the Naresh Chandra Committee Report on Corporate Audit and Governance. The committee felt that there was a need to establish "a multi-disciplinary team that not only uncovers the fraud, but is able to direct and supervise prosecutions under various economic legislations through appropriate agencies." As per its charter, the SFIO is to investigate those cases that are complex in nature and involve inter-departmental and multi-disciplinary ramifications. Accordingly, the staff of the SFIO includes experts in varied fields such as accountancy, forensic auditing, investigation, law, taxation, information technology, capital markets and financial transactions. Among the high profile cases investigated by the SFIO, the Satyam scandal is perhaps the most notorious. The SFIO has also probed the alleged Rs.870 crore fraud in Reebok India. It has also spearheaded the investigation into Sesa Goa's alleged over and under invoicing of exports and imports worth over Rs.1,000 crore[10].

Despite the tough remit set for the SFIO and the complex nature of the cases handled by it, the functioning of this non-statutory body is hemmed in on many sides. Its powers are largely restricted to examination of documents and it does not have the powers of search, seizure and arrest. The SFIO also operates within an elaborate matrix of investigating bodies with overlapping authority over such cases; the CBI, the Central Economic Intelligence Bureau, the Reserve Bank of India and the Securities and Exchange Board of India (SEBI) being some of the other bodies which have also been granted investigative roles and powers. Keeping these shortcomings in mind, the Companies Bill 2012 (which was passed in Parliament in December last year) has attempted to strengthen the SFIO. In its new shape, the SFIO will be a statutory body with the ability to initiate prosecution when directed by the Central government. The investigation report filed by the SFIO with the criminal court, for framing of charges, will be deemed to be a report filed by the police under the Code of Criminal Procedure. This measure will avoid duplication of duties and delay. The director of

[9] *ED preparing to attach Saradha properties*, National, The Hindu, July 3, 2013
[10] *Giving teeth to the serious fraud office*, The Hindu, June 13, 2013

the SFIO will have the power to arrest persons if he has reason to believe that such persons are guilty of certain offences, including fraud under the Companies Bill. An investigator of the SFIO will have the powers vested in a civil court under the Code of Civil Procedure with respect to discovery and production of books of accounts and other documents, the inspection of books, registers and other documents and the summoning of and enforcing of attendance of persons. Significantly, the Bill attempts to pre-empt the confusion caused by multiple agencies investigating the same case. Where a case has been assigned to the SFIO, no other investigating agency of the Central or the State government is to proceed with investigation. Further, any other investigating agency, State government, police or income tax authority having information or documents with respect to an offence being investigated by the SFIO is required to make such documents available to the SFIO.

While the new framework is a definite step forward, the dependence on the Central government to institute investigations is of some concern. Under the Companies Bill, in order for the SFIO to investigate a company, the Central government must be of the opinion that such investigation is necessary. Additionally, the SFIO may initiate prosecution only when the Central government directs it to do so. The alleged involvement of politicos in the Saradha scam, as well as the recent uproar over the government's interference with the CBI investigation into Coalgate, sharply highlights the danger of such dependence. Further, the efficacy of the SFIO will also be determined largely by the adequacy of resources and manpower devoted to it by the Central government. It is interesting to note that SEBI also has the powers of a civil court with respect to production of documents — powers which have been granted to the SFIO under the Companies Bill. The Saradha group, nevertheless, allegedly avoided providing pertinent information to SEBI by doing a "document dump" of cartons of irrelevant information. The absence of adequate resources and manpower could, thus, quite easily thwart the new SFIO. It remains to be seen whether SFIO's authority to arrest will act as a sufficient deterrent to such attempts to cloud the investigation.

One must also keep in mind that the changes contemplated by the Companies Bill are of import only after a scandal breaks out. These measures are not pre-emptive in nature and they are not likely to have a significant effect on the stage at which the government becomes aware of a fraudulent scheme in motion. There is, therefore, an imperative need to strengthen scrutiny at the level of the Registrar of Companies — the first level of detecting the problem. A company is required to submit various documents to the Registrar as a part of the compliance requirements under law. An SFIO investigation may be based on a Registrar's report that a company's affairs are being carried out in an unsatisfactory manner. It is also essential to create linkages between complaints made at the first instance by private individuals with the police and other regulatory bodies, on the one hand, and investigative bodies such as the SFIO, on the other hand. Effective corporate governance is, thus, predicated on coordinated action of the various enforcement agencies[11]. Thus, SFIO will pave way for a whole new definition of active investigation with rigorous monitoring mechanism and improved scientific understanding of such scams to nip at the bud.

7. PONZI SCHEME: A BRIEF OVERVIEW

In 1920, an Italian Immigrant named Carlo "Charles" Ponzi established the Securities Exchange Company. Ponzi offered investors a choice between a fifty percent return on a 45 day investment and a 100% return on a 90 day investment. Ponzi claimed that this return on

[11] *Ibid.*

investment was possible due to his unique understanding of the international postal reply coupon system; by international agreement, postal reply coupons were recognized by all countries but the cost of these coupons varied dramatically from country to country depending upon their economy. Although true in principal (an IPRC that cost a penny in Germany cost a nickel in the US), Ponzi was fully aware that the scheme did not work in actual practice because of importation restrictions. Nevertheless, the story sounded good. Investors did receive the interest on their investments that they were promised and the investments poured in. This was not a revenue generating business enterprise supported by investors; there was no underlying business whatsoever. This was an investment generating scheme that relied entirely upon today's investors to meet the obligations due to those who had invested 45 days previously. A Ponzi scheme's indebtedness increases as a function of geometric progression; however, the enterprise generates income so long as the pool of investment capital increases faster than the debt accrued. The reason that these schemes are illegal is that, as is the case with their pyramid cousin, they are mathematically doomed to collapse.

Due to the fact that there is no source of revenue other than the investment pool used to pay debt, the "Classic Ponzi Scheme" will be immediately exposed in any audit. According to generally accepted accounting procedures (GAAP), any Ponzi scheme is insolvent from the moment of its inception and becomes increasingly insolvent each day that it is in operation. The essence of a Ponzi Scheme is investment. The Ponzi operator typically represents that he has some sort of "system" that is either incredibly complex, or a proprietary secret. His system makes it possible for him to pay incredible rates of return. The elaborate office, exquisitely tailored suits, involvement with the church, and generosity toward charitable organizations are all classic window dressing. Ponzi schemes do not decline and fall; they are typically hugely successful until they collapse. Everyone is making money, everyone who wants their money out gets paid, and everyone is happy until the regulators shut it down or something precipitates a run on the bank.

To deduce similarity, a Ponzi scheme and chit funds operate on the same principle – that is divide, distribute and rule. This is thus a sequence of multi level marketing (MLM) skills adopted, crude thinking over unsound marketing decisions and strategies adopted without having a sense of humanity. As a closing note to this paper and as final remarks, all literate and illiterate waiting to save their hard earned money must obey and learn the basic warning signs and help yourself while we believe the state will also ensure that our collective interests are not slashed and taken aback. The principles of good conscience, faith and justice should reign, more so in transactions dealing with people's lives.

8. PONZI SCHEME WARNING SIGNS

As with any investment, advise[12] your clients to carefully evaluate any prospect promising unusually high returns and/or a multilevel marketing opportunity and the timeless doctrine of *caveat emptor* (Let the buyer beware) would apply to all contracts, even ones in which significant sums of money have been lost. We must remember that every scam reduces the number of people who could be misguided with another. The sheer population of India makes this a time-consuming task. Over a period of time, investors would realise that staid, but regular, returns from the usual fixed deposit with the neighbouring bank are better than

[12] http://www.fraudsandscams.com/warnings.htm

dubious promises of doubling one’s money from an exciting, far-flung projects by individuals and obsolete firms.

These below mentioned 11 key points must be remembered and should be considered the ultimate rule of thumb while being lured into an investment scheme.

1. Avoid any program they must pay to join where they are promised a commission based upon their success in recruiting investors or a “downline.”

2. Avoid plans requiring the purchase of expensive products and marketing materials (often called tools).

3. Be highly skeptical of plans involving miracle products or promising enormous earnings at no, or low risk.

4. Beware of shills - "decoy" references paid by a plan's promoter to lie about their earnings through the plan.

5. Decline to pay for anything, or sign any contracts, in pressure-filled situations. If they have already committed, have them send the promoter a written notice of their intent to cancel as soon as possible.

6. Be diligent in checking claims, backgrounds, references and use the governmental resources available to potential investors like the City and State head offices of Income Tax authorities.

7. Always get information about the investment in writing before investing. Any legitimate investment opportunity should have an offering circular with specific, detailed information about the company and the investment.

8. If the promoter claims that the information is too complicated to understand, or that time is of the essence, pick another investment opportunity. Do not believe in “secret” strategies, proprietary programs, or any other mysterious offering – nobody should ever invest in anything they do not understand.

9. Never, ever, attempt to get clever with the Income Tax authorities – by all means, they should protect their assets, but it is insane to entrust their future to some Internet huckster promising tax relief. The mere appearance of criminality may result in a federal prosecution that will ruin them, whether they are ultimately convicted or not.

10. Remember that no matter how good a product, and how solid a multilevel marketing plan may appear to be, there is no “free lunch.”

In conclusion, let’s be alert today to be alive tomorrow. A quote and a respected thought we must all learn and imbibe for our benefit, for being cautious from emerging scandals and to become a learned citizen. While making considerable and constant efforts to spread the good word and encourage investments for safety of self, family and the society.