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A Gap Analysis on Regulation of Collective Investment Schemes in India

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ABSTRACT *The Securities and Exchange Board of India was created to promote, regulate and protect the securities market as also the investors thereon and to this end it was vested with statutory powers. The increasing complexity of the financial markets witnessed in the eighties unravelled financial schemes that defrauded investors by promising exorbitantly high returns on their principal investment. It was in response to these Ponzi Schemes that the SEBI formulated regulations encompassing Collective Investment Schemes (CIS) that specifically characterised a unique manner of financial manipulations. However, a decade after its inception, CIS seems to be an uncontrollable behemoth wreaking havoc in an unregulated financial environment, the recent scams in the financial market bearing testimony to this. This submission seeks to briefly showcase what CIS is, and how they are regulated as whilst simultaneously studying the impact of the 2014 Securities Laws (Amendment) Act.*

KEYWORDS : Collective Investment Schemes, SEBI, Financial Market, Investor Protection

ANALYSIS

The overarching issue in this submission, in which direction an introspection has been attempted has had an adverse influence on millions of investors in India, and though classification of its various nuances has been sketchy, it has proven itself to be one of the greatest threats facing the financial world today. The once magnificent Collective Investment Scheme (Hereinafter referred to as CIS) has partaken the character of an investor repellent in the backdrop of the Sharada Chit fund scam. It may be trite to say that the unassuming public are often mystified with these supposed chit funds, indicating a patent lack of awareness pertaining to the regulatory framework of CIS which is not only sheltered by the Securities and Exchange Board of India (Hereinafter referred to as SEBI), but has also gained predominant consideration within the 2014 Securities Law (Amendment) Act.

Though the Sharada Scam made this term a household utterance, ponzi schemes had originally gained predominance in the eighties with red flags being raised in the financial market regarding financial schemes which assured investors high returns within a short interlude. Such schemes were the hallmark of Plantation Companies, Agro-based private entrepreneurs who were raising monies to commercialise certain plantation related activities. The stratagem of its implementation was ingenuous, owed partly to its inherent simplicity. Funds were primarily sourced from ordinary investors along with minimal contributions from promoters as well, all premised on the irresistible allure for any investor; a promise of high returns of approximately 18-30% or incentives which even assumed the character of land ownership thus creating a sense of security, which was combined with aggressive marketing in rural areas. The enticement of effortless wealth pooled large tranches of money from unwary customers in short periods of time and this success in illegality led to its proliferation in several regions across the country.

In its most nascent stage, until the CIS regulations were drafted, SEBI vide its press releases dated November 26, 1997 and December 18, 1997 launched a strict prescription that no person could sponsor or cause to sponsor any new CIS and thereafter raise further funds. Such agro bonds and plantation bonds were read into the purview of the SEBI Act, 1992. The S.A. Dave Committee, which was formulated to draft the Regulations in its report dated 5th April 1999, highlighted pooling of investments, management by entities, and absence of day to day control of the investors as the key criteria to identify, isolate and eradicate illegal CIS. Consequently, the SEBI (Collective Investment Schemes) Regulations, 1999 were issued on October 15, 1999 alongside the Securities Laws (Amendment) Act, 1999 which added Section 11AA to the parent SEBI Act, all together regulating the CIS in India.

The crucial ingredients endorsed in Section 11AA (2) of the SEBI Act identifying the CIS are:

- Contributions made by investors are pooled and used in different schemes.
- Object of the contribution is to earn profit, income, produce or property.
- Investors have no control on the management of funds, which are managed on their behalf.

A surprising twist to this saga was the challenge made to the constitutional validity of Section 11AA on the fragile and insubstantial assumption that the sale and purchase of agricultural land and/or development of agricultural land cannot be regulated by a Parliamentary legislation, being a subject enumerated under Entry 18 of the State List. Whilst rejecting this contention as misconceived, the Court held that on examining the issue of legislative jurisdiction, the pith and substance rule is relatable only to the objects and reasons of legislation and it isn't the activities of a party that hold relevance in this realm of jurisprudence. Clarifying that the pith and substance of the legislation was 'investor protection', the Court upheld its validity by placing the same within the residuary clause under Entry 97 of Union List thereby giving the Parliament the right to legislate on the subject matter.

In the backdrop of the judicial approval that was established in its favour, an examination of the features of this provision becomes essential. The more fascinating aspects of India's law on CIS are the exemption categories which it offers. The law specifically excludes investments made in co-operative societies, NBFC's, mutual funds and even chits funds. Oddly, in most of our western counterparts, there is a lack of uniformity in the jurisdictions regulating CIS. For example, while in the UK a CIS includes unit trust schemes, the US excludes them as well as mutual funds. Thus, it becomes imperative for us to understand that a traditional chit fund does not necessarily possess all the characteristics of a CIS. This submission merits that we briefly delve into a discussion of the Sharada Scam, which is a stellar example of the aforesaid differentiation.

The Saradha Group was a consortium of over 200 private companies which allegedly collected around200 to 300 billion from over 1.7 million depositors by initially issuing secured debentures and redeemable preferential bonds. These were thereafter changed frequently so as to acclimatize to SEBI's persisting investigations, predominantly in states such as West Bengal, Jharkhand, Assam and Chhattisgarh where the group had secured its maximum reach. Promoters of the CIS hatched up their Schemes as having the disposition of a chit fund, thereby giving the impression of State complicity who seemed to be the regulator of chit funds. Despite SEBI classifying the group's activities as CIS and demanding it to stop its operations, the Sharada group continued its investment schemes until it collapsed in April 2013. The fact that ongoing investigation was handed over to the CBI after being strongly condemned by the Judiciary is indicative of declining investor confidence in SEBI's ability to regulate the actions of CIS. Nev-

ertheless, if one were to render an accurate account of SEBI's actions, it may not be precise to completely discount the credibility or the endeavours of the SEBI in curbing this problem, the sufficiency of these endeavours being the only question thereon.

Until late, numerous instances have been reported relating to CIS, thus creating a predicament as to whether SEBI has truly protected investors from the clutches of CIS. In their quest to tackle this menace, the SEBI (Prohibition of Fraudulent and Unfair Trade Practices relating to Securities Market) Regulations, 2003 was amended in 2013 thereby categorizing any illegal mobilization of funds carried on as CIS by any person a fraud and made provisions for it to be dealt with accordingly. However, data from the SEBI website, till April 17, 2012 indicates 179 judgments in CIS related prosecution matters and as of July 31, 2009 almost 552 prosecutions were launched by SEBI against CIS entities. In the absence of any further strictures forthcoming either from the SEBI or any other regulatory body, fraudulent entities are bound to entrench themselves in a legal and social system which is plagued with public ignorance and governmental apathy. This realisation ought to have been the very reason SEBI sought greater powers via the Ordinance, which finally became The Securities Laws (Amendment) Act, 2014. The Act amends the SEBI Act, 1992 as well as introduces consequential changes in the Securities Contracts Regulation Act, 1956 and the Depositories Act, 1996.

These vital changes brought about concern the expansion of the definition as to what constitutes a CIS. Section 11AA of the principal Act was amended to include a new proviso which gave SEBI the power to regulate all pooling of funds under any scheme or arrangement in excess of 100 crores not regulated by any other law, thus slipping into the net of a CIS. Although this indirectly relaxes compliance with some of the otherwise mandatory conditions such as having operational or managerial control of funds, taking into consideration the investor protection mandate of SEBI such an action may be justified. Yet another investor friendly addition is that the former manner of identification of a CIS being run as an 'company' has been replaced by 'persons', which includes natural and artificial persons, and thus activities of any 'person' which qualify the requirements under the section, will be prosecuted by SEBI. The alternate argument however has found a substantial voice in saying that the power granted to SEBI to frame regulations and specify conditions which may categorise any scheme as CIS is excessive delegation of legislative powers as the SEBI could identify and pinpoint schemes over which it chose to exercise its jurisdiction as opposed to the general and slightly fairer practice of being governed by the tenets of the parent act when it came to identification.

Incidental to these changes, are the amendments related to power to order disgorgement without a Court order, powers to search and seizure with the prior authorization of SEBI chairman and to attach property without actually seeking the Court's permission etc.

FINAL NOTE

Whilst describing the CIS as a complicated regulatory regime, the OECD Occasional Paper emphasised the CIS sector as being characterised by complex agency relationships as well as by asymmetry in market power and information. Identifiable issues range from cases of fraud and misrepresentation of asset portfolios to instances of conflict of interest wherein there are possibilities of financial operators managing assets in their own interest as opposed to the benefit of the investors. Thus, without proper safeguards or an adequate investor protection framework, CIS becomes an excessively risky area to venture into.

Two recent events have indicated the inadequacy of the safeguards provided in our legal framework to protect investors from such Ponzi schemes. The first incident involves the firm Pearl Agrotech which continues to collect funds from investors defying the market regulator's ban. Such moves were undertaken even after its activities were branded as a CIS and because it was not registered as a CIS within SEBI's regulatory overview, Pearl Agrotech were made liable to refund around Rs 50,000 crores raised from over 58.5 million customers. The second incident however is even more drastic with the Supreme Court questioning SEBI's lax approach in handling the Saradha scam and the CBI's decision to probe four SEBI officials for their alleged involvement. Such occurrences point towards a degenerating system which is in need of a major overhaul in order to sustain the hope that these new changes would be able to intensify the scrutiny and bring the necessary stability in the financial market against the proliferation of unregulated and illegal collective investment schemes.

However, SEBI's latest developments indicate that it has set aside the old adage that 'one must first keep its own house in order before venturing into another', as SEBI seems to be in hot pursuit of regulating newer activities like crowd funding. It is imperative to halt and introspect as to how effectively SEBI can guard the securities market with its new powers rather than bringing in new frontiers for its jurisdiction. This submission began and ends with the profound hope that that the existing and new powers vested with SEBI would be effectively used so as to provide the best possible protection to the Indian investor Community.

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