Article

Financial frauds in India: An enquiry into their causes and cures

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07th March, 2014

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Article

Financial sector regulatory laws in India are an edifice built on a landscape of frauds – every major fraud would lead to a new law. In all cases of financial frauds, fraudsters have taken advantage of human fallibilities and lack of awareness and cheated hapless depositors into putting their money into get-rich-easy schemes. All this would have actually been carried in broad daylight, while regulators either pretended to be unaware, or were just caught in jurisdictional squabbles. Mostly the fraud machine would have collapsed under its own weight – which is quite natural for such schemes. And then, regulators would have jumped into action and passed a new law, quite often curbing enterprise itself merely because of an aberration[1] in their suddenly discovered over-enthusiasm.

India is not an exception in reactive law-making. The mammoth US law, Frank Dodd Act, was admittedly enacted following the Sub-prime crisis of 2007-8. However, the Damodaran Committee[2] specifically and significantly has made recommendations that laws should be based on policy and principles rather than as a reaction to isolated happenings.

This article does a quick review of major financial frauds over the last few decades, and whether such aberrations happened due to lack of law, or lack of implementation. We examine whether split regulation of the financial system creates a scenario of regulatory uncertainty, resulting in delays in timely detection and injunctive action. Finally, we get into the significant question of professionals' responsibility with respect to frauds.

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[1] One of the best examples of such over-enthused law-making killing an instrument because of an accident, is optionally convertible debentures (OCDs). The draft rules of the Ministry of Corporate Affairs on public deposits seem to be taking away the exemption available to OCDs from the definition of "deposit", the only ostensible reason for which can be the misuse of the instrument as noted in Supreme Court ruling in Sahara Financial. The Supreme Court directed SEBI to provide inputs on what OCDs are: "In this matter the questions as to what is OFCD and the manner in which investments are called for are very important questions." *Order dated May 12, 2011 in Petition for Special Leave to Appeal (Civil) No.11023/2011*

[2] See Report of the Committee for Reforming the Regulatory Environment for Doing Business in India: "It has been noticed that very often regulations are brought into effect in order to address a single instance of transgression or misdemeanour, or even non-compliance, intentionally or otherwise, with the content or form of existing regulations.
(http://indiainbusiness.nic.in/newdesign/upload/Damodaran_Committee_Report.pdf)

Brief history of financial frauds

The common feature in financial frauds is fund-raising by a sponsor, under promises of quick or easy money, while the sponsor clearly knows that the promise is unlikely to be met by gainful investment of the funds so-raised. Most such fundraising is via Ponzi schemes. The whole enterprise lacks economic sustainability; fund-raising is done by mobilising extensive highly-rewarded network of agents. The targets may either be hapless rural population who have low access to regulated banking system for channelizing their savings, or are simply lured with high returns or by a herd mentality, or urban population by exaggerated performance track record offering alluring rates of return.

Since most financial frauds raise money from public, it is necessary to understand the deposit regulation in India. India is one of the few countries in the world which allows non-banking non-financial companies to raise deposits from the public. Cotton mills in Maharashtra and Gujarat relied on deposits to quite an extent in the 1960s, and burnt lot of investor's money, thus ushering the restrictions on deposit-taking in Companies (Acceptance of Deposits) Rules, 1975. Soon thereafter, the Reserve Bank of India decided to proceed against Peerless General Finance and Investment Company running a savings certificate scheme and a set of rules called the Miscellaneous Non-Banking Companies (Reserve Bank) Directions 1977 and the Non-Banking Financial Companies (Reserve Bank) Directions came into force in 1977 on recommendations of the James Raj Committee. Also, the Prize Chits and Money Circulation Schemes (Banning) Act, 1978 was enacted to ban pyramid schemes which thrived on circulation of depositors' money.

Sanchayita scam

While the RBI and corporate regulators were still vigorously implementing deposit restrictions, Sanchayita Investments was collecting money. In 1980, the scam got exposed but by then more than 1,31,000 investors had placed money into the company. The FIR stated that the firm had been offering fabulous interest at 48% per annum to its members, later reduced to 36% though the loan certificate receipts showed the rate of

interest to be 11% only.[3] Sanchayita had raised more than Rs 1.2 billion[4] before it imploded. Soon after, chit funds became a hot political issue, leading to the enactment of the Chit Funds Act, 1982[5].

Equity Boom Of the 1980s

Indian stock market saw an equity boom in the mid-1980s, best reflected by the Sensex which went from 200 in April 1983 to 600 in August 1986, implying annualised returns close to 100%. This was the time when there was no Securities Exchange Board of India (SEBI) and capital issues by companies were regulated by Controller of Capital Issues. However, to ride the wave of public interest in capital issues, companies made good use of the so-called "private placement", which, in essence, was nothing but a public offer. The frenzy of public offers, or privately placed "bought out deals" continued for quite some time, and often, investors discovered, to their painful surprise, that several of the companies that raised public money ostensibly for projects were just not to be seen at all. Thus came the infamous word "vanishing companies" As per the MCA site, there still are 121 vanishing companies. The Joint Parliamentary Committee Report on Investor Protection cited one of the representations before it thus: "In the years immediately after liberalization, 1.5 crore new investors, small investors as we call them, came into the market between 1992 and 1996 through IPOs. They were duped. At that time Rs. 86,000 core were raised in four years through public issues and right issues by four thousand odd companies. Most of these 1.5 crore investors who came in for the first time in the stock market were duped…..Till date, 229 companies (only) have been identified by the Government appointed monitoring committee, as having made public issues and disappeared. No one has been arrested and no money has been recovered. There has not been even an action plan as to how to recover that money."[6]

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[3] *State Of West Bengal & Ors vs Swapan Kumar Guha & Ors*, 1982 AIR 949

[4] *Bengal in damage control, chit fund scam brings memories of '80s,* Indian Express, P Tapadar, April 23, 2013

[5] Interestingly, the Chit Funds Act was never implemented in West Bengal

[6] Text of the report is on http://www.watchoutinvestors.co.in/JPC_REPORT.PDF

The private placement syndrome was curbed only in 2000 when proviso to Section 67 (3) of the Companies Act 1956 was inserted.

Plantation companies

In late 1980s and early 1990s, thousands of investors across the country were lured to invest in plantation schemes which sold trees along with proportional interest in land to investors. Argument was simple – the tree or land unit was not a "security" – hence SEBI will not have a jurisdiction, and deposit rules will not apply as the transaction was not a "deposit" either. Some people even went to the extent of promising income tax exemption to investors, as the income will qualify as agricultural income. One of these schemes was run by Chennai-based Anubhav Group which offered 77 times return on a deposit of only Rs 6000 to mop up Rs 4 billion worth of investors' wealth.[7] Another company, GFIL had floated 9 lump sum and recurring investment schemes, issuing post-dated maturity cheques. By December 31, 1997, the company had mobilised Rs 1,037 crore.[8] According to the Punjab Vigilance Department, the total collections from investors had reached Rs 3,000 crore.[9] They paid only Rs. 450 crore to their investors. Plantations was only one possible label – investors could be buying cattle, or ostriches, or just about anything. Interesting part is that none of these schemes were raising money surreptitiously since fund-raising of this magnitude could not have taken place without resorting to media, agencies and collection networks. However, it was years after these schemes started collecting money that action was taken. In 1998, the market regulator SEBI issued caution notices against several hundred companies involved in plantation schemes, when these scams had already eloped with public wealth.[10] Many of the fraudsters are still at large and as many as 41 of these cases were dismissed.[11] . In November 1997, the government woke up to realize the need to regulate these entities

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[7] ICMR India, Anubhav Plantation Scam,
http://www.icmrindia.org/free%20resources/casestudies/Finance%20freecasestudyp2.htm
[8] Id.
[9] Id.
[10] http://www.sebi.gov.in/cis/pubnote.html
[11] http://www.sebi.gov.in/cis/ProsecutionDismissed.pdf

and asked SEBI to draft its Collective Investment Scheme regulations, which were finalised and adopted in 1999.

NBFC public deposits

While these scams were taking place on one end, many over-zealous non-banking financial companies had been raising public deposits at the other end. Strangely enough, the deposit rules allowed NBFCs to raise deposits of upto 1000% of their net worth; something that even strongest of the banks in the world would not achieve. Clearly enough, there were serious asset liability mismatches in case of NBFCs, as most of them would lend for tenures far longer than the deposits, which were mostly for 3 years. As one of them, CRB Capital Markets, went bust in 1997[12], depositors made a run on NBFCs and most them collapsed thereafter. As a result, the RBI framed new Directions in 1998 and made it mandatory for NBFCs to register with the RBI. Once again, the massive growth in the number and size of NBFCs was happening right under the sight of the RBI – however, the action followed only after the damage.

Saradha and other "chit funds" in West Bengal

Even as regulations had emerged with history of financial scams over a few decades, gullible depositors were lured with promise of attractive rates of return by several companies in West Bengal. To wriggle out of deposit regulations, these companies used schemes like booking of flats, booking of tours, etc., while in essence, the transactions were blatantly money-for-money transactions. Once again, most of this fund-raising was happening in full glare, while regulators were looking at one another as to who will actually bell the cat. For several years, until the Saradha Group imploded, so-called "chit funds"[13] were among the only business doing well in West Bengal. As the menace is still unfolding, it appears that most of the Eastern and North-East states have a massive proliferation of such companies, and painfully, one senior government officer says that companies are still being registered in Jharkhand as "potential Nidhi companies".

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[12] See discussion in *CRB Capital Markets Limited v Reserve Bank Of India*, 2007 135 Comp. Cas 86 (Del).

[13] The expressly widely used in the press for these schemes is actually a misnomer, as none of these companies were chit funds actually.

Sahara Group's OFCDs

Sahara India Real Estate Corporation and Sahara Housing Investment Corporation issued optionally fully convertible debentures (OFCDs) and started collecting subscriptions from April 2008 up to April 2011. During this period, the company had a total collection of over Rs 176.56 billion from about 30 million investors in the guise of a "private placement". SEBI passed an order only in June, 2011 when it directed the two companies to refund the money so collected to the investors and also restrained the promoters of the two companies from accessing the securities market. The matter went right up to the Supreme Court[14].

Other cases:

While the headlines have been dominated by these major deposit raising frauds, there have been many other frauds of a smaller scale elsewhere in the country. Promoters of a little-known company in Jaipur in Rajasthan named Gold Sukh promised 27 times return to investors in 18 months and managed to mop up over Rs 2 billion, leaving 200,000 investors in the hook.[15] Another such company was Abhinav Gold, which promised to pay investors Rs 1,72,000 after two years on an investment of Rs 6,000, defrauding 20,000 investors in Gujarat.[16] Another such scheme was floated by Mumbai-based City Limousine. The company promised investors Rs 4,000 every month for five years if they made an initial investment of Rs 97,000.[17] The scheme, launched in 2002, was supposed to invest the money collected to buy cars that were to be run as taxis. Another multi-level marketing

[14] http://www.sebi.gov.in/cms/sebi_data/attachdocs/1351500106870.pdf
[15] http://businesstoday.intoday.in/story/accounting-fraud-investment-schemes-ponzi-scheme-high-returns/1/22665.html; http://www.moneylife.in/article/another-mlm-company-gold-sukh-dupes-investors-for-rs200-crore/21722.html
[16] http://articles.economictimes.indiatimes.com/2011-11-07/news/30369458_1_ponzi-schemes-duping-investors-small-investors; http://businesstoday.intoday.in/story/accounting-fraud-investment-schemes-ponzi-scheme-high-returns/1/22665.html
[17] http://businesstoday.intoday.in/story/accounting-fraud-investment-schemes-ponzi-scheme-high-returns/1/22665.html

scheme was launched by Speak Asia, a Singapore-based company which promised Rs 4,000 monthly payout on an investment of Rs 11,000.[18]

How do financial frauds flourish?

It will be futile to get into why fraudsters do frauds? It might have to do with the sheer sense of self gratification, or the sense of pride in having beaten the system, or simply the urge to get rich soon. However, all that is a part of the fraudster-psychology which is not the subject matter of this article. However, this article is certainly concerned about how is it that frauds continue unchecked for quite a while, and it is only after a considerable irreparable damage is done that the regulators step into action.

We get into an investigation of some of the reasons below.

Multiplicity of Regulators and Regulatory Framework

From all these scams, a few things are clear. Firstly, there is a multiplicity of financial regulators in the country, which has given rise to gaps in the legislation and uncertainty about the roles of the regulators. This fragmented approach had not paid off but only enabled more frauds to happen. While the crux of all fund-raisings from the public is a money-for-money transaction, regulators go by the form of the transaction rather than by substance. So, if the scheme is purporting to be an ownership of asset or assets, it is a collective investment scheme, coming under SEBI's purview. If it is a receipt of money structured as a deposit or borrowing, it is a "deposit", which comes under the MCA if it is a non-banking non-financial company and under the RBI if it is non-banking financial company. Even if it is a financial company, if it is a "nidhi" company, it goes again under the MCA. If it is structured as a purchase of goods or advance for purchase of goods, it comes under neither, which is a strange view taken by the regulators and even the judiciary in case of the so-called jewellery purchase schemes.[19]

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[18] Crime Branch, Delhi Police, http://delhipolice.nic.in/home/backup/26-11-2013.doc

[19] *S B Agarwal v. SEBI*, PIL No. 43/2013, Bombay HC (Nagpur Bench)

Also, if the scheme is structured as a "multi level marketing scheme", there are conflicting court rulings on whether the scheme is at all a financial scheme[20].

The issue is simple – a purported plantation scheme, for instance, is not, in substance, a sale of plantations. The backbone of the scheme is not that the sponsor really wants to sell teak trees. Most of these schemes have buy-back provisions with a guaranteed rate of return. Even if paperwork does not show a guaranteed rate of return, the real conduct of the scheme will surely demonstrate money being returned within a short time. We need to understand that every sponsor of such scheme has to create a bunch of "satisfied customers" because that is how they popularise the schemes. So, if the "satisfied customer" comes only at the end of the 10-year scheme, there is no way these schemes will be able to sell the alluring benefits of the scheme to others. Hence, the customers who bite the bait will start getting fanciful returns in just a few months' time, thereby creating a compulsive temptation for lots of others in the community to plunge their savings into the scheme as well.

If these schemes are money-for-money schemes, how is it that the schemes do not come under RBI purview? Or, for that matter, if the RBI comes to detect that a particular scheme is actually a CIS, it may refer the same to the SEBI, or MCA in case of non-banking-non-financial companies. Reportedly, such inter-agency coordination committees are already at work, but their effectiveness is in doubt.

In the long-run, all schemes of raising money from the public in money-for-money transactions have to be under a single regulator. Currently, blame-shifting is the biggest escape of regulatory authorities, such that by the time real action is taken, it is too late.

(http://www.sebi.gov.in/cms/sebi_data/attachdocs/1385611633700.pdf)

[20] See, *Amway India Enterprises v. Union of India,* 2007 (4) ALT 808, Chandrachud, CJ held that two conditions must be satisfied for application of Prize Chits and Money Circulation Schemes Banning Act: (1) it must be proved that he is promoting or conducting a scheme for the making of quick or easy money; and (2) the chance or opportunity of making quick or easy money must be shown to depend upon an event or contingency relative or applicable to the enrolment of members into that scheme. Notably, US regulators have framed elaborate guidelines that distinguish genuine direct marketing schemes from those that are illegal. However, India has so far done nothing in this regard, though there are several MLM schemes floating which would be illegal under the US law.

Political Nexus

There seems to be a vicious political nexus between the perpetrators and the political honchos of the centre and states. For a scheme to raise a billion units of money from over a million investors is not an overnight job. It requires building a coordinated structure thriving on the back of political immunity. Even in a country like United States, some of the roots of major financial crises have been traced to perverse forms of patronage and lobbying leading to political unwillingness to regulate banking entities. The savings and loans crisis of the 1980s and 1990s and the recent financial crisis of 2008 have amply exhibited the callous role that regulators and politicians played in return for campaign contributions and high offices. It is unlikely that the authorities in India are any more honest.

The abuse of power may not be limited to the higher echelons of the Executive branch because Ponzi schemes would typically employ local authorities and political outfits within each of its areas of operations.[21] Sometimes, the local politicians decide who the agents of the company will be for that area and also induce targeted members of the public to participate in the scheme. They may themselves administer the process of fund collection and disbursement. They may also be in a position to exercise undue influence over local police departments and investigating officers. Using this model, disputes of individual consumers can be settled quietly without exposing the fraudulent nature of the entire scheme to public scrutiny. For example, under Section 45T of RBI Act, both the RBI and State Governments have been given concurrent powers to action against unincorporated bodies. Nonetheless, in order to take immediate action against the offender, the information should immediately be passed on to the State Police, which may be constrained by political patronage. In the case of Overland Investments, the Calcutta High Court had observed that "the State knew the affairs of these companies but we do not find any reason why the State waited for a long time in the matter of bringing to the notice of the Court inasmuch as long delay might have caused serious prejudice and loss to the depositors. The State should have come to this Court long back when the

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[21] See, *Once again a Ponzi lays waste*, Economic and Political Weekly, XLVIII (19),2013

State had come to know all the affairs of the company which according to the State was highly prejudicial in public interest."[22] But nothing much has changed since then.

It is surprising to see that there are scary anti-fraud provisions against corporate executives and professionals, for floating or colluding in fraud schemes, but there are none in case of politicians, bureaucrats and public officers. If the law-makers thought it fit to provide for a minimum sentence of 6 months going upto 10 years in the case of corporate executives[23], it is painful to see there is no equivalent in case of public officers.

Regulators Going For the Form, Not Substance

The financial jurisprudence in the country follows the letter of law and not the spirit. It was interesting to see the best legal brains of the country using literal sophistry as to why the OFCDs in case of Sahara were not covered by SEBI's jurisdiction. The deposit regulations are still based on whether there was a deposit of money, which is commonly interpreted literally, providing an escape route by structuring the *de-facto* deposit transaction as a purchase of goods, purchase of jewellery, advance for services, or a simple ownership of an asset. Compare this with the Moneylenders Acts of the pre-independence era, where loans were identified on the basis of substance and not form[24]. Consequently, every now and then there are schemes which are raising public deposits in disguise of a literal facade. It would not take much to put in the RBI Act a definition of a deposit similar to the Bengal Moneylenders Act 1940 which captures a "deposit in substance", and leaves a power of determination to a certain quasi judicial body. This would ensure quick remedial action.

Financial inclusion and the outreach of regulated institutions

India has a large low-income rural population with limited access to formal banking services and the large vacuum that regulated institutions leave is opportunistically filled

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[22] See, *Overland Investment Company v State of West Bengal,* AIR 1997 Cal 18

[23] Sec 447 of the Companies Act, 2013. The section is already effective from 12th Sept 2013.

[24] Bengal Moneylenders Act 1940 Section 2 (12) defines a loan to mean an advance either of money or in kind made on condition of repayment with interest and to include any transaction which in substance is a loan.

by unregulated financial operators. While no regulated institution can offer as luring interest rates as fraudsters can, but at least, the wiser of the rural folk have to have an alternative mode of putting in their savings. The idea of financial inclusion has to be seriously carried forth – quite often, development itself is an effective remedy to oppression.

The role of professionals

It goes without saying that the role of professionals, whether in employment or serving audit roles, is supreme in putting checks and balances in the system. Professionals are the extended arms of the regulators – regulators never get the inside story; professionals do. It is, therefore, in right spirit that the Companies Act 2013 casts a duty upon any auditor (and the term includes a secretarial auditor as well) to report frauds to the Central Government. There will surely be attempts at carving out literal gateways of escape to this section – it may be argued that the section applies only to frauds against companies. However, it must be noted that "fraud in relation to" as defined in sec. 447 covers frauds where the company has been used as an instrumentality. The company does not have a brain of its own – so those running company are responsible for any of the company's fraudulent acts. If the company has been used for any financial fraud, it is surely something that works against corporate interests, and therefore needs reporting.

No perpetrator of fraud can ever do much without the active assistance of professionals. Quite often, we use sophistry of argument to create structures which provide such fraudsters the shelter in which they operate. Every financial fraud business is full of violations – in letter and spirit. These become evident at the first glance at their business operations. Whether one is the secretarial auditor, or statutory auditor, or internal auditor, or a bond trustee, or rating agency, or just legal adviser – one can easily smell what is the real intent behind the complicated web being woven by the sponsor of the scheme. There, one may put short-term personal avarice in the background and take a larger view of public interest involved. It is true that as professionals, we do not have to take a larger role upon ourselves than what is conferred upon us. For example, if a client has done what seems like a wrong of the law and approaches us for defending, we cannot sit in the

position of a public prosecutor. But where a client approaches us for advising whether to do what he is proposing, we should advise client against it, cautioning of the long-term implications of the scheme he is devising.

The new regime has extremely harsh penal consequences with mandatory imprisonment in case of frauds. If indeed this was needed to make professionals aware of what otherwise should have been self-realisation, then the law now provides it. However, law-making breeds knit-picking, of holes to find a way out of the law – it is indeed more of a conscience that professionals need to invoke. Long term interest, whether in business or in profession, is always better served by scrupulous practices. It may be tempting to see the exponential rise of a short-term operator, but the fall is often far more painful than the rise. It takes years before an ex-fraudster regains social acceptability. On the contrary, one may choose to live a bit less lavishly, but with head high.

**** The author wishes to note the contribution of Shambo Dey, a Research Officer at Vinod Kothari & Company.**

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