Analytical Speaking

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Collective Investment Schemes or How Gullible Investors continue to lose money

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At one point of time, it was plantation companies raising money from investors for teak trees in unseen remote place of Madhya Pradesh. Then there were kind of ponzi schemes pretending like purchase and sale of assets but essentially giving investors money for money. Of late, several property companies, mainly from the NCR region, have been widely advertising offering "guaranteed returns" to investors for investment in properties. SEBI has reportedly sprung in action against one of these, but that is only one. Daily newspapers from Delhi are full with ads of property companies offering secured, guaranteed returns on properties. In fact, one of the leading property companies, promising to build another Connaught Place, has advertised in all India newspapers inviting contributions from investors to invest in properties. This has brought to focus the seldom-noticed provisions about "collective investment schemes".

The lure of easy money has always been strong enough, and surprisingly, well-reasoned people are very easily taken by promises of making a decent return backed by secured investments. It is not that regulators have not warned investors enough; it is also not that in the past, investors have not suffered. In fact, the operators of the scheme know that it is a short-lived schemes; the investors also know it is risky investment, but some how, interest has such an intoxicating impact on people that every now and then, one such scheme succeeds in attracting investors. And if person succeeds, it is then the demonstration effect – if the next-door uncleji has invested money and earned 18%, why would I not do it? Or, if Bobbyji has raised crores of money out of nothing and is leading a lavish life, why wouldn't I do it?

The modus operandi is simple – a property company or a property developer will invite people to invest money in land/plots/flats or simply to-be-constructed properties. Sometimes, the land/plots/flats are for real; sometimes, they are not. Assuming they are for real, an investor becomes the investor or allottee of the plot or land, with an agreement to execute conveyance whereby at some time in future, the plot or the property will be transferred to the investor. Actually, however, the investor never intends to buy the plot or property in question – he simply intends to invest money. So, after a fixed term, say a year, the investor surrenders his right to get the property, and gets back money with a promised rate of return.

This write up examines the legalities of schemes such as above.

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Regulations on collective investment schemes:

A Collective investment scheme (CIS) is regulated by section 11AA of the SEBI Act, according to which a scheme or arrangement where contributions, or payments made by the investors are pooled and utilised with a view to receive profits, income, produce or property, and are managed by a manager on behalf of the investors is a CIS. Investors do not have day to day control over the management and operation of such scheme or arrangement. The law states several exceptions to the definition of CIS, such as NBFC deposits, public deposits u/s 58A of Companies Act, chit funds, Nidhis etc. Notably, mutual funds are also excluded from the definition. Also note that a portfolio management scheme is not covered by the scheme as there is no pooling of money.

The key words in the definition are “pooling of investors’ money” and distancing of ownership and management of the funds. In other words, if the money raised from investors for sharing of profits or returns is commingled, there is CIS. The investors are passive investors; they are not managing their own money. So, the three critical features of a CIS are:

(a) pooling of money;
(b) entrustment of money to someone such that the investors are not the ones who are managing their own money; and
(c) sharing of returns from a specified investment.

CISs need to be registered with SEBI. A copy of the offer document of the scheme has to be filed with SEBI – same as in case of IPOs and FPOs. The scheme also needs rating. Besides there are several very stringent requirements – someone who is in a hurry to collect public money will surely not have the patience to comply with the regulations.

Regulatory history of collective investment schemes:

The CIS Regulations were made after plantation schemes had robbed a good amount of public money and the government came under severe critique. SEBI appointed this committee under the Chairmanship of Dr. S. A. Dave. The Dave Committee submitted its report in December, 1998 and the CIS regulations by way of notification by SEBI came in October, 1999.

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There are several rulings on the issue of registration of the existing CIS floated by many companies. There are hundreds of companies that had not applied for registration under the Regulations and had not wind up its CIS to repay investors in accordance with the Regulations and hence barred by SEBI from operating in the Capital market for few years (in many cases for 5 years). SEBI has requested the respective State Governments to initiate civil/criminal proceedings against the entities for apparent offences of fraud, cheating, criminal breach of trust and mis-appropriation of public funds. It has also requested DCA to initiate winding up of the entity u/s 433 of the Indian Companies Act to repay investors and has launched prosecution against the entity and its directors u/s 24 and 27 of the SEBI Act, 1992. As on 31st March, 2011, there are 552 companies against which prosecution cases were launched for violation of CIS Regulations.

In case of *Suman Motels Ltd. vs SEBI on 13 January, 2003 (2003 42 SCL 433 SAT),* it was held by the Securities Appellate Tribunal (SAT) that the order of SEBI directing the Appellant to refund the money to the investors was in no way faulty. The Appellant Company cannot claim that it is not required to comply with the requirements of the Regulation and the Respondent (SEBI) entrusted with the duty of enforcing the Regulation should not enforce the same.

On 23.1.1998 SEBI decided to undertake a special audit of those CIS which had mobilized an amount of more than Rs. 5 crores from the public, which included M/s Paramount Bio-Tech Industries Ltd. It was informed that a sizeable portion of the amount mobilized has been paid for commission expenses and the agencies were of the opinion that these companies were deploying the funds received from the public for non banking financial companies, real estate etc. The Allahabad high Court in case of *M/S Paramount Bio-Tech Industries Ltd. vs UOI on 25 November, 2003 (Civil Misc Writ Petition No 51911 of 1999)* dismissed the petition when the petitioner company questioned the framing of the regulation by SEBI, by stating that the facts of the case reveal that the respondent (SEBI) is only regulating the investments to protect the interest of the investors who invest in various securities/bonds in the nature of Collective Investment Schemes. In their opinion Parliament and SEBI have the legislative competence to frame the Act and Regulations.

The Punjab & Haryana High Court in the case of *P.G.F. Ltd. vs Union of India on 30 July, 2004 (2005 124 CompCas 201 P H, (2004) 4 CompLJ 288 P, H),* held that in this case, a transaction for purchase of agricultural land in the name of several investors was found to be a CIS, but then the facts of that case clearly indicate that the entire transaction of purchase of land was running as a sham. It was not proved whether land was actually bought at all, or registered in the name of the so-called investors. Hence, that case is not of precedent value for the Scheme. Decided that the transaction that was alleged as a CIS as, though in the guise of purchase of agricultural land, it was actually a pure money circulation scheme and it was a sham.

Deposit schemes or collective investment scheme:

If, in the grab of so-called investment schemes, what is being raised is a pure deposit, then RBI regulations are applicable. The definition of **"deposit"** is provided under section 45I(bb) of the Reserve Bank of India Act, 1934, that includes and shall be deemed always to have included any receipt of money by way of deposit or loan or in any other form. Hence, money for money transactions is deposits – that is, if against money, the CIS offeror offers repayment in form of money, that is a deposit. Acceptance of deposits is regulated under sec. 58A of the Companies Act, and in case of NBFCs, by sec. 45I (c) of the RBI Act. Further, as per section 45S of RBI Act, no individual or a firm or an unincorporated association of individuals shall accept any deposit.

By combined reading of the above provisions, it is clear that a company accepting deposits would have to comply with the provisions of RBI guidelines issued in this behalf.

Muddle of regulations

The unfortunate part is – it is not clear who will regulate such schemes? First of all, deposits come under RBI purview, and CIS comes under SEBI purview. Sometimes, money is raised by strange instruments like preference shares or debentures – which, arguably, is not a deposit at all – hence, it comes MCA. There is no reason why there should have been distinct regulators, but given that there are, at the first stage, no one is sure as to who is to take action against a scheme whereby gullible investors' money is being sucked off. In this unclear role, regulators keep waiting for years before they jump in action. By this time, the problem would have already become a crisis.

Another curious hole in the regulatory scheme is LLPs. No one knows why LLPs were needed in the country at all, but as they stand, LLPs are neither covered by the RBI Act, nor by the Companies Act, nor by the SEBI Act. So, technically, an LLP may keep raising deposits or investments, and still be outside any of the relevant laws. This is a major gap in the regulatory structure, but we would, as we always do, keep waiting for years before we would jump in action.