Chit funds - Laws and regulations to protect the Indian Investor

MouliMajumder[1]

Abstract

The concept of Non-Banking Financial Companies (NBFCs) has gained popularity among the masses as it promised rich dividend. Many such companies started offering lucrative schemes by promising high interest rates and borrowing schemes to their investors. These schemes, generally termed as Chit Fund Schemes slowly became the easiest choice of saving and borrowing technique. This paper attempts to give an overview of the origin and evolution of Chit Funds in ancient India, how the concept slowly developed and became popular,subsequently mentioning the various types of Chit Funds and showing the working of Chit Funds through a flowchart representation. The twin concepts of Vanishing Companies and Ponzi Schemes are also briefly explained. The major highlights of this paper are the laws and regulations that govern the arena of Chit Funds. Emphasis has been laid on the failure of SEBI to regulate Chit Funds and justification has been given as to why SEBI is required to regulate the Chit Fund business.Recent years have seen a high rise in the number of fraudulent chit fund operations and so two of the most important and biggest chit fund scamshave been briefly mentioned. The paper concludes with the benefits of Chit Funds and the safeguards that investors should take to prevent themselves getting involved in chit fund scams.

***Keywords*- **Chit, Investment, Laws, Regulations, Scam.

[1]Student, School of Law, KIIT University, Bhubaneswar.

Introduction

In the recent years, India has faced some of the biggest financial scams involving crores of rupees and millions of people, all related to Chit Funds. The Saradha Group Chit Fund scam, the biggest Chit Fund scam ever in the history of India, was closely followed by the 60,000 crores Chit Fund scam by Rose Valley Group. So, in the present scenario, it becomes extremely important for prospective investors to know and understand the nature and working of Chit Funds before they even think of investing in a Chit Fund to avoid any possibility of getting cheated and duped of their hard-earned money. It also becomes a duty on the part of the Government and the Securities Board of India to amend the laws and regulations to curb all fraudulent practices.

Comparison with ROSCAS and the origin of chit funds in India

Chit Funds are nothing but the Indian equivalents of world famous ROSCAS- Rotating Savings and Credit Associations. Informal financial institutions, ROSCAS provide for saving and borrowing facilities at the same time. Chit Fund or Chitty is the common name for the Indian ROSCA.[2] It appears to be the first stepping stone of the modern banking system.

Research says that the concept of Chit Funds originated in ancient South Indian villages in Kerala. It is believed that a small group of farmers created a unique scheme of depositing a fixed quantity of grains periodically to a selected person working as a trustee. This trustee saved a portion of grains for himself and gave the rest to any member of the group who was in dire need of money which was available in exchange of those grains. Some members wanted to have additional benefits like early chances, even at the cost of accepting lesser quantity of the lot. This gave rise to a lot of competition which led to the holding of auctions to determine which bidder would get the lot.[3] It was decided that it would be the lowest bidder who got the money and continued to contribute till everyone else got their lots.

Defining chit and the Nature of chit funds

Like ROSCAS, Chit Funds are also savings plus borrowing schemes. Chits have pre-determined value and generally have a fixed duration, two to three years at the most. At the beginning only, the specific number of members are decided who would contribute and

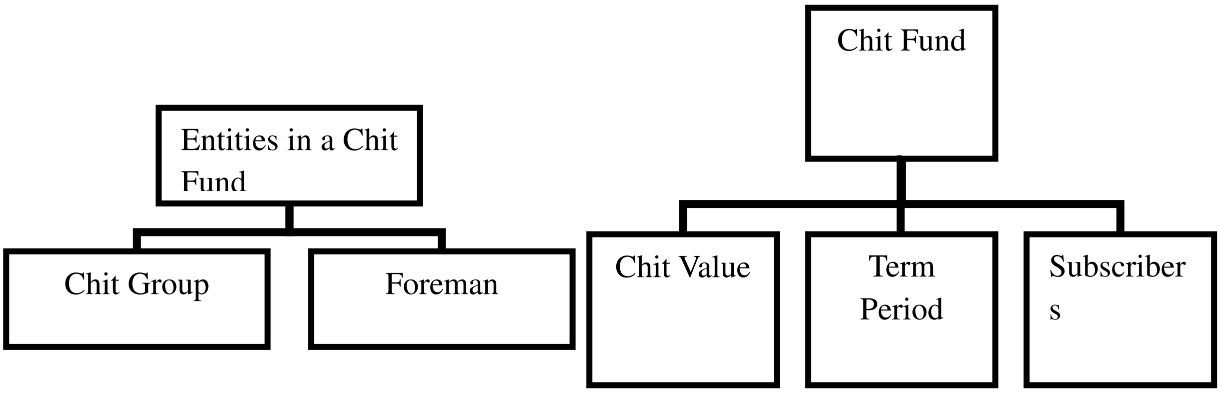
[2]M.Kapoor, Chit Funds as an innovative access to finance for low-income households,2011, p. 342
[3]MuditKapoor et al,Chit Funds-the evolution, operational scenario, role and regulatory framework, p.119

their individual contributions would add up to the total amount at the end. This collection of money (generally, monthly) is called the ‘pot’ and as prevalent from ancient times, auction is held to give the lowest bidder.

Chit Funds mainly attract investors like small businessmen, homemakers and lower and middle income class people who want immediate liquidity or want to raise immediate capital or loans. Individuals with low credit scores also want to utilize these schemes for borrowing.

A Chit Fund Company is defined as a corporation that governs handles or deals with such a Chit Fund involving a Chit which is defined[4] as a transaction under which a person enters into an agreement with a specified number of persons

Types of chit funds on basis of different classifications

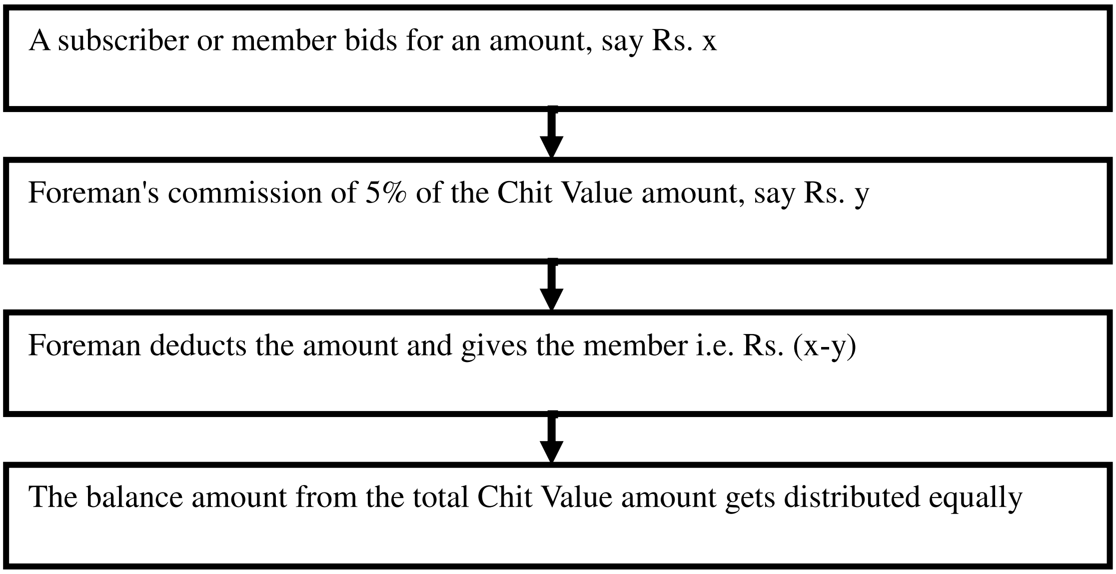


Chit Funds can be variously classified, the broad division being Registered and Unregistered. Registered Chit Funds are organised by Chit Fund firms or companies and regulated by the Chit Fund Act. There are also privately held registered Chit Funds. On the other hand, Unregistered Chit Funds can be organised and run by friends, relatives or personal groups. Those which exceed hundred rupees are illegal in India.

Government of various States runs Chit Funds like Kerala State Financial Enterprise and Mysore Sales International Limited. Another classification of Chit Funds can be Simple Chit, Business Chit and Prize Chit. Prize Chits are totally banned in India under The Prize Chits and Money Circulation Schemes (Banning) Act, 1978.[5]

The working of a chit fund as shown schematically

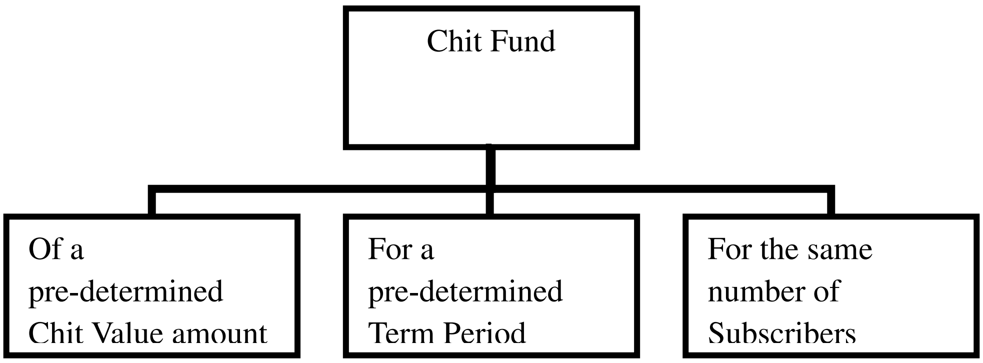
[4]Section 2(b) of The Chit Funds Act, 1982.
[5]Section 3 of The Prize Chits and Money Circulation Schemes (Banning) Act, 1978.



A Chit Fund is a unique financial system. It typically consists of 2 entities- a Chit Group consisting of individuals working on mutual trust, deciding on a pre-determined amount for a pre-determined period and a Foreman who is the organizer. He is registered and licensed to legally conduct the chits.

The Members of the Chit Fund are also known as Subscribers and the duration of period for which the chit fund is decided to operate is known as the Term Period. The total value of the Chit Fund is known as the Chit Value. A Chit Fund operates in this way- The amount collected from the Members of the Chit Group is also known as the ‘Pot’.

The Monthly Subscription is determined by dividing the Chit Value by the Number of Members. This is the maximum amount that each Subscriber has to pay. But at times, the Subscriber need not have to pay the entire amount every month. He may have some discounts deducted, known as Chit Discounts.



Concepts of vanishing companies and Ponzi schemes

Before addressing the different laws and regulations protecting the investors of Chit Funds, it may be useful to discuss the concepts of Vanishing Companies and Ponzi Schemes.

Vanishing companies

No as such formal definition of Vanishing Companies can be found in the Companies Act, 2013. Vanishing Companies are generally understood as companies which raise money through IPOs (Initial Public Offerings) from public and then fail to comply with requirements (like listing or filing) prescribed by ROC (Registrar of Companies) and Stock Exchanges for two years. At the time of inspection, they are not found at their registered office addresses.

A Company becomes a Vanishing Company when-

1. It fails to file returns with ROC or Stock Exchange (in case of listed companies) for two years

2. It does not maintain its registered office at the address given to the ROC or Stock Exchange

3. It's Directors are not found.[6]

The criteria for determining Vanishing Companies is decided by the CMC (Coordination and Monitoring Committee) of The Securities and Exchange Board of India (SEBI). The RBI (Reserve Bank of India) and MCA (Ministry of Corporate Affairs) also do play some role in it.

When a company, including a Chit Fund Company or any other NBFC (Non-financial Banking Company) disappears after accepting deposits from the public, RBI declares them as Vanishing Companies and place the list of such companies in the official website of RBI. Till now, more than 1,550 NBFCs have been declared such by RBI. Then RBI refers the matters to the Economic Offences Wing of the respective State Government to investigate the case and take legal action including penal actions as per the Indian Penal Code, 1860 following procedures as laid down in Code of Criminal Procedure, 1963.

If frauds are committed by multi-level marketing schemes which are regulated by The Prize

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[6]Rosemary Abraham, *Vanishing Companies*, ARTHAPEDIA http://arthapedia.in/index.php?title%20=VanishingCompanies.

Chits and Money Circulation Schemes (Banning) Act, 1978[7] and monitored by the respective State Governments, along with the Economic Offences Wings, the cases are sent to the State Police Departments to take action under the said Acts.

If these NBFCs are Companies registered under the Reserve Bank of India Act, 1934and the bank's regulatory purview is involved, then RBI can issue Prohibitory Orders to these companies to stop all transactions at once and criminal actions can be initiated against them.

Ponzi schemes

Fraudulent or Ponzi Schemes are a kind of pyramid schemes which work on the principle of robbing one person to pay another. Fraudulent investing scams in reality, Ponzi Schemes give false promises of high rates of return with minimum risk involved. Very much evident from the principle, it generates returns for its older investors by procuring new investors. Such schemes can be exposed due to any one of the following reasons-

1. Promoter runs away with the entire fund leaving practically nothing for the investors.

2. Liquidity crunch is created when new investments cease to come.

3. Mass withdrawal of funds due to market conditions.

Quite unfortunately, SEBI has no role to play in so far as regulating these Ponzi Schemes are concerned. The only legislation banning these fraudulent schemes is The Prize Chits and Money Circulation Schemes (Banning) Act, 1978 and the concerned State Government being the only enforcement agency of the said law.

Laws protecting investors of chit funds

Classifying them as Contracts, the Supreme Court has read Chit Funds as being part of the Concurrent List of The Indian Constitution[8]; hence both the Center and State can frame legislation regarding Chit Funds.[9]

The Kerala Chitties Act, 1975 and The Tamil Nadu Chit Funds Act, 1961 are some of the legislations enacted by the States for regulating Chit Funds.

The principle legislation governing Chit Funds is the Chit Funds Act of 1982 which was

[7] *Supra* p.3
[8] List-III, Seventh Schedule, The Constitution of India, 1950.
[9] Vishnu, *Chit Funds: Q & A,* the PRS Blog (May 28, 2018)http://www.prsindia.org/theprsblog/?p=2678.

enacted by the Ministry of Finance, Government of India in the year 1982. The sector of Chit Funds is regulated by the Central Government through this Act and by the State Governments through the rules framed under the said Act. The Act requires prior permission for all Chit Funds from the respective State Governments.[10]

Another legislation regulating the business of Chit Funds is The Prize Chits and Money Circulation Schemes (Banning) Act, 1978[11] whose basic objective is to prohibit any kind of illegal Chit Fund scheme (examples can be schemes where auction winners are not liable to future payments). Here it is the State Government alone who has the power to investigate such cases. Different types of Chits like 'Conventional Chit'[12] and 'Prize Chit'[13] have been defined in this Act.

Clause b(iii) of sub-rule (2) of Rule 8 of Companies (Incorporation) Rules, 2014 framed under the Companies Act, 2013 provides that if the Company's main business is that of a Chit Fund, it's incorporation will not be allowed unless its name is indicative of that financial activity.

Prevention of Money Laundering (Amendment) Act, 2012 has recognized Chit Funds in Section 2(l).

Role of reserve bank of India and securities board of India

RBI regulates the banking sector as well as the NBFCs but some NBFCs like Housing Finance Co., Merchant Banking Co., Venture Capital Fund Co., Nidhi companies and Chit Fund companies have been exempted from requirement of registration under S. 45-IA of the RBI Act, 1934, subject to certain conditions. This exemption is allowed by RBI to avoid duality of legislations as NBFCs like Chit Funds are regulated by the State Governments.[14] Though functionally RBI includes Chit Funds in the definition of NBFC under the sub-heading 'Miscellaneous Non-Banking Company (NBFC)', but RBI do not provide for any separate regulatory framework for them. It is true that Deposits are accepted by Chit Funds, but the definition of 'Deposits' as given in the RBI Act, 1934 nowhere contains the provision of subscription to Chits. Nevertheless, RBI, in certain matters advise the State Governments on matters related to Chit Funds.

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[10] Section 8 of Chit Funds Act, 1982.
[11] *Supra Note* at 5.
[12] Section 2(a) of The Prize Chits and Money Circulation Schemes (Banning) Act, 1978.
[13] Section 2(e) of The Prize Chits and Money Circulation Schemes (Banning) Act, 1978.
[14] Reserve Bank of India, https://www.rbi.org.in/Scripts/FAQView.aspx?Id=92.

Along with being the regulator of the Securities Market of India, SEBI also regulates Mutual Funds, Collective Investment Schemes (CIS) but Chit Funds in particular have been excluded from SEBI's purview. Chit Funds act as an exception to CIS. This failure of SEBI to regulate Chit Funds has given rise to an urgent need for SEBI to regulate the same which has been justified accordingly.

Failure of SEBI to regulate chit funds

Chit Funds and even Nidhi Companies deal with mostly private companies and that is one of the main reasons behind SEBI's failure to regulate Chit Funds, which thus fall under the respective State Government's jurisdiction. The unscrupulous entities take advantage of this regulatory loophole and carry on their unfair trade practices.

In 2016, NGO Humanity Salt Lake filed a PIL before a Supreme Court bench led by the CJI, T. S. Thakur in the case *Humanity Salt Lake v. Union of India &Ors*.[15] They sought the Court's intervention to direct the Government to prepare a long term plan, putting an end to unauthorized deposit schemes, CIS as well as prosecute fraudsters and recover the investors' money. In an affidavit which was perused by the Bench, SEBI's submission was that Ponzi Schemes do not fall under the regulatory purview of SEBI but comes under the control of the State Governments, banned by The Prize Chits and Money Circulation Schemes (Banning) Act, 1978[16] as well. This Act is no doubt a Central Act but the enforcement agency of this law is the State. In this regard, SEBI was helpless as far as regulating "banned activities" was concerned, unless previously informed. SEBI also rightly pointed out that CIS was not a banned activity and can be authorized with registration or prior permission from SEBI.[17] Thus the Court dismissed the writ petition.

Need for SEBI to regulate chit funds

When thousands of depositors were duped in the Saradha Chit Fund Scam, an urgent need was felt for a strong regulatory mechanism. A single regulator for Chit Funds, Nidhi Companies etc. is what the common people of India need immediately. Till such an arrangement is made, the Government can at least include more stringent provisions in the SEBI Act, 1992. In this way, SEBI can effectively curb such fraudulent funds from luring

[15]Humanity Salt Lake v. Union of India &Ors,Writ Petition(s)(Civil) No(s). 928/2013
[16]*Supra*note 5.
[17]KrishnadasRajagopal, *Ponzi schemes not under our purview: SEBI,* THE HINDU (May 29, 2018), http://www.thehindu.com/news/national/Ponzi-schemes-not-under-our-purview-SEBI/article14559017.ece.

investors, promising them high rates of returns, only to disappear with the whole money.[18] Along with the SEBI Act, The Depositories Act of 1996 and The Securities Contracts (Regulation) Act, 1956 also need to be amended.

Complaints in overwhelming numbers have been reported by public at large related to unauthorized money mobilization in Ponzi Schemes. These are activities mainly in the nature of prize chits, money circulation schemes, multi-level marketing or pyramid schemes and Ponzi schemes.

Irrespective of the amounts mobilized or number of investors involved, all the entities which call themselves as Chit Funds or any other name that come under State Government's jurisdiction, should be brought under SEBI's jurisdiction and mandatorily registered under CIS norms.[19] This will help bring out the exact nature of their money pooling activities and the procedure followed by them for doing business.

Quite recently, the Union Cabinet has approved the passing of the "Banning of Unregulated Deposit Schemes and Chit Funds (Amendment) Bill, 2018"in the Parliament. Some of the salient features of the Bill are-

1. Provisions like preventing deposit takers from promoting, operating, issuing advertisements or accepting deposits in any Unregulated Deposit Schemes (UDS) are included in the Bill. Proposals for heavy fines and stricter punishments are also made.

2. The Bill also includes provisions for repayment of deposits, attachment of properties and assets for repayment etc.

3. The Bill deals with companies which collect deposits and then refuse to pay, by allowing respective authorities to act before a fraud takes place.

4. The proposed Bill prevents Ponzi Scheme frauds by banning all UDS.

5. The Bill seeks to cover up the flaws of The Chit Funds Act of 1982 by retaining the requirement of minimum two members for conducting a draw and preparing the minutes of a meeting but adds the requirement of video recording of the entire procedure of drawing of the

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[18]ShishirSinha, *Let SEBI oversee chit funds till regulator is put in place: Sinha,* THE HINDU (May 29, 2018) https://www.thehindubusinessline.com/markets/let-sebi-oversee-chit-funds-till-regulator-is-put-in-place-sinha/article20619495.ece1.
[19]*SEBI may get more powers to regulate money pooling,* LIVE MINT https://www.livemint.com/Politics/vljo0AWteAaeLYsAeWovEK/Sebi-may-get-more-powers-to-regulate-money-pooling.html.

chits. The two members can join the proceedings by video conferencing and sign the minutes within two days.

6. The Bill directs State Governments to designate a competent authority to assure repayment of deposits, in case of a default.[20]

Chit fund scams in India

This analysis of the concept of Chit Funds would never be complete without mentioning the various chit fund scams that have taken place in the country over the past decade. Two of the biggest scams that have taken place are worth mentioning in brief.

The Saradha group scam

The biggest chit fund scam in India, came into light when Kolkata based Saradha group, a consortium of more than 200 private companies, went bankrupt in January, 2014. The group used to collect small deposits and promised rates of interest as high as 24%. The Company used the name 'Chit Fund' in its operation but actually it was in nature of a Ponzi Scheme, as a Chit Fund Scheme can never promise guaranteed, fixed returns due to the varying factors like number of investors. The charge sheet was filed against Saradha Group Chief, Mr. SudiptoSen, and the other owners under Sections 120B, 409 and 420 of the Indian Penal Code, 1860 relating to offences like Cheating, Criminal Breach of Trust and Conspiracy as well as Sections 4 and 6 of The Prize Chits and Money Circulation Schemes (Banning) Act, 1978 related to penalty for contravention and offences committed by companies.

The Rose valley chit fund scam

An alleged political scandal and a major financial scam, the Rose Valley Chit Fund Scam was also in the nature of a Ponzi scheme run by the Rose Valley Group. Many of the entities affiliated with the group like Rose Valley Real Estates and Constructions and Rose Valley Hotels and Entertainment used to collect crores of rupees from investors, in installments for property purchases or holiday packages. But investors got an option of getting back their money with up to 21% annualized interest. SEBI started getting complaints from various authorities and served notice to which the persons-in-charge of Rose Valley deliberately delayed and subsequently appealed. In the course of the proceedings, SEBI established that

[20] *New rules for chit funds and deposit schemes, LIVEMINT,* https://www.livemint.com/Money/aasZcBKy9PcW3jK0ZOi6dN/New-rules-for-chit-funds-and-deposit-schemes.html.

the schemes were CIS which were not registered with SEBI. Order was given for the schemes to be wound up and money refunded back to the investors and these resulted thousands of investors to be left in the lurch since there was not much money left to be refunded back. In the meantime, after the Supreme Court's direction to probe suspicious companies raising funds from small depositors which was a direct fallout of the Saradha Scam, Central Bureau of Investigation (CBI)and the Enforcement Directorate (ED) started investigatingagainst Rose Valley.[21] As a consequence, Rose Valley Group was charged with sections of Prevention of Money Laundering Act, 2002**.** SEBI too filed complaints against the Group for violations of "unauthorized issue of debentures".[22]

Conclusion

The concept of investing in Chit Funds is not inherently bad. A Chit Fund is a good savings option for small investors. In a nutshell, the benefits of Chit Funds can be higher rates of interest, funds available for emergency and secured funds. Before investing in a Chit Fund, a person must make sure that there is an immediate need for funds in the near future which he may not be able to get from his bank. Investing in Chit funds is advisable when comparable institutional savings and loan products are not available. But at all times, the credibility and trustworthiness of the investment company and its promoters should be checked. The reason for people, tending to avoid chit funds today may be because of the fact that some unscrupulous people have misused the basic objective of chit funds and misappropriated the money of the investors, which have led to some of the biggest financial scams in the country. Some of the precautions that investors can take before investing in chit funds include complete checking for the credibility and creditworthiness of the company and its promoters beforehand, opting for state-run chit companies and going with firms with a long record and financially sound promoters, understanding the different laws which give protection to investors investing in Chit Funds, implementing easy-to-use web-based Chit Fund Management system (CFMS) etc.

[21]AnandKalyanaraman, *All you wanted to know about Rose Valley scam,* THE HINDU, https://www.thehindubusinessline.com/opinion/columns/all-you-wanted-to-know-about-rose-valley-scam/article9468861.ece.

[22]SaikatGochhait,*A Case Study of Chit Fund Scam in India,*3 IRC's International Journal of Multidisciplinary Research in Social and Management Sciences, 135-140 (2015).