

SUBMISSION OF COMMENTS TO THE COMMITTEE ON FINANCE

"EFFICACY OF REGULATION OF COLLECTIVE INVESTMENT SCHEMES, CHIT FUNDS, ETC"

1. Background

The Committee on Finance (Sixteenth Lok Sabha) selected the subject of "Efficacy of Regulation of Collective Investment Schemes, Chit Funds, etc." for examination during the year 2014-15 and presenting a Report thereon to Parliament. Pursuant to a press release dated 19 September 2014, the Committee invited suggestions on the subject from interested stakeholders.

Consumer Unity & Trust Society (CUTS) is a vigilant institution working in the area of economic regulation, consumer protection, competition, trade, and investment. CUTS' suggestions on the subject are set out in the following sections.

2. Regulation of collective investment schemes

Collective Investment Schemes (CIS) have been historically regulated by the securities market regulator, Securities and Exchange Board of India (SEBI), which was empowered in this regard by the SEBI Act, 1992 (SEBI Act). SEBI issued regulations to regulate CIS in 1999 (CIS Regulations). The SEBI Act and CIS Regulations were amended in 2014¹ to enhance regulatory powers of SEBI.

2.1. Who should regulate collective investment schemes?

Since the inception of CIS Regulations, one only entity has been registered with SEBI.² However, in recent past, various entities³ have been unearthed which have been allegedly operating CIS' without registration. This raises doubts on the supervision and enforcement capacity of SEBI. In most cases, it initiates probes only after it has approached by some enforcement agency. For instance, in Saradha Realty case, SEBI got a reference from the Economic Offences Investigation Cell in the West Bengal Government.

This might be a result of limited manpower and expertise available with SEBI even though it is empowered to call from information or records from any person for ensuring compliance with its regulations.⁴

The other financial sector regulator, Reserve Bank of India (RBI), in spite of having greater manpower and resources than SEBI, and mandate to regulate deposits,5 has expressed its inability to regulate all non-bank financial entities (including CIS).

¹ See, Securities Laws Amendment Act, 2014 and the SEBI (Collective Investment Schemes) (Amendment) Regulations, 2014

Collective See. Registered Management Company, available at http://www.sebi.gov.in/sebiweb/home/detail/23271/new/Registered-Collective-Investment-Management-Company, last visited on 09 October 2014

³ Pearl Green Forest Limited, Pearl Agrotech Corporation Limited, Saradha Realty, etc.

⁴ See, Section 11 of the SEBI Act, 1992

⁵ Section 45I(c) of the Reserve Bank of India Act, 1934

While the recent amendments in the SEBI Act and the CIS Regulations increase the scope of powers of SEBI, these may prove ineffective, if infrastructure and manpower constraints remain with SEBI.⁷

Suggestions: In light of the recent proliferation of unregistered CIS', which often operate as ponzi schemes, and dupe investors' of their money, it is suggested that financial sector regulators, SEBI, RBI, and IRDA, along with the Ministry of Finance, come together and join forces in a coordinated manner to check this menace.

The Financial Stability and Development Council (FSDC), constituted in the wake of financial crisis, to institutionalise and strengthen financial stability, inter-regulatory coordination between financial sector regulators⁸, could be the right platform to ensure constant communication and coordination amongst regulators on this issue.⁹

It must be noted that CIS regulation is just one of the issue that passed through cracks of financial regulation, and has threatened financial stability. A systematic mechanism must be established to identify similar issues, for reference to the FSDC, which could then facilitate prompt coordinated and corrective action.

2.2. The Securities Laws (Amendment) Act, 2014

The Securities Laws (Amendment) Act, 2014 (Amendment Act), made several changes to the SEBI Act, including with respect to regulation of CIS

2.2.1. Scope of CIS

The Amendment Act inserted a proviso to section 11AA of the SEBI Act. The proviso deems pooling of funds involving a corpus of at least Rs. 100 crores, not already registered as CIS or exempted from such registration, to be a CIS.

There seems to be several issues with this formulation. One fails to understand the logic of threshold of Rs. 100 crores. It might be argued as too high or too low. ¹⁰ The unintended consequence could be proliferation of unregistered schemes of less than Rs. 100 crores, in a scenario where regulating low-value schemes is already proving to be difficult.

Further, while the threshold might be reasonable in the current scenario, it might need changes in future, which might be difficult, as that would require an amendment to the statute. The threshold, if at all, should have been part of the Schedule to the statute, which would have been easy to amend.

⁶ Remya Nair, RBI expresses inability to regulate all NBFCs, Livemint, 23 July 2013, available at http://www.livemint.com/Industry/7xWBWccb9TImNz5LEdLEkM/RBI-expresses-inability-to-regulate-all-NBFCs.html, last visited on 09 October 2014

⁷ Supra note 1

⁸ See, Ministry of Finance notification dated 30 December 2010, available at http://finmin.nic.in/fsdc/GazNote31122010.pdf, last visited on 09 October 2014

The financial sector regulators recently signed MoU to jointly monitor financial conglomerates. Similar mechanisms could be developed for regulation of CIS'.

¹⁰ Somasekhar Sundaresan, New SEBI Act has one missing link, Business Standard, 28 July 2013, available at http://www.business-standard.com/article/opinion/new-sebi-act-has-one-missing-link-113072800717 1.html, last visited on 09 October 2014

The focus should be to enhance the monitoring, supervisory capacity of SEBI by increasing its manpower and expertise, rather than making a regulatory distinction on the basis of monetary value.

Further, under the current formulation, any (and every) entity pooling funds in excess of Rs. 100 crore could be deemed to be CIS, even when the intention is not to operate CIS, but a genuine business activity. As a result of such wide scope, unpretentious business entities would fall within the regulatory purview of SEBI and would have to comply with its prescriptions, making doing business even more difficult and costly.

2.2.2. Delegation of legislative powers

The Amendment Act also inserted sub-section 2A to section 11AA of the SEBI Act, which delegates powers to SEBI to specify conditions under which any scheme or arrangement can be termed as CIS.

This could have several ramifications. The regulator might use this power to exempt genuine entities from the regulatory burden, however, the possibility of regulator casting a wide net, thereby exceeding the scope of parent statute, cannot also be denied.

In an ideal scenario, it is the legislature which should determine constituents of CIS, and the regulator must be tasked with the function of investigating if a particular entity falls within the scope determined by legislature or not.

Suggestions: Consequently, there is a need to review the (intended and unintended) impact/consequences of provisions of the Amendment Act, which affect the regulation of CIS (such as mentioned above), and consult stakeholders to reformulate the provisions.

This practice is known as impact assessment, and is widely followed in jurisdictions such as US, UK, Australia etc. and has been recommended for India as well. 12 It is high time that laws are made by following this scientific process, and a review of the Amendment Act could be the right start.

2.2. The CIS Regulations

According to the CIS Regulations, a person must be *fit and proper* to launch a CIS. SEBI has been empowered to determine if such person is *fit and proper* on the basis of considerations it deems fit. The considerations include integrity, reputation and character; absence of convictions and restraint orders; competence including financial solvency and net worth, etc.

Such aforesaid criterion provides wide discretionary/ subjective powers to SEBI, which might result in differential treatment of similarly placed entities. Such a scenario must be avoided.

Suggestions: SEBI must explain the criteria for determining fitness and proprietary of applicants. In addition, it must provide a detailed explanation to the applicants, on why (or why not) it considers the applicant fit and proper.

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¹¹ Such as, housing, jewellery purchase or travel packages

¹² See, recommendations of the Financial Sector Legislative Reforms Commission (2013), and the Damodaran Committee (2013). CUTS is also working to facilitate ex-post impact assessment in India

Such explanation will aid SEBI in reviewing its evaluation criteria, should an applicant approved by it mismanages the CIS in future.

3. Regulation of chit funds

Chit funds are currently governed by the Chit Funds Act, 1982, which provides power to regulate chit funds to the state governments, within whose jurisdiction the fund is operating. Registration is usually required with the Registrar of Chit Funds (RoCF) in the respective states.

3.1. Role of Registrar of Chit Funds

It seems that the state-based RoCF are passive bodies acting as custodian of documents, such as chit agreements and the annual balance sheet. While having the right to appoint chit auditor, they do not seem to actively indulge in regulation and supervision of registered (and unregistered) chit funds operating within their jurisdictions. This is evident from the fact that several unregistered and unregulated chit funds have mushroomed all over the country. ¹³

Suggestions: There is a need to revisit the role of RoCF to effectively and efficiently regulate the chit funds industry. It must be equipped with adequate infrastructure, resources, and manpower, to regulate the industry and take actions against the unregistered entities. The financial sector regulators, RBI and SEBI can assist RoCF in this regard. The RBI already has powers to inspect chit books and records of foreman under the RBI Act, 1934, and the RoCFs could act as its satellite offices to conduct such inspections.

However, the RoCF seem to lack teeth to initiate suo moto investigation and prosecution proceedings against illegitimate chit funds. They must be provided such powers, while ensuring that they follow principles of natural justice, and ensuring their accountability. Guidance could also be taken from the recently enacted Securities Laws (Amendment) Act, 2014, which has empowered SEBI to act against unregistered entities.

3.2. Inter-state coordination

As mentioned earlier, chit funds are regulated by the States. While some states have developed efficient regulation and enforcement mechanism to regulate chit funds, others have failed to do so.

Suggestions: Thus, there is a need for greater coordination and communication between states to discuss and debate best practices and lessons learnt in regulation of chit funds. As a start, each of the states must enact an effective legislation to combat unregistered and illegal chit funds/ ponzi schemes.

Recently, RBI and SEBI organised first-of-its-kind meeting with chief secretaries of different States, ¹⁴ in which the States were requested (and ensured full support) to take actions against illegal money-pooling schemes and enact a State Deposit Protection Act.

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¹³ In form of art funds, tea plantation schemes, housing schemes, land acquisition schemes et al

¹⁴ Press Trust of India, Ponzi menace: SEBI wants states to put frontline checks, Business Standard, 14 September 2014, available at http://www.business-standard.com/article/pti-stories/ponzi-menace-sebi-wants-states-to-put-frontline-checks-114091400339_1.html, last visited on 09 October 2014

In order to realise this vision, the regulators and civil society organisations must come together and work with State level actors to build their capacity to enact and effectively implement such legislations.

4. Need for an omnibus Financial Consumer Protection Act

Financial consumer protection has historically been subjected to short shrift in the country. Illegitimate money collection, circulation, and ponzi schemes and sale of complex and unsuitable financial products by unaccountable financial firms have been order of the day.

Hidden and inflated charges or fees; unfair contract terms and conditions (including unfair variation of contract terms, interest rates or charges); undisclosed level of financial risk; Unauthorised fund transfers, fraudulent withdrawals from ATMs using duplicate cards, phishing e-mails aimed at extracting personal information, and data privacy violations, have been order of the day.

Thus, there is an urgent need of a strong consumer protection mechanism, setting clear rules for financial institutions regarding their dealings with retail customers. While experts have recommended reforms such as introduction of suitability requirements, simple and standard financial products, move to seller beware principles, much more needs to be done. Adoption and implementation of a strong and omnibus financial consumer protection law covering the entire sector to implement various suggestions is need of the hour.

Suggestions: An omnibus Financial Consumer Protection Act must be adopted for regulating illegal money circulation, ponzi and pyramid schemes and addressing on-going malpractices in the financial sector such as hidden and inflated charges or fees; undisclosed level of financial risk; unauthorised fund transfers, etc. Such law must take into account successful and not-so-successful practices implemented by various States and comparable jurisdictions. It should establish a new national single independent financial consumer protection mechanism (regulator), having state units, thus covering the entire country.

In addition to creation of such law, capacity must be build existence of adequate infrastructure must be ensured to aim effective implementation of such law.

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