

## Prize Chit and Money Circulation (Banning) Scheme Act, 1978: Precautions



Prize Chit and Money Circulation (Banning) Scheme Act, 1978 basically bans promotion or conduct of any money circulation and/or prize chit scheme and provides for imprisonment and penalty in case of failure to comply with the provisions. This act bans any prize chit or money circulation scheme or enrolment or participation as members in those schemes or receiving or remitting money under those schemes. This article deals with various aspects of this act with special reference to Multi-level Marketing business in India and gives various related judicial pronouncements in this regard. Multilevel Marketing or Network Marketing has been going on India for many years. Multilevel marketing or Network marketing are ways to sell the products directly to the consumers in which the salesmen are compensated not only for the work done by them but also for the sales of people who have joined the company through them. These people are usually referred to as the down line and various levels of down line are created. The article also highlights the role and responsibilities of the Chartered Accountant as a statutory auditor or consultant with respect to compliance with this and other laws by network marketing companies.

### Introductory Concepts

#### **Multilevel Marketing or Network Marketing (MLM):**

Multilevel marketing or Network marketing are ways to sell the products directly to the consumers in which the salesmen are compensated not only for the work done by them but also for the sales of people who have joined the company through them. These people are usually referred to as the down line and various levels of down line are created. The commission which is distributed among the salesmen depends upon the scheme used for division of the commission. These salesmen are known by various

names like distributors, affiliates, dealers, sales consultant, etc.

**Pyramid Schemes:** A Pyramid Scheme is a non-sustainable business which involves payments to participants primarily to recruit other people into the scheme and there is no real investment or sale of products.

**Ponzi Schemes:** In a Ponzi scheme the returns are paid to investors from their own money or money of subsequent investors rather than actual profit earned. It is best summarised as “rob peter to pay paul”.



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### Legality and Legitimacy of MLM

MLM business operates in over 100 countries including countries like United States of America. Multilevel Marketing or Network Marketing has been going on in India for many years and Amway, Oriflame, RCM are some of the companies which have been frontrunners in this field. The Federal Trade Commission of USA which deals with issues of consumer protection and competition jurisdiction clearly states: "Not all multi-level marketing plans are legitimate. Some are pyramid schemes. It's best not to get involved in plans where the money you make is based primarily on the number of distributors you recruit and your sales to them, rather than on your sales to people outside the plan who intend to use the products."<sup>1</sup> Reserve Bank of India in its Notification number RBI/2009-10/158 dated 16-9-2009 has asked all Primary (Urban) Cooperative banks to ensure KYC/AML guidelines in the accounts of multilevel marketing companies and has also given example of seven such Multilevel marketing companies in India. RBI has mentioned in the notification that these companies are luring the depositors by promising huge returns of their investment. In India the pyramid schemes and ponzi schemes are banned under the Prize Chit and Money Circulation (Banning) Scheme Act, 1978.

### Prize Chit and Money Circulation (Banning) Scheme Act, 1978

This act basically bans promotion or conduct of any money circulation and/or prize chit scheme and provides for imprisonment and penalty in case of failure to comply with the provisions. This act bans any prize chit or money circulation scheme or enrolment or participation as members in those schemes or receiving or remitting money under those schemes.

In June, 1974, the Reserve Bank of India had constituted a Study Group under the Chairmanship of Shri James S. Raj, the then Chairman, Unit Trust of India, for examining in-depth the provisions of Chapter III-B of the Reserve Bank of India Act, 1934, and the directions issued thereunder to non-banking companies in order to assess their adequacy in the context of ensuring the efficacy of the monetary and credit policies of the country and affording a degree of protection to the interests of the depositors who place their savings with such companies. In its report submitted to the Reserve Bank in July, 1975, the Group observed that the prize chit/benefit/savings schemes benefit primarily the promoters and do not serve any social purpose, and that they are prejudicial to the public interest and affect the efficacy of the fiscal and monetary policies of the country. Ultimately the Group recommended that prize chits or money circulation schemes, by

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whatever name called, should be totally banned in the larger interests of the public and suitable legislative measures should be undertaken for the purpose. Pursuant to the said recommendation, the Parliament enacted the Prize Chits and Money Circulation Schemes (Banning) Act, 1978.

### Money Circulation Scheme -Section 2(c):

Any scheme for below mentioned transactions:

- i. Making of quick or easy money or
- ii. Receipt of money or valuable thing as consideration for a promise to pay money on any event or contingency, relative or applicable to the enrolment of members into the scheme.

It is not relevant as to whether the money or thing is derived from the entrance money or periodical subscriptions.

### Prize Chit – Section 2(e):

It covers any transaction or arrangement under which a person collects money as –

- i. Promoter
- ii. Foreman
- iii. Agent
- iv. In any other capacity

In any of the below mentioned methods:

- i. Lump sum
- ii. Instalments by way of subscriptions or contributions
- iii. Sale of units
- iv. Sale of Certificates or other instruments
- v. Membership fees
- vi. Admission fees
- vii. Service charges
- viii. Savings, Mutual benefit or thrift

### Banning - Section 3:

No person shall promote or conduct any prize chit or money circulation scheme, or enrol as a member to any such chit or scheme, or participate in it otherwise, or receive

<sup>1</sup> "The Bottom line about Multilevel Marketing Plans", FTC, October 2009

or remit any money in pursuance of such chit or scheme.

#### Penalty:

The act prescribes two types of penalties –

1. Penalty for contravening Section 3 – Imprisonment up to three years or fine up to 5,000/- or both.
2. Penalty of Imprisonment up to two years or fine up to 3,000/- or both, for other offences associated with Scheme like:
  - a. Printing of brochure, tickets, coupons, etc for use in Prize Chit or Money Circulation Scheme;
  - b. Sells or distributes or advertises for selling or distribution of , tickets, coupons, etc for use in Prize Chit or Money Circulation Scheme;
  - c. Prints, publishes or has in possession for the purpose of publication or distribution
    - i. Any advertisement
    - ii. Any list of member, complete or incomplete
    - iii. Any such matter descriptive of or relating to such scheme which may act as inducement to any person
    - iv. Brings or invites any person to send for the purpose of sale or distribution any tickets, coupons etc for use in Prize Chit or Money Circulation Scheme or any advertisement of such scheme;
    - v. Uses any premises or causes or knowingly permits to use any premises for such schemes
    - vi. Causes or procures or attempts to procure any person to do any of the above acts

#### Offences by Companies:

Every person who is in-charge and was responsible to the company for the conduct of its business, at the time of committing of the offence, and Company itself are liable to be proceeded against provided that in case a person proves that the offence was committed without his knowledge or that he exercised all due diligence to prevent the commission of such offence.

In case it is proved that the offence was committed with consent or connivance or is attributable to any neglect on the part of any director, manager, secretary or other officer of the company, such director, secretary of other officer shall also be deemed to be guilty for that offence and shall be liable to be proceeded against and punished accordingly.

Company includes a firm or association of persons and in case of firm the director mean the partners.

**T**his scheme called Multi-level Marketing creates a chain of customers and the long and unbroken chain would ensure larger amount of quick or easy money. The shorter and missed links in the chain would result in earning lesser commission. Therefore, there should be unbroken chain or customers. Secondly, the person does not get the value of the money he pays; thirdly, the companies are collecting service charges as stated above in a sale of goods. No service charges can be collected while the goods are sold. For all these reasons the scheme of so called Multi-level Marketing cannot be said not to violate the provisions of Section 2(c) of the Act. ☺

#### Judicial Pronouncements

These are some of the significant judicial pronouncements on the Prize, Chit and Money Circulation (Banning ) Act, 1978

**(1) State of Bengal and Ors vs. Swapan Kumar Guha and others, SC, 1982 AIR 949 1982 SCR(2) 121**

**Background:** One Sanchita Investments is a registered partnership firm consisting of three partners with a share capital of ₹7,000/-. In the year 1975 the said firm started its business in finance and investments. On a report given by the Commercial Tax Officer concerned, FIR was registered with the allegations that the firm had been offering 48 per cent interest which was later reduced to 36 per cent and that, therefore, it was involved in money circulation scheme for making of quick or easy money. The firm and its partners filed two writ petitions in the Calcutta High Court under Article 226 of the Constitution of India for quashing the FIR. The High Court allowed the writ petition and quashed the FIR and the State of West Bengal filed appeal by Special Leave in the Supreme Court. After an in-depth analysis of the definition of "money circulation scheme" in Section 2(c) of the Act, the Supreme Court went into the question as to whether the FIR prima facie discloses an offence under Section 4 read with Section 3 of the Act in the light of the requirements of Section 2(c) of the Act.

**Decision:** In this case the Supreme Court made an in-depth analysis of Section 2(c) of the Act i.e. the section defining money circulation scheme and analysed and interpreted that that any and every activity for the making of quick or easy money by itself would not fall within Clause (c) of Section 2 of the Act and that making of such quick

or easy money must depend upon any event or contingency relative or applicable to the enrolment of members into the scheme. It was held that to hold a person guilty of an offence under Section 4 read with Section 3 and 2(c) of the Act, two conditions must be satisfied: (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.

Having so analysed the definition of "money circulation scheme", the Supreme Court applied the said definition to the allegations made in the FIR and negated the contention that the scheme attracted the provisions of Section 2(c) of the Act.

**(2) M/s Apple FMCG Marketing Pvt. Limited and Mr. R. Eric vs The Union of India, The State of Tamil Nadu and the Director General of Police, Chennai, Madras High Court, 2005**

**Background:** In this case, M/s Apple FMCG Marketing Private Limited filed a petition praying for a writ of declaration that selling products through the Network Marketing System is legal and not in contravention of the provisions of the Prize Chits and Money Circulation Schemes (Banning) Act, 1978 or any other law.

M/s Apple FMCG Marketing Private Limited was a company registered under the Companies Act, 1956. It is marketing various products including shampoo, tea, coffee powder, after-shave lotion, etc. under the brand-name 'Joy Eternal' through "network marketing". The marketing process was carried out directly by recruiting

the customers themselves as distributors of the products and services; the company regularly organised business development meetings and seminars, distributors meetings, etc. The participants of the meetings were encouraged to take up the distributorship of the products and were suitably registered if they so desire. There was no service fee for registration as distributor. Any person who was interested was given a product for the price fixed. The distributors were encouraged to enrol more distributors. The commissions were given only as per the volume of sales made by the individual distributor and his team.

Arguments by M/s Apple FMCG Marketing Private Limited

1. So far no complaints have been received against them from any distributor. Therefore, this Multi-level Marketing has not caused any loss to any of the distributors.
2. There is no 'service fee' for registration as distributor.
3. Every distributor gets commission on the basis of the volume of business that is generated by him.
4. No chain of customers in the process.
5. The distributors and the purchasers pay the value of the product that is purchased, therefore, they are not paying any excess amount.
6. They collect only nominal service charge for the service rendered.
7. The surveillance by the respondents violates the petitioners' fundamental right provided under Articles 19(1)(a) and 19(1)(g) of the Constitution of India.
8. Further the Union of India has also clarified that the "Multi-level Marketing" does not infringe the Prize Chits and Money Circulation Schemes (Banning)

Act, 1978 (Hereinafter referred to as 'The Act').

**Decision:**

1. The scheme, as stated above, creates chain of customers and only when the chain progresses without any break in any of the links, the 'principal distributor' gets more commission. If, for any reason, the chain is broken, at any stage, then the principal distributor's commission would get reduced proportionally to that extent. Therefore, it is not correct to say that there is no chain of customers in the process.
2. The contention that no service charge is collected also does not appear to be correct in view of the fact that every person who purchases a kit has to pay a service charge of Rs.50/- for each kit. Service charges are collected by governmental institutions like Electricity Board and Telephones as they are authorised by the Statutory Rules. No individual can collect any charge as service charges. The collection of service charge is, therefore, not legal.
3. From the very fact that 65 per cent is earmarked for paying as commission to the distributors, it is clear that the value of the product is only 35 per cent of the sale price. That is, when the goods are sold at ₹550/-, the actual value of the goods that are sold is only ₹188/- (calculated at 35 per cent).
4. The progress of the chain of customers, at some point of time, would get saturated and the distributor, who purchases the goods, will not find any purchaser/sub-distributor to sell or enrol afresh. At that time, due to the progress of the chain, in the manner stated above, such persons who would not find new members may be in lakhs

or even millions. Therefore, lakhs or even millions of people are bound to lose their entire money of Rs.550/- (value of one starter kit). At the same time, major portion of 65 per cent of the amount would be a gain to the petitioners-company since there would be no one to share that money.

5. The petitioner submitted that Union of India has made a clarification in an answer to a question in Parliament that Multi-level Marketing does not violate or offend the provisions of the Prize Chits and Money Circulation Schemes (Banning) Act. It is suffice to say that it is not for Union of India or any Member of Parliament to interpret the provisions of any act. The Act has been passed by the Parliament, but the power to interpret the Act is only vested in Judiciary, and that power is not given to the Executive. The statement given by the Union of India or its Officers that Multi-level Marketing does not attract the provisions of the Act cannot legalise an illegal act.

6. This scheme called Multi-level Marketing creates a chain of customers and the long and unbroken chain would ensure larger amount of quick or easy money. The shorter and missed links in the chain would result in earning lesser commission. Therefore, there should be unbroken chain or customers. Secondly, the person does not get the value of the money he pays; thirdly, the companies are collecting service charges as stated above in a sale of goods. No service charges can be collected while the goods are sold. For all these reasons the scheme of so called Multi-level Marketing cannot be said not to violate the provisions of Section 2(c) of the Act.

### Role of Chartered Accountants

Chartered Accountants may be associated as Statutory Auditors or Consultants to the network marketing companies. The role and responsibility of the Chartered Accountants would also vary depending on the type of assignment done by the Chartered Accountant.

#### Role and Responsibility as an Auditor:

'SA 250 Consideration of laws and regulations in an Audit of Financial Statements' deals with the auditor's responsibility to consider laws and regulations when performing an audit of financial statements.

It basically the responsibility of the management to ensure compliance with various laws and regulations during the entity's operation including compliance with provisions of laws and regulations that determine the reported amounts and disclosures in an entity's financial statements.

The SA puts the auditor's responsibility regarding legal compliance as follows:

Legal Requirement type	Auditor's responsibility
The provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements such as tax and labour laws.	The auditor's responsibility is to obtain sufficient appropriate audit evidence about compliance with the provisions of those laws and regulations
Other laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the financial statements, but compliance with which may be fundamental to the operating aspects of the business, to an entity's ability to continue its business, or to avoid material penalties; non-compliance with such laws and regulations may, therefore, have a material effect on the financial statements.	Limited to undertaking specified audit procedures to help identify non-compliance with those laws and regulations that may have a material effect on the financial Statements.

In the case of MLM or Network Marketing Companies, if there is any violation of the provisions of the Prize Chits and Money Circulation Schemes (Banning) Act then the direct effect will not be on amounts and disclosures in the financial

statements. The auditor then needs to undertake such specified audit procedures in case of the MLM or Network Marketing Companies so that they are able to identify the non-compliance with this act. In case non-compliance is identified then the auditor is required to undertake specified audit procedures and report as per the requirements of SA 250.

#### Role and Responsibility as Consultant/Employee:

The role and responsibility of CA as consultant or Employee of the company will be to ensure compliance with the provisions of Prize Chits and Money Circulation Schemes (Banning) Act by the company. The CA may have to play an advisory role and inform the Directors or other person entitled with the management of the company about the various legal provisions and the penalties on contravention of the same. It is also the ethical responsibility of all the members to duly inform any person who wishes to start a network marketing company about all the legal requirements

and ensure compliance with Prize Chits and Money Circulation Schemes (Banning) Act and other applicable laws and regulations. This would help the person greatly in avoiding future legal hassles. ■