

# Ponzi Scheme: A Violation Against Good Corporate Governance and Islamic Concept on Investment

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**Abstract:** There have been many cases of investment fraud, both in a national and global scale, that use Ponzi Scheme as the basis of calculation to attract a great number of investors. However, in the end it caused many victims who suffered losses. The investment practice of Ponzi Scheme which is potentially harmful to investors is a violation of Good Corporate Governance based on applicable state law, as well as a contrary to the principles of investment based on Islamic shari'a, in which the concept of investment should essentially be beneficial to all parties and should not harm anyone. The Ponzi Scheme-based business is rife in Indonesia. It is an ironic phenomenon that most of Indonesia's populations are Muslim. Applying a qualitative method through content analysis of applicable rules and investment principles, this conceptual paper aims to describe and identify violations of the Ponzi Scheme against legal regulation and Islamic shari'a of investment. This study found that The Ponzi Scheme-based investment is a violation of Good Corporate Governance principles of transparency, accountability, responsibility, and fairness, as well as a violation of Islamic law in terms of ignoring the values of honesty and fairness by harming the investors and violating the rules on usury and gambling.

## 1 INTRODUCTION

The business cases with the Ponzi scheme are not only occurring recently in Indonesia. There have been many big cases of Ponzi-scheme investment revealed since several years ago, among others are the case of agribusiness investment initiated by PT. Qurnia Subur Alam Raya (QSAR), an investment fundraising by Cipaganti Karya Guna Persada Cooperative (KCKGP), gold investment scheme by East Gold Mining Corporation (EGMC) and Virgin Gold Mining corporation (VGMC), and the one which is recently and famously revealed case is First Travel.

QSAR was doing agribusiness by collecting fund from investors and promised to return the investment with high-rate profit within a short term. In reality, however, QSAR is unable to pay the pledged capital payback debt to the investors. QSAR debt reached a value of 476 billion Rupiahs to 6,480 investors. And finally on December 17, 2003 QSAR was declared bankruptcy by the Cibadak District Court, West Java (DetikNews, 2013).

Cipaganti initially offered investment opportunities to the public to become a partner in the

transportation business it ran. The investment offer was accompanied by a promise of a very high yield, which was about 20%. Then, Cipaganti started to expand aggressively to other business areas that are not its core competence, such as mining business. It then complicated the financial situation of Cipaganti, so Cipaganti found difficulty fulfilling its promises to investors. Finally Cipaganti pursue the practice of Ponzi Scheme and it led to corporate bankruptcy and failure to payback to investors (Frensidy, 2014).

EMGC and VGMC offered investment opportunities in gold by promising 10% -20% profit per month to investors. Both are actually illegal companies. Both do not even have gold mines in any countries. The rotation system of funds it did was like Multilevel Marketing (MLM) business. They kept looking for new investors to cover the debt of payback to their old investors. Finally, both companies failed to pay to investors (DetikNews, 2015).

First Travel ran a business travel bureau for umroh and hajj at a cheaper price than other travel agencies bureau. Initially the business was running smoothly, and managed to capture a lot of customers to reach the number of 70,000 customers. But along the time,

First Travel began to find difficulties to dispatch customers for Umrah and Hajj. Finally it was revealed that the business run by First Travel was done with the practice of Ponzi Scheme so it is known that among 70.000 First Travel customers, only 14.000 of them were successfully managed to depart umroh and hajj, while the rest failed to depart and never get the refund they have deposited. First Travel is alleged to have a debt of 500 billion Rupiah. First Travel business was declared collapsed. This case was handled as a major criminal case, and currently the three business owners of First Travel have been detained by the police (Silitonga, 2017).

Those fraudulent investment cases show that Ponzi-schemed businesses have been proven to bring a great loss to society in large numbers. Businesses with this pattern initially always seem very profitable so as to attract a lot of investors with a huge investment value. But it has been frequently proven that business with this pattern will not last long, and eventually involves the business owner in a criminal law case.

The list of those cases can still be extended by a row of many other fraud cases on investment scheme in Indonesia. The Financial Services Authority (OJK) stated that during the first quarter of 2016 there were about 400 companies in Indonesia without license but offering investment products to the public (<https://www.antaraneews.com>, June 5, 2016).

The fraudulent business practices are certainly not allowed by Islamic laws. This is a very ironic phenomenon in which most of Indonesia's populations are Muslim, but Ponzi Scheme-based business practice is rife in Indonesia.

Human beings are allowed to earn a living to meet the needs of their lives without neglecting the obligation to serve Allah. Earning a living to fulfil the necessities of life is a human's obligation, "Seeking halal sustenance is obligatory after fulfilling the fardhu (like prayer, fasting, etc.)" (Hadith Ath-Thabrani & Al-Baihaqi). But the obligation to seek sustenance must be done within certain limits set by Allah SWT as He has said in the Qur'an (Al-Baqarah: 60), "Eat and drink the provision given by Allah, and do not roam on the earth by doing damage."

An effort to strive for sustenance is doing business. Business is lawful and permissible in Islam. "There is no sin for you to seek the grace (sustenance from the result of doing business) of your Lord" (Qur'an, Al-Baqarah: 198). In another verse Allah says, "Allah has justified the sale and purchase and forbid usury." (Al Qur'an, Al-Baqarah: 275).

Although doing sale and purchase (commerce) is a legitimate activity, but in practice there are often

violations in commerce that cause one or several involved parties to suffer loss. Businesses are always oriented to obtain maximum financial benefits. This is what often leads to various frauds in commerce, some of which are caused by business practices based on the Ponzi scheme.

Ponzi scheme is a type of investment scheme that tends to be fraudulent. In this investment scheme the entire return on investment along with the dividend and interest paid is not derived from the profits of the business it carries on, but derives from additional capital investments submitted by other new investors. When additional new investments are insufficient to pay back the investment returns to existing investors, the business that runs on this investment scheme will eventually collapse (Paulo & Gale, 2012).

The Ponzi scheme is also well known as a pyramid investment scheme or "get-rich-quick". This kind of business is also intensively promoted through a member-get-member pattern just like multi-level marketing (Sulaiman, 2016).

These such cases certainly do not only occur in Indonesia, but have occurred in many other countries in the world. The fraudulent investments that use the Ponzi scheme have been originated in UK and US since several years ago. The Ponzi Scheme is more well-known as "The Pyramid Scheme" in UK. This scheme had been an issue in UK since decades ago and it is prohibited by some legal regulations, i.e. Part XI of the Fair Trading Act 1973, the Trading Schemes Act 1996, Trading Schemes Regulations 1997, the Consumer Protection from Unfair Trading Regulations 2008, and the Gambling Act 2005 (Paulo & Gale, 2012). The Ponzi Scheme was also applied in US by Madoff business. The such scheme of investment is also called as alternative investment, and it is not registered with the US Securities and Exchange Commission (SEC). (Evola & O'Grady, 2009). The Ponzi Scheme-based investment is not a novel issue in Malaysia. The such investment scheme was applied in Malaysia as "Swisscash-fund". Malaysian regulatory authorities have prohibited it in Section 210 of the Malaysian Capital Market and Services Act 2007 (CMSA, 2007) (Sulaiman, 2016).

This fraudulent business practice has clearly violated the various laws of the state in carrying out ethical business practices and Good Corporate Governance (GCG). The issue of corporate governance (CG) was first raised around the early 1990s. It was marked by the release of Cadbury Report in the UK in 1992. In the USA, corporate governance awareness began to emerge after the unfolding of Enron and Worldcom business fraud cases around 2002. This prompted the issuance of a

new legal regulation in the USA which is called as Sarbanes-Oxley Act (SOA). Awareness to abide by the rules of corporate governance leads to reforms in legal regulations (Lazarides & Drimpetas, 2010).

Corporate governance is a set of rules established to address agency problems, namely the conflict of interest between shareholders (investors) as the principals and managers who run the business as the agents. Corporate governance is a controlling mechanism that oversees managers to keep business profits and shareholder gains properly (L'Huillier, 2014).

In addition, the business practices that bring harm to many parties are certainly not in accordance with the rules of commerce that have been established in Islam as the words of Allah in the Qur'an, "O those who believe, do not eat each other's treasures by the false way (not true), except in the trades that apply mutual willingness basis. And do not kill yourself. Truly, Allah is Most Merciful to you." (An-Nisa: 29).

Running a business is permissible in Islam, but there are certain boundaries that should not be violated. Islam regulates the way of doing business justly so as not to harm all parties, as Allah says in the Qur'an (Hud: 85), "Fill the measure and the scales with justice, and do not harm human beings against their rights and do not make evil on earth by doing mischief."

In addition to emphasizing justice in business, Islam also upholds honesty, as Allah says in the Qur'an (Al-Anfal: 58), "And if you (Muhammad) fear the betrayal of a party, then return the covenant to them in an honest way, God does not love the one who betrays." Allah really hates those who cheat in business. This is contained in the Qur'an (Al-Muthaffiin: 1), "Woe to those who cheat (in measuring and weighing)."

Many previous studies have conducted research regarding investments based on the Ponzi Scheme. All authors agree that the Ponzi-Scheme investment practice is a form of infringement that harms investors. However, none of them discussed the Ponzi-Scheme-based investment from the viewpoint of Good Corporate Governance and Islamic law simultaneously. Whereas, Good Corporate Governance and Islamic Law are sets of rules that are aligned in regulating human life for the sake of the world and the hereafter. Thus, this paper aims to depict the violations committed by Ponzi-schemed businesses against the rules set forth in the principles of Good Corporate Governance (GCG) as well as violations against Islamic law regarding the conduct of business and investment. The discussion in this study will be conducted through content analysis of

legal rules established by the law of the country and the study of business rules that have been established by Islam in the Qur'an and Hadith.

## 2 METHODOLOGY

This article is a conceptual paper. The study conducted in this paper applies a qualitative method through content analysis of applicable rules in Good Corporate Governance principles from literature review of previous studies and Islamic rules based on Al Qur'an and Hadith. This content analysis is conducted with an in-depth discussion of the Ponzi Scheme linked to Good Corporate Governance principles consisting of Transparency, Accountability, Responsibility, Independence, and Fairness. In addition, content analysis is also done by discussing the verses of the Qur'an that regulate the provisions of business practices and investments in Islam. Discussing the verses of the Qur'an is aimed to dig up information about parts of Islamic law that are violated by Ponzi Scheme-based business practices.

## 3 RESULTS AND DISCUSSION

Companies around the world are currently encouraged to implement the principle of Good Corporate Governance (GCG) which is the best practice of ethical business conduct. According to Lazarides & Drimpetas (2010), one of the main things regulated in the legal law is the protection of the rights of shareholders and all stakeholders in the financial markets. Corporate governance is one of the frameworks required by investors to reduce the risk of investing in businesses.

Good Corporate Governance is essential to maintain long-term sustainability for financial and capital markets and to maintain the sustainability of the business itself. This is to ensure the efficient and productive use of company assets for the benefit of investors and all stakeholders (Sabbaghi, 2016). The spirit of Good Corporate Governance is to protect the rights of investors and all stakeholders. This is to avoid frauds and any parties get harmed in running a business. Thus, Ponzi-schemed investment practices are not in line with the principles of Good Corporate Governance because of the potential to cause harm to investors.

The Ponzi Scheme is like a financial game playing in capital economy. When the maturity of the debt has been due, the business must seek new debt to pay

principal and interest of previous debt. This goes on and on to keep the business continues (Al-Zoubi et al., 2008).

Corporate Governance is now considered as an important and key driver of business performance. It is also increasingly recognized by regulators, business actors, and capital market authorities (Pillai & Al-Malkawi, 2017). Based on the general guidelines of Good Corporate Governance Indonesia issued by the National Committee on Governance Policy, there are five basic principles of GCG implementation: transparency, accountability, responsibility, independency and fairness (KNKG, 2006).

Transparency refers to disclosure of information that the company should deliver to the public, such as financial and annual reports. In terms of transparency, the Ponzi-schemed businesses usually cannot disclose their financial reports, so that the profit generated by the business is not clearly stated and the company cannot give return to investors in a proper way based on profit calculation. According to Evola & O'Grady (2009), the business practice with Ponzi Scheme is not transparent and the business can continue to deceive investors by hiding behind the desire of investors to gain an increase of profits

Accountability is a continuation of transparency, in which the company performance must be clearly demonstrated. Company performance should be measurable with a clear calculation. In terms of responsibility, the company should comply with prudential principle and applicable regulations.

Mathematically, businesses with Ponzi schemes are very difficult to survive for long periods of time, unless they are supported by a steady increase in the number of investors. But in such a business pattern, the more the number of investors, the more likely it will be to fail because this means the business will have an exponentially inflated debt of investment return (Carey & Webb, 2017).

In Indonesian term, the investment pattern in the Ponzi scheme is called as "digging a hole to close a hole". This is potentially detrimental to investors if it turns out that the increase in the amount of new investment is not as fast as the maturity date of repayment to existing investors until the business finally cannot afford to pay all debts and falls to collapse. In this case, the Ponzi-schemed business fails to comply with prudential principle. Thus, applying the Ponzi Scheme is not allowed according to the rules of Good Corporate Governance and Islamic laws on business and investment.

Promotion of transparency and accountability is an enabler to establish a comprehensive accounting,

tax and regulatory framework to reinforce Shari'a capital market which is based on Islamic values. It is also an effort to resolve problems of ethics and frauds in business (Said et al., 2013).

The matters governed by GCG principles are very much in line with the virtues of Islam. In this case the values associated with running a business in accordance with the Shari'a. Islam came down to earth as a mercy and welfare for the whole universe (*Rahmatan lil Alamin*). Islam also regulates the way of doing business and investing with the aim of giving benefit to all mankind. Therefore, Islam highly upholds the value of justice and honesty, and prohibits fraudulent business practices that harm any party.

Fairness and honesty in business are repeatedly emphasized in several verses of the Qur'an. In Surah Al-Isra': 35, Allah says, "And complete the measure when you measure, and weigh it with the right scales. That is the greater (for you) and the better of it. In Surah Asy-Syu'ara': 181-183, it is stated by Allah, "Complete the measure and do not harm another; and weigh with the right scales. And do not harm mankind by diminishing their rights and do not cause harm to the earth." Fairness is also emphasized in another verse of the Qur'an, namely in Surah Ar-Rahman: 9, "And enforce the balance fairly and do not diminish that balance."

In Islam, the money invested in our business is a mandate that we must safeguard as best we can to deliver good results for investors. Businesses with Ponzi-schemed investments are certainly not very much aligned with this, because when the business is collapse and we are unable to refund the funds entrusted by investors to us, it means we have betrayed the mandate given to us. This is contrary to the word of Allah in the Qur'an (Al-Anfal: 27), "O you who believe! Do not betray Allah and the Rasul and do not betray the mandate entrusted to you while you know."

Besides being a mandate, money invested in our business is also our debt to investors. Debt is an absolute obligation to be paid. Debt accounts issue is fully regulated in Al Qur'an Surah Al-Baqarah: 280-283, that if any transaction is made not in cash, then the debt will arise, and that transaction must be recorded in writing. The transaction should also include at least two witnesses so that if one forgets, the other can remind. Debt is a trust in which the obligations arising therefrom must be fulfilled.

In addition, Islam also strongly prohibits the existence of usury (*riba*) in business transactions. Allah says repeatedly in several verses in the Qur'an regarding the prohibition of usury. In Surah Al-

Baqarah: 275 it says that, "Allah has justified buying-selling and forbidden usury." In Surah Ali 'Imran: 130 Allah says, "O you who believe! Let not eat usury doubled and fear Allah to make you lucky." In Surah An-Nisa: 161 it is mentioned, "and because they practice usury, whereas indeed they have been forbidden from it, and because they eat the treasures of people by unlawful means. And We provide for the unbelievers among them a poignant penalty."

Therefore, a justified investment in Islam is an investment in the form of Musharakah, in which the profit earned by investors is the result of profit or loss sharing from the business run. Shari'a investment of Musharakah system is an original Islamic instrument that is based on return and risk sharing (Azmat et al., 2016). The Ponzi-schemed investment is defined as the scheme of investment that the return on investment is not derived from the profits of the business, but derives from additional capital investments submitted by other new investors. In this case, the Ponzi-schemed business does not comply with Islamic regulation on investment which should be based on profit and risk sharing. In terms of clearly measurable risks, Ponzi Scheme-based business practices are also closer to the practice of gambling. The Ponzi Scheme-based investment is an investment system which is similar to money game playing. It certainly contains a very-high vagueness of business transaction that is called *al-maysiri*. Thus, Ponzi Scheme also violates Islamic law regarding gambling as contained in the Qur'an at Al-Baqarah: 291 and Al-Maidah: 90-91.

#### 4 CONCLUSION

From this study, it can be concluded that businesses with Ponzi-schemed investments have violated several rules of Good Corporate Governance (GCG) and Islamic Shari'a law. Ponzi-schemed businesses are not in line with GCG principles, especially transparency, accountability, responsibility, and fairness. In the case of violations of Islamic Shari'a law, Ponzi-schemed businesses fail to uphold the values of honesty and fairness by harming the investors and violating the rules on usury and gambling.

This paper has limitations, one of which is the study conducted is not specific in the case of certain business firms that apply Ponzi-schemed investment. Therefore, further research is expected to continue this research with case studies that refer to particular cases of Ponzi-schemed business, so that it can further explain the detailed and specific violations committed

by the Ponzi Scheme on certain types of business, so that the public can avoid it.

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