NSEL SCAM: WHAT WENT WRONG

Sonam Kumari Gupta
University of Delhi

Introduction

National Spot Exchange (**NSEL**) is a Commodities exchange in India, and is a joint venture of Financial Technologies (India) Ltd. (FTIL) and National Agricultural Cooperative Marketing Federation of India (NAFED) . National Spot Exchange commenced its live trading operations in different commodities on Wednesday, 15 October 2008. It began trading in pre-certified cotton bales for Mumbai delivery and imported gold and silver bars for Ahmedabad delivery immediately, and has since added a number of commodities. National Spot Exchange's stated mission is to develop a common Indian market by setting up a nationwide electronic spot market and providing state of art trading, delivery, and settlement facilities in various commodities. This exchange is now in the middle of a controversy due to a major commodity scam and all the trades have been stopped.

SERVICES and FACILITIES IT OFFERED:

- *Selling* - NSEL provides an electronic trading and *auction* platform to sell commodities (Agri, bullion and Metals).
- *Procurement* - Bulk buyers can procure the agri-commodities directly from farmers through electronic platform provided by the NSEL.
- *Warehousing* - NSEL provides warehousing facilities for various commodities and also facilitate to sell it through the electronic platform to the bulk buyers and millers situated across the country.
- *Investment* - NSEL provides investment instruments. E-series products launched by NSEL can be bought by the investors for accumulation in the Demat account, just like the shares in the equity market. Currently, E-Gold, E-Silver and E-Copper are available to investors.
- *Arbitrage* - A trader can do arbitrage using different prices available for the same commodity.
- Single day trading contracts
- Intra-day trading with settlement of obligation on net basis
- All positions outstanding at end of the day resulting into compulsory delivery
- Demat delivery facility available
- Fungibility of delivery between National Spot Exchange and MCX with common ICIN numbers.
- Loan facility against pledge of Demat / warehouse receipt
- Cash futures arbitrage opportunity

PRODUCTS

A new form of commodities investment: Initiative of NSEL with E-Series Products

For the first time in India, National Spot Exchange has introduced E-Series products in commodities. Retail investors can now trade and invest in commodities like they invest in equities. This will be a unique market segment, which will function just like cash segment in equities, but offer commodities in the demat form in smaller denominations. The clearing and settlement pay-in and pay-out will be based on a settlement cycle as per the practice in the stock market. This instrument will provide ample opportunity to the masses as secured investment in their product basket of diversification. NSEL launched its first product under the E-Series as E-Gold on Wednesday, 17 March 2010. Clients/retail investors who wish to purchase E- GOLD units are required to open their beneficiary account with NSEL empanelled Depository Participants (DPs) and disclose their client ids and DP ids to their respective members to enable them to transfer the units to the respective client's accounts. On receipt of Demat ICIN in the CM-POOL account, the member should transfer the same to the beneficiary account of the respective client. NSEL has made necessary arrangements with National Securities Depository Limited (NSDL), and Central Depository Services (India) Ltd. (CDSL) is the depository for holding commodity units in the electronic form. E-series trading has been suspended w.e.f 5 August 2013 till further notice. Pursuant to Forward Markets Commission's (FMC) NOC to NSEL, dated 27 March 2014, the Exchange had initiated the process of rematerialization from 12 April 2014 and subsequently the Exchange commenced the 'Financial Closure' of the balance units of e-Series starting from 6 May 2014.Infoline, India (5 April 2014) "Financial Closure of e-Series". IndiaInfoline. Retrieved 5 September 2014. On 23 June 2014, the Exchange completed Financial Closure of e-Gold with total payment of Rs 154.77 Crores was made to the unit holders. Likewise, on 27 August 2014, the Exchange completed Financial Closure of e-Silver with total payment of Rs 141.23 Crores. The process of financial closure of Platinum, Copper, Lead and Nickel, which constitute the remaining balance 1.6% of the total value is in progress and is expected to be completed soon. Despite the crisis, the Exchange has been able to recover Rs. 354 core till 31 May 2014 and bridge loan of Rs. 179 Crores was taken from FTIL (total Rs 533 cr) and paid to investors, with which it has cleared up to 50% settlement liability of around 7,000 retail investors. The newly constituted Board of Directors is leaving no stone unturned to recover outstanding from the defaulting members with a view to restoring confidence of investors on the financial markets.

History

NSEL was promoted as a spot commodity exchange by FTIL and a token 100 shares were given to NAFED so that the brand of NAFED can be used and the exchange could be touted as a 'farmer's market'. Even before NSEL commenced business it was given a specific exemption from Forward Contracts Regulation Act (FCRA) 1952 by ministry of Consumer affairs in 2007 headed by Shri Sharad Pawar. This exemption was only for all one day forward contracts up to 11 days. Mr.Paul Joseph who signed this exemption later was known to have joined the FTIL group. The business between 2007-2009 was lackluster and that is when NSEL with full knowledge of Jignesh Shah and other board members introduced fraudulent 'paired contracts' where investors could buy short duration contract and sell a long duration contract at the same time (usually T+2 and T+25). NSEL in 2010 applied to FMC for registration of these NTSD (Non Transferable Specific Delivery) paired contracts exceeding 11 days under section 14A of FCRA. The FMC did not approve or reject this application till the scam broke out in 2013. Without waiting for the FMC regulation approval or registration, NSEL went ahead and sold these contracts rampantly through brokers. The FMC-Ministry of consumer affairs fully knowing these contracts were illegal (they were collecting NSEL data from early 2012) did not stop them and let the scam balloon into an astronomical amount. In early 2012 the FMC was appointed as 'designated agency' to collect data from NSEL and protect investors' interest. In April 2012 the Ministry of Consumer affairs issued a show cause notice to NSEL that it was violating the conditions of 2007 exemption like 'no short sale' , 'no stock verification mechanism' and ' conducting trades beyond 11 days'. So from early 2012 to July 2013 the FMC knew about fraudulent NTSD contracts rampantly being conducted without registration under section 14A-14B of FCRA but for reasons unknown did not act. NSEL kept operating outside the realms of law and in March 2012, it notched up a mind-numbing Rs. 45,500 core (about 7.5 Billion USD) turnover, the highest ever monthly average.

The Crisis

The NSEL was incorporated to bring price transparency, better price realization for farmers and lot of arbitrage opportunities for investors and trading community. Thus NSEL was brought in to sync with existing markets and provide synergy among the existing marketing systems. NSEL was an electronic platform which would bring three entities together. The sellers of commodity, forward buyers and the investors, who were actually funding all the transaction. On settlement, the buyers would pay the differential (which usually came at a premium to the spot price) and settle the contracts. The eventual payout would ensure that the financiers or investors got their money. Investors got the benefit as they were receiving more than the amount of interest on the transaction they actually financed. As mentioned before, Spot exchanges, including NSEL, were allowed to offer one-day forward contracts provided that members would not resort to short sales and that outstanding positions at the end of the trading day would result in delivery. However, the FMC found that the exchange allowed trading on its platform without verifying whether the seller had stocks, in effect allowing short sales by members. At the end of July, 2013, the investigations by the FMC found that the contracts traded on the exchange for which the settlement period exceeded 11 days were non-transferable specific delivery contracts, which were violating the provisions of Forward Contract Regulation Act, 1952. This problem escalated further when The amount involved in unsettled payouts as on July 29, stood at around Rs 5400 crore. This lead to suspended trading and suspended launch of new contracts indefinitely. To make matters worse, it was found that demutualization concept was found to violated altogether as NSEL was found to be an entity owned by the Financial Technologies promoted by Jignesh Shah. NSEL scam is found to loop in borrowers, sellers and investors in a puzzle altogether. It was found through investigations that investors and speculators used forward contracts to make money. The forward contracts in the beginning involved some set of commodity stockists selling warehouse receipts to investors for immediate payment. These investors also entered into buyback arrangements by selling back the commodity to stockists after 25 to 35 day periods ignoring the forward markets regulation act. Thus earning atleast 12-14 percentage returns. Thus the deal helped stockists receive immediate money and investors their returns. It came to light that just 24 members of the exchange, called Planters or Processors or Borrowers existed. These members owned plants that processed commodities – or, at least, they said they did. NK Proteins owned a plant to process castor seeds in Kadi, Gujarat. The contract – the Kadi Castor Seeds contract – was settled at an NSEL warehouse located inside the Kadi plant of NK Proteins. Processors like NK Proteins (and there were 23 other such members) were on the other side of the trade. They would sell at T+2 and buy back at T+23, offering huge returns. The actual problems arose when investors entered into arrangements without proof of underlying stock. The investors actually sold commodities without proof of underlying stock and entered into buyback arrangements. It is observed that the quantities of underlying commodities may be fictitious. Table 3 shows certain quantities of sugar and metals as well as other commodities to be practically out of sync with reality. Though Demutualization is an important aspect preventing such instances, the Financial Technologies group as a whole has been found to have had interests in the NSEL. According to reports, investors the settlement guarantee fund which has drastically come down from initial claim of Rs. 839.53 crore to just Rs. 65 crore has been under scrutiny. Thus investors not aware of structural intricacies of the instruments invested into these trade arrangements. Lack of knowledge of underlying instruments and lack of information lead to amount of Rs. 5400 crore unsettled payouts as on July 29th, 2013. The NSEL scam has once again raised doubts over investing opportunities and investment safety.

What Government did

In a show cause notice, on 27 April 2012, based on the data provided by the Forward Markets Commission (India), the Ministry of Consumer Affairs asked the NSEL to answer why legal proceedings should not be carried out against the company given it was conducting illegal trades, and that there the company did not provide any apparent mechanism to verify commodity stocks. However, until 12 July 2013 that is close to 15 months after the show cause notice no action was taken by the Ministry. The lack of early government intervention allowed the scam amount to balloon to Rs. 5600 crores.

The FMC also has played a dubious role in the scam as the ex chairman of FMC Mr.B.C. Khatua (whose son is employed with FT group) knew about NSEL's application for registration of NTSD (paired) contracts but neither accepted nor rejected them. The dubious exemption to NSEL from FCRA was given in 2007 within weeks of Mr.B.C. Khatua assuming office when the Ministry of Consumer Affairs was headed by Sharad Pawar. Another ex FMC Chairman Mr. Venkat Chary also works for FT group raising doubts about the working of FMC and their possible complicity collusion in NSEL scam.

It has been claimed that heavy political maneuvering was done by Jignesh Shah with various government entities to keep this SCN in abeyance and that cost the investors their hard-earned money. Interestingly, a committee headed by Shri Arvind Mayaram suggested that the entire system was an 'unregulated exchange' and the HNIs (High Net-worth Individuals) invested with open eyes, pointing out the scam was the fault of the investors. However, the committee ruled so ignoring the role of FMC - the designated agency to supervise NSEL from early 2012. It does not even mention that the NSEL has in 2010 already applied for registration of NTSD contracts. Apparently, FMC was aware of 'NBFC like activities' going on at NSEL and it is also claimed that FMC declined to file FIR against NSEL in spite of being aware of SGS finding that there were not enough commodities in the NSEL warehouses.

A formal complaint against the role of officials of FMC and Ministry of Consumer affairs has been filed with CBI by NSEL Investors' Action Group.(NIAG)

A panel of high-level officials, and headed by the Economic Affairs Secretary Arvind Mayaram, submitted to the Finance Minister P. Chidambaram its report on the alleged irregularities at the NSEL. However, the report did not reveal key shortcomings and acts of omission and commission by the bureaucrats of DCA and FMC was claimed to be more of a cover up.

Role of Auditors

At the behest of the Forward Markets Commission (FMC), the NSEL asked Grant Thornton to conduct a forensic audit of the books of NSEL. The report, though not complete and with insufficient cooperation from NSEL, brought out various glaring irregularities. On the basis of the Grant Thornton report, the FMC served a show cause notice to the promoters of NSEL about their 'fit and proper' status to run exchanges. There are still wide differences between the books of the NSEL, and those of the most borrowers. The Grant Thornton report also pointed out how Mr. Anjani Sinha wrote an internal email to stop using IBMA for rigging MCX prices, and to use SNP Designs P Ltd (his wife Shalini Sinha's company) to conduct proprietary speculative trades on the exchange. As an inference, it was clear that the whole group NSEL/IBMA/MCX and FTIL were working in tandem and cooking books. Subsequent to a court petition by some investors of NSEL, FMC has been directed by the Mumbai High Court to conduct a forensic audit of E-series bullion contracts of NSEL. After petitions from certain NSEL pair trade investors, the Bombay high court directed the FMC to appoint a forensic audit of E-series products of NSEL. An audit firm by the name of Choksi and Choksi was given this assignment and their audit report has damning revelations against the promoters and FT group. The FMC also asked PWC to conduct an audit of MCX where after the audit a lot of related party trades and other deviations were found which raised serious questions about the integrity and functioning of the FT group.It was learnt that MCX paid Rs 2.25 crores as dubious donations to Mukesh P Shah (Jignesh Shah's uncle and NSEL auditor) and Rs 17.76 crore either as donations or as professional charges to entities to which Sunil Daga Khairnar — former director of NBHC and NSEL. Maintaining that the settlement backlog was due to redemption pressure, the NSEL, on 5 September 2013, announced that its stock position of Gold, Silver and Platinum for e-series contracts tallies with depository records, citing an audit report by M/s Sharp & Tannan Associates – one of the Top-

10 audit firms in India – which conducted physical verification of stocks of precious metals lying with Brinks Arya India Pvt. Ltd at its vaults in Mumbai, Kolkata, New Delhi, Hyderabad, Ahmedabad and Jaipur. NSEL also appointed SGS to carry out quantity and quality inspection of the commodities lying in various warehouses. The audit indicated that significant stock shortage was found in 9 warehouses relating to 7 defaulters. In respect of 29 warehouses relating to 11 defaulters, the SGS audit team was not allowed inside the premises.

Aftermath

The EOW Wing of Mumbai police filed an FIR against all the directors of the NSEL and Financial Technologies India Ltd including Jignesh Shah, Joseph Massey and Shreekant Javalgekar. The Grant Thornton forensic audit report also indicted the board of directors/promoters including Mr. Jignesh Shah who were present in all the crucial meetings, including the ones where fraudulent pair trade contracts were introduced, and money was allowed to be sanctioned to NK Protein Ltd. It is worthy to note that the owner of NK protein Ltd is also the son-in-law of the then Chairman Shankarlal Guru. It has also come to light in forensic audit that FT the promoter company had conducted a system/process audit of NSEL in 2011-2012 but the report was never finalized even after finding high risk irregularities. The FMC in their show cause notice, and the Registrar of Companies (ROC) in their interim report, have held the promoters including Mr. Jignesh Shah, squarely responsible for the fraud. Jignesh Shah also came on TV on 5 August 2013, and promised a financial settlement. Interestingly, he said, "What will investors do with commodities, that's why we have decided to go for financial settlement" – which made people believe that he knew there were no underlying commodities in the NSEL warehouses, contrary to what was shown on the NSEL website. Mr. Jignesh Shah also promised a committee of three to look into the scam. The committee was to include the retired police commissioner Sivanandan, but it was merely a whitewash and was never formed. Various forensic audits by Grant Thornton, PWC, Chokshi and Choksi confirmed the involvement of the board of NSEL in the scam and dubious role of Financial Technologies Group Anjani Sinha's custodial statement squarely puts the blame on Jignesh Shah who he claimed was the mastermind of this whole NSEL fraud and the motive was to sustain profitability and market cap of FTIL which was dwindling as a result of loss making foreign exchanges that it floated. It seems most exchanges being run and promoted by FT group have been mired in mismanagement, fraud and deceit. The fact that the parent company Financial Technologies India Ltd (FTIL)which owns 99.998% of NSEL had conducted an audit of NSEL systems/processes and did nothing even after knowing about NSEL shortcomings confirms the fact that the board of NSEL and FTIL knew much more about the scam then what is being made out.Soon after the news of the scam broke, FTIL claimed that the server that housed sensitive data related to the company has crashed. This seems more like a planned move on the part of the promoters. The FMC also held FTIL, Jignesh Shah, Shreekant Javalgekar and Joseph Massey to be complicit in NSEL fraud and not 'fit and proper' to run any exchange in India. The latest revelations from EOW investigation and the police charge-sheet on Jignesh Shah confirm that a company associated with Jignesh Shah pulled out its money just before the exchange went bust. Jignesh has been charged with insider trading on NSEL and also MCX exchanges. An email between NSEL and NCS Sugar which was first sent to FTIL outbox (FT outbox) and then relayed by FTIL clearly shows FTIL's knowledge of launching of bogus T+2 - T+25 contracts on behalf of NCS sugar to 'liquidate old outstanding dues'.It was explicitly clear that these contracts were mere bogus contracts and the monies generated from investors will have to be given back to NSEL. This clearly underlines FTIL's complicity in the fraud. The economic offences wing (EOW) of Mumbai Police has found evidence of some irregularities on the part of the brokers in the National Spot Exchange Ltd (NSEL)scam. An interim report on the police's forensic audit had thrown up evidence of hawala transactions, benami trades and client code changes at some of the brokers. The interim report also states some of the brokers were aware of the impending danger at NSEL; the EOW found volumes of the spot exchange saw a sudden fall in April and May 2013. The report mentions evidence of illegal and unauthorised changes at the back-end of NSEL severs, where brokers may not have any control. The names of clients on NSEL servers were found to be different from those in brokers' ones. Anjani Sinha's police statement also confirms that the brokers associated with Jignesh Shah/FTIL were conducting bogus trading in overseas exchanges of FTIL through their overseas subsidiaries. The NSEL brokers have been charged by investors with giving away their clients' monies without even securing the title of the goods i.e. the 'warehouse receipts' result in 'criminal breach of trust'. In the latest development, the NSEL Investors' Action Group – a forum of aggrieved investors – has alleged that high-profile brokers involved in NSEL scam have been privy to the scam. The association, in a letter to the police, has urged them to take stringent action against brokers. "Most NSEL brokers were wealth managers to the investors and they falsely sold NSEL as an 'arbitrage product' on false assurance of safety and existence of stocks in NSEL warehouses. Most brokers including Motilal Oswal took Power of Attorney to sell/purchase/receive/deliver/pledge commodities on behalf of the investors and also open DMAT account to handle commodities in electronic form and also got an agreement to sign 'Hold and transact in warehouse receipts'. In a criminal breach of trust they gave away investors' monies without securing these warehouse receipts as promised," said the investors in a letter to the Commissioner of Mumbai Police. They have also alleged that the brokers charged warehouse receipt transfer and delivery charges when actually there was no delivery of goods and warehouse receipts. They also charged the brokers for falsely assuring them of NSEL being a regulated exchange and that their investment was secure. Besides, the Hon'ble Bombay High Court observed that "...brokers do have their own legal team and a full knowledge of how the market operates. The legalities of the transactions were quite expected to be known to the brokers ... the brokers being quite experienced, and the investors being informed persons, it is apparent that the issue of illegality of the transactions raised by them is not out of their concern to adhere to legalities, but in order to project the applicant as the main offender, rather than the defaulting parties. The EOW wing of Mumbai police on 3 March 2015 arrested 3 top brokers in NSEL scam. Those arrested were Amit Rathi, managing director of Anand Rathi Financial Services Ltd; C P Krishnan of Geojit Comtrade Ltd; and Chintan Modi of India Infoline Ltd (IIFL). The three have been charged with mis-selling NSEL products, cheating, forgery and criminal conspiracy, among other charges. On 21 October 2014 the Ministry of Corporate affairs announced a draft order for merger of NSEL which is the subsidiary company with its holding company ,viz., FTIL. The govt by announcing this merger has exercised its power under sec. 396 of the Companies Act,1956. All stakeholders have been given 60 days to report to MCA and the order may get finalized after this. As of now FTIL has challenged this merger in Mumbai HC before the bench of Mr. V M Kanade. On 28 February 2015,The ministry of corporate affairs convinced about FTIL's fraudulent activities, moved a CLB application to take over the board of FTIL and replace it with govt. nominated directors. This move is being contested by Jignesh Shah appointed FTIL board. On 30 June 2015 the Company Law Board (CLB) barred FTIL from selling its assets.

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