

# 3

# Principles and Practice

Overlooking Principles of Fairness to Unjustly Punish the Financial Technologies Group

*While FTIL and NSEL have been pursuing and fulfilling obligations, within the framework available in the legal sphere, to ensure recovery and to attend to the interests of the affected constituencies, the treatment that was meted out to them by the various authorities has been plain unjust, in a great hurry, contravening and in contradiction of principles of fairness that need to be applied to a company working towards crisis resolution.*

If it is a Private Market Problem Why Excessive Regulatory Zeal?

Regulation: Can it be Discretionary or should it be Mandatory?

Unfair Comparison with Earlier Crisis

Puzzling Attitude of Pick and Choose

Questionable Application of Fit and Proper

Differences in Definitions

The Money Trail

Should a Payment Crisis Only Lead to Closing Down of the Exchange?

Why the Approach Needs to Change

Avoid Measures that could be Counter-Productive

The manner in which the accident at NSEL was handled is a cause of concern. The way it was addressed by various agencies, including the regulatory authorities raises far more important issues that could cause anxiety and disquiet for those people who believe in free markets and fair justice. A complete and comprehensive review of the whole episode what contributed to the crisis and how it was managed subsequently – brings into light the importance of balance and maturity in handling crisis such as this, which unfortunately is in severe shortcoming in this case. In democracies and free markets, crises are not uncommon. If the authorities go into excessive overdrive, demolishing everything that is remotely connected with the issue in the name of resolution of the crisis, the image and ability of India to emerge as a major and mature economic power will come into serious doubt and dispute.

There is so much of misconception, misinformation, misreading, misunderstanding and misinterpretation around the whole crisis that it has made it into a sordid drama where players who should have taken the responsibility of finding a solution to the crisis went beyond their brief, leading to a complex situation arising.

The NSEL accident is not something that the world has not known in the past or that has never taken place. The context of the crisis is also not something so unusual. The question that only comes to mind is how and why there was so much hurry on destroying a vast ecosystem that has great potential to grow and contribute to India's progress, which was carefully built over long years, in the name of solving a crisis just to fulfill the demands of a few high networth trading clients who themselves are also to be blamed, in the first place, for the crisis to happen?

The way it was dealt with raises more questions than answers. Here are a few that are quite puzzling and perplexing.

## IF IT IS A PRIVATE MARKET PROBLEM, WHY EXCESSIVE REGULATORY ZEAL?

The big issue about NSEL is about its regulation. The Forward Markets Commission, which regulates the commodity exchanges in India, disowned the regulation of the spot exchange saying that it is not under its purview, while, the Department of Consumer Affairs, Government of India through various notifications entrusted the FMC with regulation of spot exchanges and oversight which are core issues that form any regulatory mandate. Assuming for a moment that the FMC is not responsible for spot market business, then why is it so keen on punishing the promoters of NSEL for payment defaults that took place in the private market. In fact, some of the Government committees set up initially to investigate the issue observed that the affected parties were few and niche and this crisis did not cause any systemic problem. In that case what could be the motivation for the FMC to take exceptional and extraordinary interest in this issue?

## REGULATION: CAN IT BE DISCRETIONARY OR SHOULD IT BE MANDATORY?

The institution that received it (i.e. the FMC) and the department that issued it (i.e. the DCA) belong to the same ministry until Sept. 2013 but the interpretation to the circular is entirely different. In its letter dated August 5, 2011, the Department of Consumer Affairs, Ministry of Consumer Affairs, Food and Public Distribution, Government of India, under which the Forward Markets Commission was functioning had sent a circular to the Commission with the subject as **"Regulation of National Spot Exchanges" (ANX-18)**. In its letter dated 10 August 2011, the FMC advised the spot exchanges to submit information on a fortnightly basis **(ANX-19)**. Three important regulatory terms were used in these letters, entrusting the responsibility to the Forward Markets Commission: **"providing oversight", "safeguarding investor interest", "submitting information on a fortnightly basis"**. Globally, these three words form the bulk of the regulation in any market but is rather strange why FMC chose not to fulfill these functions entrusted to it.

How FMC was entrusted with the responsibility of regulation of the national spot exchanges, such as provision of oversight, safeguard investor interest and collection of periodic information.	How the regulatory functions entrusted to the FMC as the designated agency were selectively ignored for the last two years prior to the crisis and only pursued against NSEL and Financial Technologies after the crisis
What is advised	How it was ignored
<p>FMC letter Dated 10th August 2011</p> <p>To The Managing Director, National Spot Exchange stated:</p> <p>"I am directed to enclose herewith a copy of the letter from the Department of Consumer Affairs nominating Forward Market Commission as the 'Designated Agency' for providing oversight over all the Spot Exchanges, which have been granted exemptions under Section 27 of the FCRA. The Spot Exchanges may please note the content of the said letter for further necessary action at their end. It may also be mentioned that the Exchanges would be required to forward a return on a fortnightly basis to the Commission. The reporting format will be indicated to you shortly." Excerpt from letter from Ministry Consumer Affairs, Food and Public Distribution to the FMC dated August 5, 2011</p> <p>"In order to safeguard the interest of the investor and to ensure that the conditions stipulated for grant of exemption are complied with, the competent authority has decided to nominate the Forward Markets Commission as a Designated Agency for providing oversight over all the Spot Exchanges which are granted exemption under section 27 of the Forward Market Contract Regulation Act, 1952.</p> <p>4. In view of the above FMC may ensure that the conditions stipulated for grant of exemptions are complied with. In case, there is any breach of conditions subject to which exemption is granted, the FMC will be competent to take action deemed necessary and fit."</p>	<p>The Notification from the Ministry of Consumer Affairs, Food and Public Distribution, Government of India nominating the FMC as a designated agency for regulation of the National Spot Exchanges, including providing oversight, protection of investor interests and periodic collection of information was not implemented by FMC in a serious manner.</p>
What is advised	It was only NSEL and FTIL that were targeted
<p>Gazette Notification dated 6th August 2013</p> <p>"(ii) Settlement of all outstanding one day forward contracts at National Spot Exchange Limited shall be done under the supervision of Forward Markets Commission and any order or direction issued by the FMC in this regard shall be binding upon the National Spot Exchange Limited and any person, intermediary or warehouse connected with the National Spot Exchange Limited, and for this purpose, the Forward Markets Commission is authorized to take such measures, as it deems fit."</p>	<p>Whereas the Government notification clearly said the Forward Markets Commission should take all those measures relevant to the settlement of outstanding, including NSEL, any person, intermediary or warehouse connected with the crisis, the FMC chose to pursue action only against FTIL and NSEL. But no action initiated against the defaulters and the brokers.</p>

## UNFAIR COMPARISON WITH EARLIER CRISES

Loose comments and comparisons about NSEL crisis abound in the media and public platforms comparing it to the earlier stock market crises. Harshad Mehta and Ketan Parekh's crises, which are normally brought to comparison, are completely different and out of context to the NSEL crisis as could be evident from the following:

EARLIER CRISES (HARSHAD MEHTA, KETAN PAREKH, NSDL, SATYAM)	NSEL CRISIS
Diversion of banks' money into stock price appreciation	There is no diversion of any sort of money from any Institution to NSEL. Instead money has gone to banks
Clients did not know the background of the stocks in which they were trading	Clients are fully aware of the commodities in which they are trading
Lakhs of clients and investors	The Exchange's privity of the contract is with 148 brokers
Money invested by clients have diminished or evaporated with fall in the price of stocks	Collateral and assets close to the tune of affected money of the clients (about Rs 5690 cr) is secured and now is with the EOW
Exchanges in which the clients lost money were not involved in recovering money	NSEL, the exchange, and FTIL, its promoter, are striving hard to recover the money lost by the trading clients from the defaulters
Both these crises have contributed to huge systemic risk	There is no systemic risk involved as mentioned by various committees including that of RBI   Government of India
Happened in the financial markets where the value of the assets depleted and does not match with what the clients lost	Took place in the real economy where the value of assets attached by the EOW as collateral matches with that of the claims
In the NSDL IPO problem, 13.58 lakh retail investors were affected	Less than 1000 clients account for nearly 70 percent of the claim.
In the case of Satyam, the parent company itself admitted to lapses and the Board and the Management were not in a position to conduct normal business and fulfill obligations owing to the crisis	The parent company is not connected with the crisis in any manner. The Board and the Management are in total control of the parent company business ensuring smooth conduct of the business and fulfilling all obligations.

## PUZZLING ATTITUDE OF PICK AND CHOOSE

Notwithstanding where the issue stands, either in respect of public or private domain or who has the power to regulate, the Department of Consumer Affairs, Ministry of Consumer Affairs, Food and Public Distribution, following the crisis, issued a notification dated August 6, 2013, stating that the FMC is authorized to take such measures as it deems fit in the settlement of all outstanding one-day forward contracts at National Spot Exchange and the said notification makes it binding on the exchange, any person, intermediary or warehouse connected with National Spot Exchange to abide by it.

**Whereas all measures of the FMC were directed at NSEL and its promoter FTIL, why measures such as forensic audit, extensive investigations are not directed towards defaulters, brokers, warehouses, intermediaries and clients involved in the crisis. If the crisis is made out of the participation of all, then why punishment is directed against only FTIL and NSEL.**

## QUESTIONABLE APPLICATION OF 'FIT AND PROPER'

A cursory glance at the manner in which Fit and Proper guidelines are enforced by the Forward Markets Commission on FTIL shows several inconsistencies. The Fit and Proper order was passed without any independent fact finding inquiry by the FMC. The FMC relied solely upon the audit report of Grant Thornton, which had very limited scope of review within a limited period of time. The Audit report was prepared without Management response (i.e. a completely one sided story) and had a clear disclaimer that it cannot be used for legal purposes which was subsequently changed at the instance of the FMC. The FMC acted in undue haste without giving FTIL and its promoters a fair chance and sufficient time to cross-examine the audit report that led to such drastic action having irreversible consequences.

The following criteria determine Fit and Proper status and how FTIL and its promoters meet them:

### **FINANCIAL STATUS:**

FTIL and its promoters are financially very sound. FTIL has a strong balance sheet with robust reserves and network.

### **EDUCATIONAL QUALIFICATIONS OR EXPERIENCE:**

FTIL is a pioneering company in designing state-of-the-art financial market solutions and its promoters are not just highly qualified but are considered as visionaries of creating new-generation markets in India and abroad.

### **ABILITY TO CARRY ON THE REGULATED ACTIVITY COMPETENTLY, HONESTLY AND FAIRLY:**

The Financial Technologies Group has multi-asset-class exchanges functioning in international financial centres, such as Singapore, Mauritius, Dubai, Bahrain and Botswana. After elaborate due diligence and assessment of the promoters, the licence for these exchanges are issued by the monetary authorities and regulators of security markets of the respective jurisdictions. Investors in FTIL have received excellent returns in terms of price appreciation and dividend declared for 36 continuous quarters. The Financial Technologies Group's exchanges in India, such as MCX and MCX-SX, are subjected to annual statutory and regulatory audits, which found no problems with the regulatory and compliance standards at the exchanges. FTIL or any of its group companies do not have any claims pending with any of its bankers, lenders, customers, vendors or employees. The IPO of MCX received phenomenal response of mobilizing nearly US\$ 7 billion of subscription to an issue size of US\$132 million. Leading auditors are engaged to examine the businesses of FTIL and its Group companies. FTIL and its group companies received numerous awards and citations in various international and domestic forums.

### **REPUTATION, CHARACTER, RELIABILITY AND FINANCIAL INTEGRITY:**

The reputation of the promoters is so high that once MCX-SX the new stock exchange promoted by the Group began its membership drive, it evinced unprecedented interest with road shows that received resounding success. The character was without any blemish, focusing on how to expand the sphere of markets in India and reward the investors. Growth and Inclusion was the theme that was promoted for the exchanges, which dominated the character of the group. FTIL and the Group ventures delivered beyond what was promised, demonstrating a high degree of reliability. When exchanges in India used to shut operations briefly during the sun outage, FTIL showed how this could be overcome, which was later followed by other institutions. FTIL promoted MCX-SX reduced the time gap for crediting the clients with money, making it available before the trading time, thus enormously helping the liquidity position of the brokers and clients. On the financial integrity issue, FTIL or any of its Group companies do not have any record of any disputes regarding payments or claims or financial obligation to any of its constituents.

FTIL and the promoters of FTIL fulfill all the criteria of financial soundness, fitness and probity. Yet for a crisis in one of the subsidiaries, hasty and undue punishment is awarded to FTIL and its promoters causing severe damage to the reputation and business prospects of the Financial Technologies Group

## FTIL IS THE VICTIM

The affected parties in the NSEL crisis are many. However, first and foremost are the promoters of FTIL who lost greatly in terms of reputation, management of exchanges that they have created and developed, erosion in the company value, potential loss of business, opportunity cost involved in entire energy being diverted to the crisis resolution, etc. The group companies of FTIL were the next to get affected as regulatory actions forced FTIL to sell reputed exchange ventures in distress such as Singapore Mercantile Exchange, MCX, IEX and National Bulk Handling Corporation, the stakes of which were picked up by pedigree institutions such as the NYSE Group, Intercontinental Exchange, Kotak Bank, TVS led group and private equity firms. Some other companies were closed down. Reduced business led to several job cuts.

On the clients whose money is stuck with the defaulters, the exchange's view has been that these are trading clients in commodities who are fully aware of the nature of the product that they traded and the counter parties with which they dealt in trading of the product. The Hon'ble Bombay High Court in its order dated August 22, 2014, opined the same regarding this constituency (**ANX-20**).

Brokers are the next group who knew the product very well, provided funding to their trading clients, earned huge commissions from the trade, inspected warehouses on behalf of the clients and found these to be in order without bringing any shortcoming or deviance to the attention of the exchange administration. The very brokers who are now seeking action against the promoters, had mis sold the products after doing their due diligence. Both the trading clients and brokers knew, from the VAT invoices, their respective counter-parties (which are now defaulters). Unlike the anonymous trading that takes place in the stock markets, in NSEL, in the contracts paired by the brokers, trade took place between two parties fully knowing about each other, without direct contact.

NSEL was submitting information on all the trading and the stock position in each of the warehouses across India once in a fortnight to the FMC, which too did not raise any concerns to the NSEL and its Board. The entire communication channel was between the MD & CEO of NSEL and FMC | DCA.

The major shortcoming of the handling of the crisis is that several measures have been taken and proposals made without proper examination and consideration of correct facts, issues in dispute, manner in which stakeholders have been affected, comments and actions on matters that are sub-judice, and disregard for the need to conduct the investigations in a fair and transparent manner. Focus has only been on protecting the interests of 13,000 trading clients backed by 148 brokers of which just 6 percent currently account for 69 percent of the settlement amount in question.

It is high time that a more objective and fair view on the NSEL crisis be appreciated and communicated by all the authorities concerned.

## THE MONEY TRAIL

Extensive investigations were carried out to ascertain whether any money or proceeds from NSEL were diverted to FTIL or any of its promoters. After extensive investigations by the Government and the investigating authorities and a series of interrogations, over the last one year, by specialized agencies such as EOW, ED and CBI it was found that there is no evidence of NSEL or FTIL or its promoters receiving any benefit from the money being exchanged on the NSEL platform. This has also been confirmed by the Bombay High Court order of August 22, 2014.

The question that arises is that when it is established and proven that neither NSEL nor FTIL nor its promoters are beneficiaries of anything that happened in the NSEL crisis, then why they should be subjected to unwarranted pain and punishment.

The trail clearly shows money flowing into the account of the 22 defaulters and does not involve the promoters or the management of FTIL. This makes the punitive actions taken against FTIL and its promoters unfair and unjust.

Amount receivable from defaulting members as on August 31, 2013 from the period commencing August 1, 2013 as stated by Sharp & Tannan Associates (**ANX-21**)

(RS. CRORE)

S.N.	MEMBER NAME	AMOUNT RECEIVABLE
1	AASTHA MINMET INDIA PVT LTD	23.87
2	ARK IMPORTS PVT LTD	719.42
3	BRINDA COMMODITY	14.01
4	JUGGERNAUT PROJECTS LTD	219.2
5	LOIL CONTINENTAL FOOD LTD	338.4
6	LOIL HEALTH FOODS LTD	287.48
7	LOIL OVERSEAS FOODS LTD	85.19
8	LOTUS REFINERIES PVT LTD	252.56
9	METKORE ALLOYS & INDUSTRIES LTD	98.08
10	MOHAN INDIA PVT LTD	575.08
11	MSR FOOD PROCESSING	9.05
12	N K PROTEINS LTD	964.89
13	NAMDHARI FOOD INTERNATIONAL PVT LTD	51.07
14	NAMDHARI RICE & GENERAL MILLS	10.45
15	NCS SUGARS LIMITED	58.85
16	P D AGROPROCESSORS PVT LTD	637.55
17	SHREE RADHEY TRADING CO	34.59
18	SPIN COT TEXTILES PVT LTD	38.26
19	SWASTIK OVERSEAS CORPORATION	100.83
20	TAVISHI ENTERPRISES PVT. LTD.	333.01
21	VIMLADEVI AGROTECH LIMITED	14.02
22	WHITE WATER FOODS PVT LTD	84.87
23	YATHURI ASSOCIATES	424.64
24	SANKHYA INVESTMENTS**	6.29
25	TOPWORTH STEELS & POWER PVT. LTD.**	159.46
	<b>TOTAL</b>	<b>5541.12</b>

\*\* Topworth and Sankhya have settled almost all their dues

## SHOULD A PAYMENT CRISIS ONLY LEAD TO CLOSING DOWN OF THE EXCHANGE?

The need for common Commodities markets in India was espoused on various occasions by agricultural economists (Dr. M.S. Swaminathan), the then finance minister (Mr. Chidambaram) and the then Prime Minister (Dr. Manmohan Singh) as also by international organisations such as the Food and Agriculture Organization (Rome). The evolution of the spot exchange was the outcome of an initiative to create a national level common market for commodities and free the buyers and sellers of the agricultural commodities from the clutches of the middlemen. It was only in one of the numerous products that NSEL was offering that the large scale payment defaults occurred. Typically, both the national spot exchanges were offering a number of products and at NSEL, the settlement of all the e-Series contracts, involving about 33000 investors were done in an orderly manner with payments made according to the schedule. Only contracts paired by the brokers faced problem, following the instruction of the DCA to NSEL to stop issuing further contracts with immediate effect, the defaulters suddenly began to freeze payment and divert physical stock. This created a liquidity problem which led to the crisis at NSEL, the impact of which has adversely affected the Financial Technologies Group.

The important issue is just because one product failed or was caught in a malpractice, should it lead to the closure of the very spot exchange business that was established to bring into India more reforms?



## WHY THE APPROACH NEEDS TO CHANGE

Even after this fallout, the focus is not about what is in hand that could be settled. Rather efforts are being made to make this more complex and create a long and tiresome litigation that does not benefit anyone, more so the trading clients who are expecting their dues from the defaulters.

CURRENT SITUATION	ACTION REQUIRED FOR A PRODUCTIVE OUTCOME
Assets equivalent to the claims of the trading clients have been frozen and are available with the investigative authorities (EOW)	Dispose the assets frozen and other collaterals available for the settlement and distribute the sale proceeds to the trading clients
The promoter company has extended a bridge loan of Rs 179 crore to settle the claims of the small trading clients. FTIL is further assisting and helping NSEL with financial support and staff to strengthen its recovery process	Extend support to FTIL and NSEL to further intensify the recovery measures against defaulters
NSEL has initiated recovery action against the defaulters. Recovery from two members is already completed which was distributed to the trading clients	Investigate and conduct forensic audit of the defaulters to know where the stocks stored in the warehouses have gone
FTIL and NSEL are cooperating with the Government, FMC and other investigating agencies to bring an early conclusion to the NSEL crisis	Let the judicial process that is in motion be completed and avoid taking abrupt and ad-hoc actions that will lead to contest and litigation, which will drag the crisis for a long time. Set up fast track Court to expedite recovery of dues from the defaulters and liquidate their assets. Amend PMLA to enable proceeds of assets attached to go to the trading clients rather than the Government

## AVOID MEASURES THAT COULD BE COUNTER-PRODUCTIVE

Instead of finding a quick solution to the crisis by sale of assets frozen of the defaulters and also evolving a mechanism for revival of the spot exchange, the pursuit is going in a manner that could lead to prolonged litigation. It is important to look at how the two measures proposed recently could turn out to be more detrimental, leading to more delay at arriving a suitable solution to the crisis.

The recommendation of the FMC for merger of NSEL with FTIL is out of place as the FMC is neither competent nor privileged to recommend such a move when many issues in regard to NSEL are still being investigated by various agencies and several matters are under consideration of the courts. The draft order of the MCA to propose merger of NSEL with FTIL has been widely criticized and condemned by all across for the bad precedent that such a measure would set in the Indian corporate sector by destroying the concept of limited liability as also create new worries among the foreign investors. To settle the claims of a few trading clients by putting the thousands of genuine investors/shareholders of Financial Technologies at risk is something unheard in any corporate history. And how logical would be the putting up the prospects of majority of people who were never connected with the crisis at NSEL, by solving the problem of a minority who have taken risk fully knowing the implications?

Secondly, the talk about the supersession of FTIL management is very demotivating for FTIL and is unfair treatment for the promoters and the management who have been striving, in the last one year, to recover the dues of the trading clients from the 22 defaulters and working towards an early resolution of the crisis. The promoters and the management of FTIL have received punishment very high and disproportionate to the crisis that occurred in one of the subsidiaries of FTIL.