

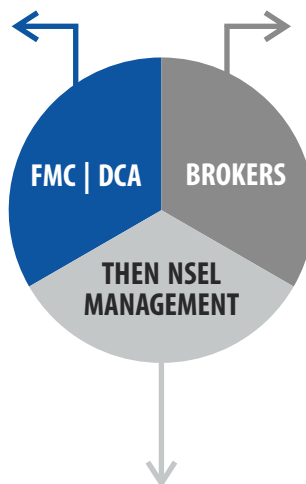
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The Cause of the Crisis

Abrupt Stoppage of Contracts by DCA | FMC

FMC/DCA letter of sudden and abrupt stoppage of further issuance of contracts by NSEL without proper consideration and assessment on the likely impact, triggered the payment default that escalated into a crisis.

Wrote to RBI that NSEL can conduct clearing operations that makes the latter a regulated entity | No response to the replies given by NSEL to the show cause notice for more than a year | Issued a letter instead of a proper order on the action following show cause notice | Sudden stoppage of new contracts without proper assessment on the impact of market disintegration | Not heeded the requests of NSEL on the consequences of sudden stoppage of contracts | Held meetings with defaulters yet no action taken against them. With 85 percent defaults accounted for by 7 defaulters, quick action against them would have resolved the crisis faster | No action against brokers | Action only against NSEL | FTIL



The then management of NSEL had functional autonomy and was the sole point of contact with FMC. The Board of NSEL, never had any direct contact with the FMC as also the latter has never approached or written to the Board on any concern that they might be having on the operations of the exchange. No red flag raised to the Board of NSEL

Created structured contracts involving buying and selling of commodities | Overlooked the exchange advice informing risks involved in buying and selling of commodities | Aggressive marketing and mis-selling | Instances of funding clients | Lured the clients as profit from commodity trading could be booked as business income against which business losses could be offset to save tax | Have strong legal and compliance departments that made them aware of the nature of buying and selling and risks involved | Visited warehouses numerous times as C&F agents of their trading clients (nearly 50 times over a three year period) and yet not raised red flags any time | Audit firms of broking firms showed inventories held in trading as annexures in the balance sheets of the respective firms | Instances of executing certain orders without client consent | Did not once raise or bring to the notice of NSEL Board any irregularity

The real cause of the crisis is the abrupt action of the FMC either on its own or through its recommendations to DCA without considering sensitivities as relevant to the markets and going full force on NSEL | FTIL without initiating a comprehensive action that could have included all the players. In a way, it is FMC on its own or as a department of the DCA which has created the crisis in the first place and escalated it further that lead to market disintegration which ultimately resulted in payment default.

The manner in which FMC created and contributed to the crisis could be explained by the following:

- On August 5, 2011 FMC wrote to DCA to request RBI to consider exempting NSEL regulated by the FMC from the purview of Payment & Settlement System (PSS) Act 2007, for its clearing and settlement function **(ANX-30)**.
- Since its operations commenced in 2007, NSEL had around 800 members which included large listed brokers of NSE, BSE, with big legal and compliance departments. NSEL offered trading in as many as 43 commodities, of which 34 were agriculture commodities. It had approximately 46 thousand trading terminals, while delivery locations were spread across the country to as many as 147 centres.
- On April 27, 2012, Department of Consumer Affairs issued a show cause notice to NSEL on certain aspects of its operation. NSEL responded to the notice promptly by its reply dated May 23, 2012 and August 11, 2012.
- There was no reply or action from the Department of Consumer Affairs for more than a year which is believed to have been satisfied on the issues raised in the notice.
- On July 12, 2013 Department of Consumer Affairs issued a letter directing NSEL to stop issuing fresh contracts. Such a letter which should have been held in utmost confidence between two institutions, was leaked to the press.
- NSEL wrote to Department of Consumer Affairs on July 12 and 22, 2013 stating that any abrupt and sudden measures of stoppage of contracts would severely dislocate and disintegrate the market functioning that could adversely affect the payment obligations.
- On July 19, 2013, FMC wrote to DCA that the exemption granted to NSEL was silent whether the exemption is applicable to all or specific provisions of the FCRA, thus, impliedly endorsing the legality of NSEL's business model.
- On July 31, 2013, all operations of NSEL had to be stopped.
- On August 4, 2013, FMC had a meeting with the defaulters about the stocks position and payment obligations and received positive confirmation from them to the material and money involved.
- On August 6, 2013, DCA authorized FMC to take such measures as deemed fit against "any person, intermediary or warehouse connected with NSEL". Whereas the entire focus and action of FMC since then has been solely directed against FTIL | NSEL conveniently ignoring the other players i.e. The Defaulters and the Brokers.
- In view of the brokers and the defaulters being completely left out of the investigations and follow up, default of payments began to take place from August 19, 2013.
- Any strong action by FMC | DCA against the 7 defaulters who accounted for 85% of the defaults could have led to a much more positive outcome and early resolution of the crisis. Rather, FMC was focusing on only FTIL by imposing severe penalties, pushing for punishments, and declaring it not fit and proper without waiting for the outcome of the investigations or the judicial process.

- The above clearly shows that the accident at NSEL occurred majorly on account of measures of FMC | DCA that resulted in payment default instead of avoiding the crisis in the first place. Once the crisis took place these actions have further accentuated the crisis rather than aiming at a quick and smooth resolution.

BROKERS

- Created structured product involving contract for buying and selling of commodities on NSEL platform
- Overlooked the exchange advice to inform risks involved in buying and selling of commodities to the clients
- Aggressive marketing and mis-selling in violation of Exchange's circulars
- Instances of funding clients
- As it was a business involving buying and selling of commodities principals of business income and offsetting expenses were applied
- Have strong legal and compliance departments that made them aware of the nature of buying and selling and risks involved
- Active as C&F agents for the Trading clients, they visited warehouses numerous times (nearly 50 times during a 36 month period) and yet not raised red flags any time
- Audit firms of broking firms showed inventories held in trading as annexures in the balance sheets of the respective firms.
- Instances of executing certain orders without client consent (approximately 3,00,000 client code modifications)
- Did not once raise or bring to the notice of NSEL Board any irregularity
- Majority of the big brokers were C&F agents and verification of stocks on behalf of their clients was their responsibility

THEN NSEL MANAGEMENT

The then management of the NSEL, which had the privilege of full functional autonomy, was saying as late as August 2013 that commodities existed in the warehouses. The management at that time was the sole point of contact with FMC or DCA which had communications of various nature. The Board of the NSEL, never had any direct contact with the FMC or the DCA as also the latter has never approached or written to the Board on any concern that they might be having on the operations of the exchange. Even the show cause notice issued to NSEL was addressed to the then Managing Director and CEO and the Board was never informed of the same. Neither the DCA nor FMC nor the Broking firms nor the management ever raised any red flag to the Board that could have alerted them to take any preventive action.

FACT SHEET



NSEL CONTRACTS

There is an impression created that NSEL has introduced the contracts that came into problem with a view to make quick profits, which is not the case. A wide range of contracts were traded at NSEL, including (a) Farmers contracts, (b) Auction Contracts, (c) Forward Auction, (d) Reverse Auction, (e) e-Series contracts, (f) Traders contracts, and also physical procurement business and LC business. Traders used all these contracts as also paired some of these as an arbitrage strategy to maximize returns.



BUSINESS

It is also wrong to say that the entire business of NSEL was built on the contracts that came into problem. During the period 2008-13 NSEL turnover was to the tune of Rs 7,67,000 crore with volume being more than 1000 crore lots. During this period, it has carried out pay-in and pay-out of Rs 2,80,156 crore. It had 147 delivery locations and paid service tax to the tune of Rs 28 crore. It has nationwide spread of 800 members, with 46000 terminals in which 52 commodities were traded of which 34 were agricultural commodities. It is wrong to say the whole business of NSEL revolved around the defaulted contract. Out of total 702 contracts launched only 29 (around 4%) contracts were unsettled due to the member defaults.



BUSINESS INCOME AND NOT INVESTMENT

Trading clients were booking income earned from NSEL products as business income which was being offset with losses. This itself demonstrates that they took it as a business activity involving buying and selling.



ORDERLY SETTLEMENT OF e-SERIES CONTRACTS

The settlement of the e-Series contracts in gold, silver and other commodities, which involved approximately 33000 investors, were being conducted in an orderly manner.



CAUTION TO TRADING CLIENTS

NSEL has been giving the brokers with whom it had privity of contract sufficient caution against advertising fixed or guaranteed return on NSEL platform. Typical to any market, as the trading clients were making good returns from pairing the contracts, brokers who marketed these products were not enforcing this discipline and caution while making aggressive sales. Brokers were even extending financing to their trading clients who were interested in trading of the contracts through pairing.



PRIVITY OF THE CONTRACT

Privity of the contract is between the brokers who sold the product and their trading clients who bought it. It is the brokers who marketed and sold the product and identified the trading clients. The brokers are the ones who should have cautioned them on the risks associated with the product, in which they failed. It is the brokers who chose the commodity counterparties while entering into these contracts and who were expected to conduct due diligence.



EXPLANATIONS AND CLARIFICATIONS

NSEL has provided explanation and clarification immediately to the regulatory authorities and the government on any issues raised by them on any aspect of the operations and business. The last of such explanation was provided in August 2012. No order was issued following the submission of the detailed explanation to the show cause notice. Instead a letter from the DCA in July 2013 to stop issuing fresh contracts unleashed and accentuated the problem.

MISCONCEPTION THAT NSEL WAS SET UP TO DEFRAUD PEOPLE

A brief sequence of events given below destroys the falsehood created by certain sections casting aspersions on FTIL that it has set up NSEL with the sole purpose of making undue gains.

2002

- The Economic Survey 2002-03 of the Government of India argued, "High investments together with entrepreneurial skills required for creation and managing the market infrastructures have to come from private sector."

2003

- Economic Survey 2003-04 reported that "an inter-Ministerial Task Force set up by the Ministry of Agriculture suggested a package of reform measures, such as amendments to the State APMC Act to encourage development of competitive agricultural markets in the private and cooperative sectors, and deregulation of marketing system to promote private investment in marketing infrastructure".

2004

- Subsequently, in the address to the nation on June 24, 2004, the then Prime Minister, Mr. Manmohan Singh spoke about the need to see the creation of a 'single market' across the country for both manufactured and agricultural produce. Soon, the then finance minister, while presenting the Union Budget for 2004-05 on July 8, 2004 stated, "India must become a single market for all products, particularly agricultural produce."

2005

- Subsequently, the then Prime Minister at the inauguration of the Agricultural Summit 2005 in New Delhi on April 9, 2005 reiterated the need for creating "a common single market in the country".
- NSEL was incorporated as a demutualized corporatized exchange as a company under The Companies Act, 1956.
- It can be noted that NSEL was originally promoted by MCX. Later, in view of regulatory concerns of regulated commodities exchanges holding equity shareholding in spot exchanges, the shareholding of MCX were transferred and consolidated with FTIL.

2006

- Soon after the establishment of NSEL, in a meeting on 'monitoring & forecasting of prices (domestic and international) of agricultural commodities' held under the chairmanship of the Secretary (Department of Consumer Affairs) on May 24, 2006 at the office of the FMC, it was decided, among others, that the commodity exchanges to submit a concept paper on the creation of the national spot exchange **(ANX-31)**. Subsequently, in a letter dated June 2, 2006, FMC formally asked MCX to submit a concept paper **(ANX-32)**. This was followed by a reminder letter from FMC dated 11 July 2006 **(ANX-33)**.
- Accordingly, on July 18, 2006 a "Concept Paper on Creation of a National Spot Market" was submitted by MCX to the Ministry of Agriculture in the government of India **(ANX-34)**. Thereafter, in December 18, 2006, NSEL submitted to FMC a business model for launching of National Spot Exchange **(ANX-35)**.

2007

- NSEL wrote to DCA and FMC proposing that spot exchanges should be monitored/supervised by FMC. On May 21, 2007, FMC suggested the conditions for the exemption leaving two points proposed by NSEL, i.e. supervision by FMC and contracts delivery period not to exceed 11 days **(ANX-36)**. Therefore, it is improper to allege that NSEL wanted to be an unregulated market or NSEL violated conditions.
- On June 5, 2007, Department of Consumer Affairs in the Ministry of Consumer Affairs, Food and Public Distribution issued a notification, in exercise of the powers conferred on the Central Government by Section 27 of the FCRA, exempting all forward contracts of one day duration for the sale and purchase of commodities traded on NSEL from operation of the provisions of FCRA subject to certain conditions.
- Subsequently, by its letter dated August 5, 2011, the Central Government nominated FMC as the 'designated agency' referred to in condition iv of its notification dated June 5, 2007.

2011

- As directed by FMC through letters dated 23 November, 2011, from 30 November 2011 onwards, NSEL has been sending detailed fortnightly reports to FMC, which contained trading & operational data including warehouse-wise stock position data **(ANX-37)**.

All of the above shows, that NSEL was a legitimately and fundamental set-up based on the vision of the Government of India to develop a common single national market for Commodities. Not only that, NSEL also achieved many distinctions in the four years of its operation as detailed below.

BUSINESS & ACHIEVEMENTS OF NSEL

- NSEL commenced live trading on its electronic platform from October 15, 2008. It started trading with agricultural commodities with contracts designed for farmers followed by for traders. NSEL took licenses under various State APMC Act in states such as Gujarat, Maharashtra, Rajasthan, Madhya Pradesh, Karnataka, and Orissa.
- NSEL carried out various kinds of trades on behalf of the government agencies.
- NSEL also launched innovative e-Series contracts starting with e-Gold in 2010 for trading in precious and base metals in demat form, which was highly popular amongst the retail clients for its smaller trading and delivery denomination.
- NSEL had around 800 members which included large listed brokers of NSE, BSE, with big legal and compliance departments. NSEL offered trading in as many as 43 commodities, of which 34 were agriculture commodities. It had approximately 46 thousand trading terminals, while delivery locations were spread across the country to as many as 147 centres. NSEL had empaneled around 10 clearing banks.
- NSEL was the only exchange to receive FOW awards for best innovation for two consecutive years. The path breaking work of NSEL in the field of agricultural commodities was appreciated in renowned publications like Financial Times.
- Thus all the trading which was going on at NSEL for four years can't be washed away as intended by the promoter to defraud the people.

MISSING STOCKS: HOW IT COULD HAVE HAPPENED?

Throughout, the FMC maintained that the crisis emerged out of a warehousing problem. In reality, the FMC was provided periodic (fortnightly) information on the stock of commodities held in the warehouses by the executive management of NSEL. The MD & CEO had repeatedly assured that stock position was comfortable. Even after the crisis, the MD & CEO made public statements that the stocks in the warehouses were more than the value of the settlement. Trading members of NSEL belonging to the public sector have conducted separate inspection of the warehouses, on select basis, through CAG approved auditors and found no shortages or lapse in the warehouses. Additionally, brokers also have visited warehouses nearly 50 times over a 36 month period to confirm stock positions and raised no concern. NSEL statutory and internal audit reports, periodically brought out, also found no deviance or deficiency in this regard. When all these measures have never raised any red flag over the stocks in the warehouses, blaming the NSEL Board and FTIL for missing stocks and attributing motives is plain unjust and unfair. Thus, the action being initiated against the non-executive members of the NSEL Board, FTIL and the promoters of FTIL are not justifiable in this context.

In a meeting FMC held with all the players on August 4, 2013, it was assured by the brokers and The Defaulters that the money and stocks relating to trades remained adequate. The situation however drastically changed thereafter. There could be a possibility that once the Government caused sudden stoppage of business, some of the defaulting members with a view to protect their positions might have migrated the stocks from the designated warehouses. This further accentuated the liquidity position leading to default in the settlement. The possibility of banks cutting off their credit lines without the stocks in place might also have induced them to shift the stocks out of the warehouses. Such a scenario could be expected in any financial markets business and not just in NSEL. Sudden stoppage of business will create panic in the market that will lead members to try to get away from the responsibility and obligations, which happened in the case of NSEL also.

ROLE OF EMPLOYEES

The NSEL business was spearheaded and conducted by the MD & CEO, who enjoyed complete autonomy and functional freedom. The role of the top management of NSEL and officials entrusted with different functions and responsibilities is under investigation for any possible lapses and deviances from established practices of risk management and due diligence. While NSEL has now revamped the entire management team, it will comply with any actions required to be taken in case if any involvement of the staff in any action leading to the crisis is established.

NO RED FLAGS TO THE BOARD

Since the commencement of trading in October 2008, NSEL Board laid down systems, processes and risk management framework like margins, auction, etc., by virtue of various circulars and instructions under the Rules and bye-laws of NSEL. All these instructions were legally binding on the market participants and the officials of NSEL were to ensure that they were followed. This practice is similar to banks where the Board of Directors lays down the instructions and if these are not followed the relevant officials are held responsible and the directors are responsible only if they were complicit in committing any irregularities.

HOW WAS THE BOARD TO KNOW WHEN?

- A** The MD & CEO of NSEL confirmed in all the Annual reports that there was no fraud or irregularities and this was backed by a Management Representation signed by the MD & CEO.
- B** Statutory and internal auditors did not mention any shortcomings in stocks in warehouses or operations of NSEL.
- C** In some cases, auditors approved by CAG verified that stocks were in place at warehouses and never raised any concern.
- D** Brokers who visited the warehouses multiple times as C&F agents of their respective Trading Clients never made any complaint of any shortage in commodity stocks.
- E** FMC which used to get fortnightly statements on the stocks in warehouses since November 2011, never pointed any deficiency of any manner.
- F** There was no concern expressed or communicated to the Board by any quarter.
- G** The MD & CEO of NSEL submitted quarterly compliance reports to FTIL Board since March 2011 after NSEL became a material subsidiary of FTIL (**ANX-38**). These reports did not highlight that anything was amiss.
- H** MD of the exchange confirmed to the entire Board on July 30, 2013 (**ANX-39**), to the FMC on August 4, 2013 (**ANX-40**) and also gave public statements as late as mid-August 2013 that stocks in excess of the outstanding settlement were available in warehouses.
- I** The contracts were approved by the Board to work as in the case of Topworth, Metkore where commodities were available at closure of market. There was detailed documentation, VAT paid and received and booking of profits / losses by trading clients on account of commodities traded. Different departments at NSEL headed by different AVPs managed over 20 staff each. There was absolute distinction between trade, warehouse, delivery and settlement departments. The same staff handled e-series contracts also where everything was found in order and the contracts were settled for over 33,000 trading clients. Therefore the organizational structure laid down was fool proof. There were proper systems & processes implemented and verified by statutory auditors, knowledgeable brokers and clients participated in the products and the activities were monitored by FMC/DCA.

When so many agencies never raised any concerns on the stocks in the warehouses, putting all the blame on the NSEL Board, who was dependent on statements coming from any of the above sources, is not fair.

BROKERS AND TRADING CLIENTS

- The Brokers sold the contracts to their trading clients as a structured product in violation of two NSEL circulars dated February 7, 2012 and August 2012 which prohibited promise/guarantee of assured returns by any member, and that is how the popularity of the contracts increased. The volumes in these types of contracts increased only during 2012-13. During 2012-13, the equity markets were not doing well and many brokers and their trading clients started participating in the T+2 and T+25 contracts with a view to make trading profits.
- All the brokers and their trading clients who traded on NSEL are experts and knowledgeable and participated in the contracts after duly assessing the risks. All the trading clients made financial gains through trading commodities until July 2013 when the market was halted due to government directions.
- The contracts on NSEL were traded by large listed brokerage houses. These brokers have large legal and compliance teams and are operating in equity and commodity futures markets as well. These brokers have participated in NSEL only after exercising due diligence. Brokers pushed client investment in a particular NSEL contract due to higher yield they could get for the clients and higher brokerage they could charge from their clients. Many brokers sold this product as a part of portfolio management and also made loans available where client's paid only 10-20 percent and the balance money was deployed as loan taken by the client from the brokers, which earned the brokers additional return on money lent. The clients got lured due to fixed cost of borrowing and a higher returns against the commodities trading.
- Further, several brokers acted as C&F agents for their trading clients and visited (50 times over a 36 month period) warehouses (of the defaulting members) storing the commodities under intimation of NSEL for stock verification and never complained or brought to the notice of NSEL about missing or shortfall in commodities. Further their audit firms have also certified inventories and reported the same in the annexures to the balance sheets of the respective broking firms.
- The police found that in some instances the broking houses used their clients' accounts, without their (clients') information and consent for doing purchases. The brokers altered the rules for their personal benefit.
- Essentially, a distinct aspect came to the EOW's notice during their investigation, which was also mentioned in their charge sheet - that a big broking firm assured its trading clients about the security of their invested money, besides the existence of stocks in the warehouses.
- The defaulting members are operating entities and were having huge bank limits as well. Prima facie it was impossible to detect that irregularities were being committed as the warehouse inspections by market players did not raise any alarms. It appears that many of these defaulters have repaid the banks out of the funds received from trading at NSEL. The defaulting members are willful defaulters.
- Further, these defaulting sellers issued VAT invoices in the name of the trading clients as late as until June 30, 2013.
- Throughout the vilification campaign against the Financial Technologies Group, the impression that was created was that of innocent trading clients were duped by NSEL and thus needed to be helped with great urgency. It took more than a year till Hon'ble Justice, in it's Order given on August 22, 2014 in the Criminal Bail Application No. 1263 of 2014, observed as under.

OBSERVATIONS MADE IN THE ORDER GIVEN BY HON'BLE JUSTICE ABHAY M THIPSAY J



There is great substance in the contentions advanced by the learned counsel for the applicant that the brokers through whom the so called trade transactions were entered into, 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 and the traders who do not hesitate to term themselves as 'investors', and they were expected to assess the legalities of the transactions. 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... Though the case has been projected as a 'scam of Rs 5600 crore', it needs to be kept in mind that these amounts have not been received by NSEL. As already observed, it is difficult to accept that the brokers and/or their clients for whom they were working were 'deceived' by NSEL in as much as in all probability, the brokers and the investors were well aware that they were not entering into a genuine sale and purchase contract. When there is a clear and obvious possibility that these persons knew about the transactions, the 'deception' if any, caused to them cannot be said to have been caused by the nature of the transactions and, at the most, they can be said to have been misled by a propaganda that 'investing' money in those transactions was safe. The money invested has not come to NSEL, but has gone to the borrowers, i.e., bogus sellers. It is the borrowers who have been benefited by the transactions and the money of 'investors' has gone to them. The names of 25 different companies who are the defaulters have been mentioned in the FIR itself. Thus, though projected a 'scam of Rs 5600 crores', the ill-gotten amount has not gone to the applicant, or for that matter, to NSEL. In fact, it is not the case of anyone

