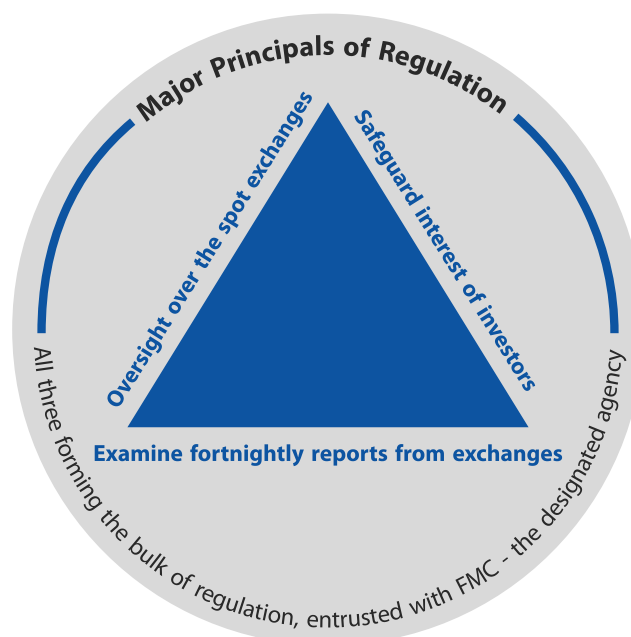


6

Shortcomings of the Regulator

Failures of Regulatory Agency

There is enough to substantiate that in the NSEL crisis, regulatory shortcoming is abound. Virtually every aspect of regulation such as oversight, investor interest, fortnightly reporting of critical data were entrusted to the designated agency, i.e., FMC. Post-crisis, the regulator went into an overdrive, just focusing on one institution leaving others that have jeopardized speeding up the recovery and an early resolution to the crisis. This further heightened the impact of the crisis but both FMC and DCA ignored this fact. Why?



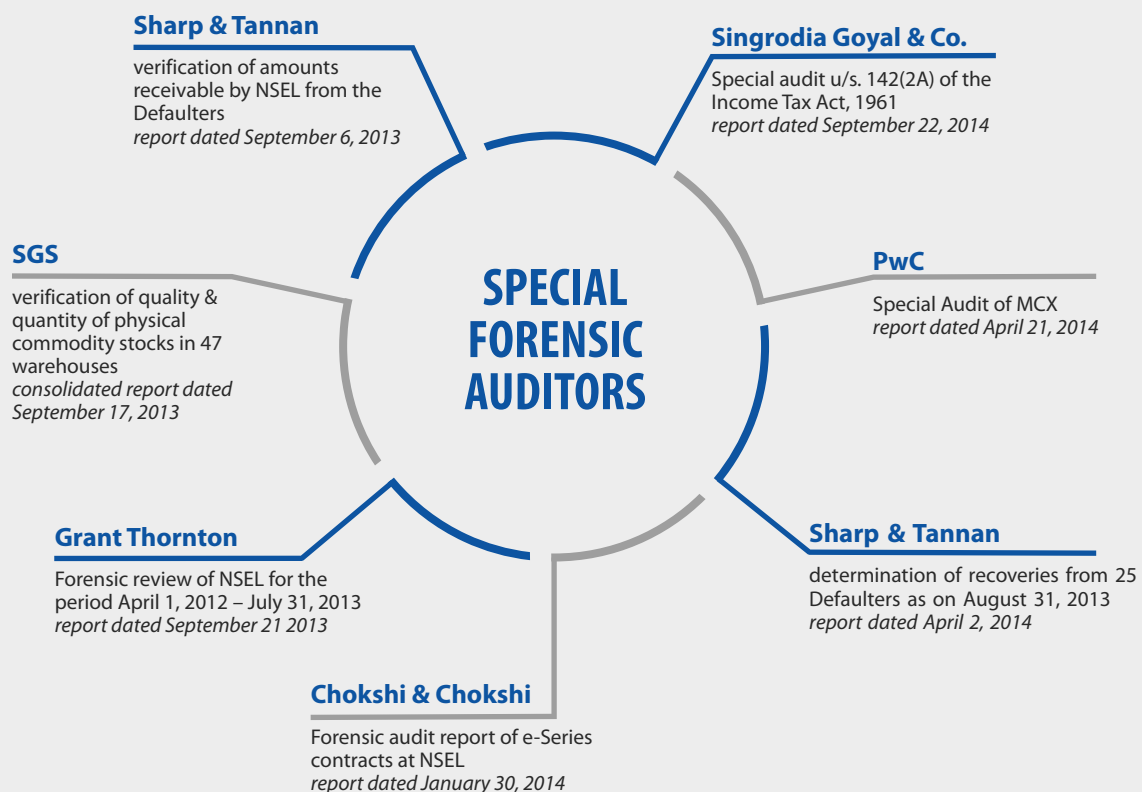
FACT SHEET

- ☒ The then, MD of MCX, had repeatedly requested the Government that the Forward Markets Commission be entrusted with the regulation of the national spot exchanges. All the exchanges promoted by FTIL are regulated and it was keen from the beginning that NSEL too be regulated.
- ☒ In accordance with the need to create a regulatory framework for the functioning of the national spot exchanges, the following measures were taken:
- ☒ In any regulatory structure, the most critical aspects are "Oversight", "Investor Interest" and "reporting", for all of which the FMC was nominated as the Designated Agency. NSEL was providing to the FMC, on a fortnightly basis, information on various aspects of the business that include (a) Price Statement, (b) Summary of Trade Participation, (c) Top Ten Participants, (d) Margin Collection, and Price Volatility, (e) Stocks in Warehouses, and (f) Investor Grievances.
- ☒ All the communications from the Forward Markets Commission to NSEL was addressed to the Managing Director & CEO, who was responding and providing clarifications from time to time. Even the show cause notice issued to NSEL by DCA on April 27, 2012 was addressed to the MD & CEO with no reference or copy to either the NSEL Board or to FTIL. The replies to the show cause were provided by the MD & CEO, NSEL, to the FMC on which there was no further action or initiative, which made him to believe that the issues raised were explained to satisfaction till the DCA ordered stoppage of fresh contracts on NSEL platform, on July 12, 2013.
- ☒ In November 2012, Mr Ramesh Abhishek, FMC Chairman, sought specific clarifications from NSEL erstwhile MD & CEO regarding price formation and financing type of transaction at NSEL. The erstwhile MD & CEO response was also recorded in the minutes dated November 8, 2012 **(ANX-41)**. Thereafter, there was no communication. This shows that FMC was convinced at that point of time or it would have taken action immediately. Even as of May 2013, DCA was only contemplating, imposing penalty on NSEL. The crux of the issue is that FMC was of the view that NSEL was not exempted from all provisions of FCRA, but NSEL was of the view that section 27 exemption was from all provisions of FCRA. If it was a general exemption, there would have been no violation by NSEL and the show cause notice of April 2012 was not required. DCA could not come to a conclusion if FMC was right or NSEL was right. However, they issued the market stoppage instruction in July 2013, pending legal advice, as admitted by them **(ANX-42)**. However, it became apparent that FMC was all along misleading DCA, which was relying on FMC for inputs as it was an expert body under FCRA. This is evidenced by the letter dated July 19, 2013 of FMC wherein FMC admitted that the exemption notification of June 2007 does not specify if the exemption is from all or specific provision of FCRA. If FMC was unsure, it should have told so earlier to DCA, not after stopping the Market. So the conspiracy of FMC is obvious.
- ☒ Immediately after the crisis, Department of Consumer Affairs wrote to the FMC in August 2013 that "settlement of all outstanding one-day forward contracts at NSEL shall be done under the supervision of the Forward Markets Commission where it will be binding upon the exchange, any person or intermediary or warehouse connected with NSEL". However, the FMC chose to put all pressure and focus only on NSEL and FTIL by resorting to such extreme and unwarranted measures such as declaring FTIL & its promoters not fit and proper, coercing MCX to force FTIL to sell its stake, failing which no fresh contracts will be issued to it and frequently coming out with statements not consistent with the care and concern that a regulatory authority should exercise on issues, which are still under investigation and sub-judice and finally recommending merger of NSEL with FTIL and change of management of FTIL. Why no action on brokers & the Defaulters against whom there was a clear money trail?
- ☒ A regulatory institution is expected to make complete investigation and examination of the issue before coming up with any assertion and should cover all those related to the problem to get a complete and comprehensive picture. From the very first day, FMC has just targeted NSEL and FTIL, and began to make statements that are contestable and initiating actions that are not justifiable. Through this, the regulatory authority tried to shift the lapse and negligence on its part by taking stern actions on the basis of unsubstantiated claims made by the brokers and their trading clients who in the first place were the cause and contributors to the crisis. Perhaps in no regulatory regime such unjustified actions can be found even for academic reference, just targeting one company, which has fully committed to cooperate to resolve the crisis and has been compliant with various measures prescribed since the crisis broke.

THE MULTIPLE OF AUDITS...

The audit reports based on which several actions were initiated against FTIL, its promoters and the management were full of disclaimers and deviation from the terms of reference. Quite a few audit reports went beyond their brief to present certain aspects that created undue concerns on various aspects of operations that led to unwarranted actions and punishment on the promoters and management of FTIL.

Subsequent to the crisis on directions of FMC, a series of audit firms were engaged to assess various aspects of the functioning of NSEL and to ascertain where the problem arose and escalated. The list of special forensic auditors engaged for various examinations and studies include:

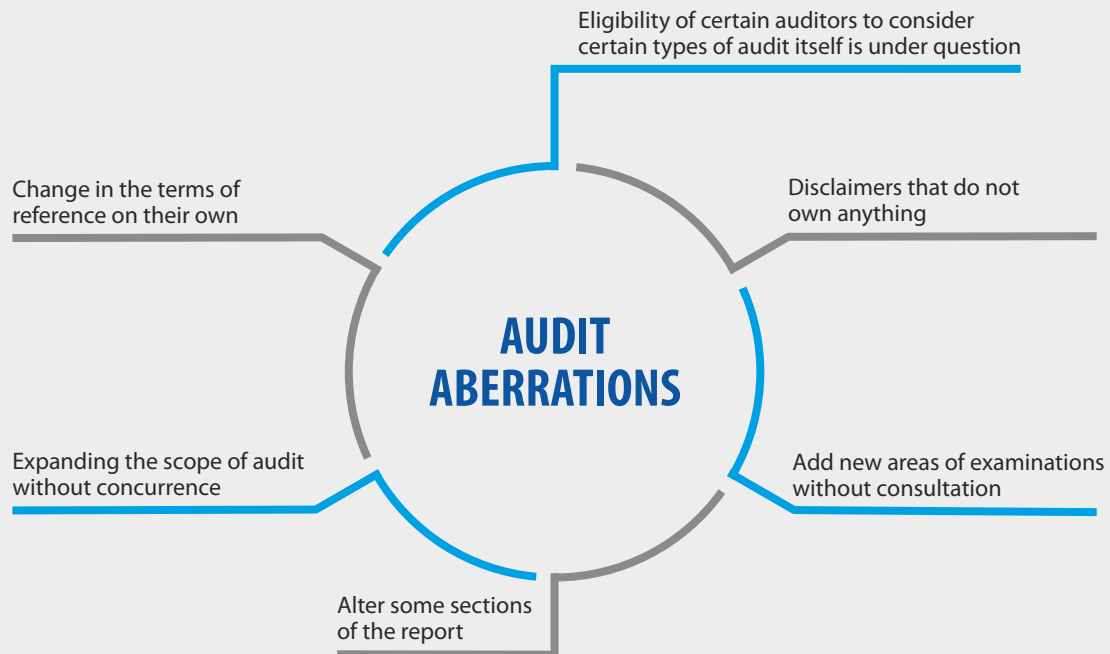


However, strangely, in the course of submission of the reports, at FMC's instruction some auditors began to change the terms of reference on their own, alter some sections of the report, add new aspects which are not related to the audit exercise without explaining the purpose or the background for the same. While this has been the trend in general, NSEL | FTIL was restricted from giving their point of view or cross-examining the auditors. The audit exercises was conducted after a long gap of the transactions taking place and the concerned officials dealing with various functions would be in a better position to explain the context, background, process and procedure for any particular activity and transaction commented on by the auditor.

Whereas the audit firms were mandated to examine the transactional aspects of various activities, they over-extended their brief to prepare additional commentaries without prior discussion and consent on aspects such as governance, internal functioning, monitoring, Board committees, which are completely outside the purview of audit. It is not to say that these aspects are not of importance urely they are of great importance to any corporate entity, but an auditor taking the liberty of commenting on this without a proper study, mandate and consultation is purely trying to side-step the real issue and drive the discussion into some vague aspect that lacks clarity.

AND THE ABERRATIONS

Similarly, the importance of disclaimers made by the auditors was not taken seriously by the authorities when reviewing the reports and taking actions based on these reports.



Grant Thornton

The limitations that Grant Thornton mentioned in its report include:

- Our findings are based upon the information made available to us and we have not independently verified or validated the information.
- Our work did not constitute an audit under any accounting standards and the scope of our work was significantly different from that of a statutory audit. Hence it cannot be relied upon to provide the same level of assurance as a statutory audit.
- Work done by us was as considered necessary at that point of time to reflect the scope of work and rigour required. Restrictions include "comments in our reports are not intended, nor should they be interpreted to be legal advice or opinion".

NSEL has given a detailed response to the audit report of Grant Thornton, which was never considered, and the Exchange was not given an opportunity by the FMC to cross-examine Grant Thornton.

PWC Report

Disclaimers (Extracts)

The Final Report is prepared solely for the information and use of the Forward Market Commission ("FMC") as a Regulator and MCX and may not be relied upon by any Third Party. Neither the deliverable nor its contents may be distributed to, discussed with, or otherwise disclosed to any Third Party without the prior written consent of PwC. PwC will accept no responsibility or liability to any party to whom our Final Report may be shown or in whose hands it may come. Our Final Report should not be published or reproduced in part or in whole without consent from us, except by The Forward Market Commission in its capacity as the Regulator.

The procedures performed under this Special Audit do not constitute an audit or examination or review in accordance with generally accepted auditing standard or attestation standards. Accordingly, PwC will not provide an attestation report or opinion or other form of assurance pursuant to generally accepted auditing standards or attestation standards of the Institute of Chartered Accountants of India.

PwC has relied on the data provided by MCX and has not verified its authenticity.

Certain information in this Report may be hearsay and may not be accurate or reliable when identified as being alleged or of unknown reliability.

Chokshi & Chokshi

For instance the disclaimers made by Chokshi & Chokshi include statements such as:

- This audit didn't constitute an audit under any standards on audit issued by ICAI.
- Key personnel (especially ex-employees) have either resigned or been relieved from NSEL and IBMA or under the custody of investigating agencies or are not available for discussions. Hence the relevant information could not be gathered from them.
- Our scope of work excludes cross examination by NSEL or any of its companies, affiliates, lawyers etc. It further excludes representation before any courts and that we will not be a party to any such legal proceedings.
- Subsequent to the completion of the engagement we will not be under any obligation to update our report for subsequent events or transactions, unless FMC separately engages us to do so in writing

The restrictions include "Our audit report is submitted to the FMC pursuant to our appointment letter dated November 19, 2013. Our report being confidential cannot be circulated or published or quoted or referred to in whole or in part without our prior written consent. We shall not be liable for any cause, damages, losses, liabilities and expenses incurred by any party as a result of distribution | circulation | reproduction of a report in all part."

WHAT IS GOOD REGULATION?

How Australian Securities and Investment Commission describes its role and what is seen in India in the recent period.

Maintain, facilitate and improve the performance of the financial system and entities in it	Commodities markets in India were functioning for ten years. While exchanges have taken India to global scale in trading, hardly any efforts are evident to facilitate the market to increase its scope and significance. All through the Indian commodities derivatives markets remained a single product market (Futures), whereas the world has witnessed enormous growth and diversity in the product range
Promote confident and informed participation by investors and consumers in the financial system	A mature regulation involves proactive efforts of extensive interface and interaction with investors and consumers for every product traded in the market by giving periodic information, assessment and analysis, which is totally absent in commodity derivatives markets in India
Administer the law effectively and with minimal procedural requirements	Adopt a pro-active approach in regulatory mandates entrusted to it from the Government from time to time and not being selective or

Enforce and give effect to the law	<p>evasive about what responsibility to be taken and what to avoid that could lead to a regulatory bias</p> <p>Enforcing law effectively involves orderly and well-defined processes that address the problem without damaging the ecosystem and making a comprehensive plan to deal with all the concerned in a balanced and unbiased manner rather than solely targeting one institution unfairly and excessively</p>
Receive, process and store, efficiently and quickly, information that is given to us	There is hardly any scientific study and analysis of various trends and developments in the markets in regard to products, investors, emerging needs and requirements and institutions, etc.
Make information about companies and other bodies available to the public as soon as possible	All action directed against one institution, leaving out others that have greater contribution to the crisis. Information released to the public on a pick and choose approach rather than a comprehensive manner

DESIGNATED AGENCY

Public perception is made to believe that there is no specific regulatory authority for the spot exchanges and these exchanges functioned under regulatory vacuum. However, there was a clear effort to entrust the FMC to look after certain critical aspects of functioning of Spot Exchanges that are clearly in the realm of regulation.

The letter from the Ministry of Consumer Affairs, Food and Public Distribution, dated August 5, 2011 addressed to the Chairman, Forward Markets Commission, has the subject as "Regulation of National Spot Exchanges" in which it was directed that "the competent authority has decided to nominate the Forward Markets Commission as a designated agency for providing "oversight over the spot exchanges", which are granted exemption under section 27 of the Forward Market Contract Regulation Act 1952."

The letter from the Forward Markets Commission dated August 10, 2011 addressed to the Managing Director of the National Spot Exchange under the subject "Regulation of National Spot Exchanges" says, "I am directed to enclose herewith a copy of the letter from the Department of Consumer Affairs nominating the Forward Markets 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 contents 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".

Important words that run through both these communications are **"Regulation of National Spot Exchanges", "Oversight over the spot exchanges" "safeguard the interest of investors" and a return to be submitted on a fortnightly basis"**. What more does the Designated Agency require to assume regulation that it was entrusted to when all the letters in this regard end with a common statement that "FMC will be competent to take action as deemed necessary and fit".

POINTS OF CONTACT AND COMMUNICATION

The Board of NSEL consisted of professionals as Non-Executive Directors with eminent expertise and experience in the area of agriculture and related services, which laid the broad policy framework for the functioning of the exchange in accordance with the conditions of the exemptions granted by the Government. The Bye laws, Rules and Regulations have entrusted the functions and operations of the exchange to the management. The management of the Exchange consisted of a professional team headed by the MD & CEO who steered the management of the Exchange since inception. It was the management that was in contact with the government | regulatory authorities | other development agencies of state and Central Government in all aspects pertaining to various operations of the Exchange. Similarly, all agencies in the realm of policy, regulation and monitoring were in direct contact with the MD & CEO in all aspects of functioning and management of the Exchange. At no point of time since inception, any of the agencies as described above have either written to or met or advised or instructed or questioned the Board of NSEL or the promoter of NSEL on any aspect of the functioning of the Exchange.

REPORTING TO THE FORWARD MARKETS COMMISSION

FMC was monitoring the operations of NSEL and raised many queries from November 2011. All the queries and show cause notices were replied by the then MD & CEO, NSEL. The FMC had even raised specific questions about the availability of commodities in the warehouses, which were responded to satisfactorily by the MD & CEO. Therefore, there was no reason for the Board of NSEL to doubt that the operations were not being carried on properly.

PUBLIC STATEMENTS

All through July and August 2013, the MD & CEO through public statements had assured that stocks available in the warehouses equaled to settlement dues and could be sold and used for paying off the receiving brokers and their trading clients. However, since MD & CEO was not taking action to liquidate the commodities and make the payouts, the Board ordered an independent stock verification which resulted in finding out the shortfall in the stocks. How did the stocks go missing is a matter under investigation by the EOW.

THE SHOW CAUSE TO NSEL

The dispute began on February 22, 2012 with the FMC writing a letter to NSEL seeking clarifications on fulfillment of conditions stipulated under the notification dated June 5, 2007 governing the exemption given to NSEL **(ANX-43)**.

On April 27, 2012 the Department of Consumer Affairs, issued show cause notice to NSEL seeking information in 15 days on two specific issues

- NSEL was not preventing short selling
- NSEL was enabling trading in contracts beyond 11 days

NSEL promptly replied to both these communications – on February 29, 2012 to the FMC **(ANX-44)** and May 23, 2012 to the Department of Consumer Affairs - justifying the legal position of NSEL on both these matters. Further on August 11, 2012, NSEL provided a further follow up reply to the show cause notice, explaining the justification of legal position of NSEL.

On October 3, 2012 NSEL issued communication to all members with a copy of the same posted on the company website giving details of the communication received from the FMC and the DCA and the

replies given to both these agencies with an advice that there was no further communication either from the FMC or DCA on this subject. Thus, all the market participants, ie., the brokers, their trading clients and the defaulters were well aware of all the issues raised by the FMC and the DCA vis-a-vis NSEL's business model as early as October 2012, ie., nine months prior to the payment defaults occurring in July 2013.

THE NSEL REPLY

NSEL has replied to the FMC and DCA providing the following clarifications to the issues raised. Both these replies are consistent with the legal stand of the exchange on these aspects.

ON SHORT SELLING	ON CONTRACTS MORE THAN 11 DAYS
<p>Short sale implies a trade to create a sale position in a contract and to hold such position (without giving delivery or squaring up) by carrying it forward or rolling it over, with the intention of making profit out of a price fall in the near future.</p> <p>A member who deposits the goods in the warehouse post-execution of sale order and is able to tender his delivery within the stipulated time can't be said to have done short sale.</p> <p>Short sale is only such outstanding sale position, which is not settled by offering delivery as per the delivery schedule declared by the Exchange.</p> <p>The purpose of the exemption order by the DCA was to allow intra-day trading on NSEL. Going by the logic that ownership and possession of goods by a Member should be ascertained before he executes sale transactions, then none of the intra-day trading involving netting or squaring-off will be possible. So the condition of 'short sale' will contradict and defeat the very intention why the Gazette Notification was issued.</p>	<p>All forward contracts of one-day duration for sale and purchase of commodities traded on NSEL was exempted from operations of the provisions of the FCRA, 1952.</p> <p>All forward-contracts offered by NSEL were of one day trading duration with netting/ squaring-off facility.</p> <p>The Gazette notification has exemption of all one-day duration forward contracts from the provisions of the FCRA, provided all outstanding positions at end of day must result in delivery.</p> <p>In case of NSEL, all outstanding position at end of day result into delivery only. Now the question is whether the delivery should happen on the same day, within 11 days or it can happen beyond 11 days too. As the Gazette notification has not specified any period within which delivery must be given taken and so, even if delivery happens beyond 11 days period, it is in full compliance. Further, the contract was a forward contract by virtue of its settlement by transfer of title and netting of intra-day trading, in which case there was no limitation of period.</p> <p>Even NSPOT, the other national spot exchange, had launched several long duration contracts, beyond 11 days as it was a general exemption (ANX-45).</p>

After the replies in which clarification was provided in May and August 2012, till July 12, 2013 there was no further comment on the subjects raised by the FMC or DCA. Suddenly on July 12, 2013, the DCA asked NSEL to stop issuing fresh contracts.

Subsequent reply of the FMC to the Ministry of Consumer Affairs, Food & Public Distribution dated July 19, 2013 says exemption of NSEL under section 27 was general and not specific to any section and therefore, it appears that all reasons given by NSEL in its May 23, 2012 letter were correct and the NSEL business was stopped illegally. Stopping of NSEL business abruptly without any valid grounds and without giving sufficient time to follow a particular instruction, such as gradual phasing out of the contracts which are contested, is not consistent with the legal norms in this regard.

TAKING A PARTISAN VIEW

The dispute began on February 22, 2012 with the FMC writing a letter to NSEL seeking clarifications on fulfillment of conditions stipulated under the notification dated June 5

It is rather puzzling to note that the Forward Markets Commission is adopting a partisan approach of taking actions on the view obtained from the trading clients overlooking the enormous efforts and energies deployed by NSEL and FTIL in carrying out recovery of dues. FTIL was not given the opportunity despite repeated requests to cross examine the auditors whose reports have made the FMC to take this extreme action of declaring FTIL not a fit and proper.

The FMC, in its letter dated September 4, 2014, addressed to NSEL, has chosen to rely upon the inputs | suggestions of members | trading clients represented on the MAC (who were nominated by the FMC), to attribute negligible progress in recovery of dues by NSEL from the defaulting members on 'depletion of human resources, lack of financial resources and weak organizational structure at NSEL'. These brokers are also being interrogated by the Agencies and the fact was overlooked by the FMC while nominating them on the MAC through its letter dated November 29, 2013 **(ANX-46)**. They have even stated that the above alleged weaknesses at NSEL is posing major impediment in the recovery process, while in their same letter they have themselves acknowledged that assets of the defaulting members have been attached by the agencies and the same will be liquidated 'by competent authorities as per the procedure under the respective governing law'. It is worth mentioning that many of the assets attached by various agencies were actually identified by NSEL recovery team with the assistance of professional agencies and also by internal effort. The FMC has also acknowledged that High Court appointed a high powered Committee to ascertain 'the dues payable by each of the defaulters and for the recovery of such dues'.

The Defaulters have already admitted, before the Bombay High Court and | or MPID Court, to a liability worth more than Rs 2000 crore. Moreover, assets worth Rs 5000 crore belonging to the defaulters have already been attached by the EOW. Further, NSEL has recovered and paid more than Rs 540 crore to the trading clients.

Thus, NSEL has been doing practically everything possible to accelerate the recovery process, take suitable legal measures in various courts and also coordinating with various investigative agencies and providing them with voluminous data and information besides meeting various requirements of the FMC as indicated by them, their nominated MAC, and the various forensic auditors appointed by them. Despite all the efforts, FMC has blamed NSEL for delay in recovery without giving credence to the nature of the Indian legal and regulatory framework, which takes time in such complex recovery proceedings.

REGULATORY ACTION ONLY ON FTIL

The mandate given by the Ministry of Consumer Affairs, Food and Public Distribution (Gazette notification) to the Forward Markets Commission vide letter dated August 6, 2013 makes it amply clear that the regulatory agency should take all the measures against all the parties.

Para 2 (ii) of the said notification states:

"Settlement of all outstanding one-day forward contracts at National Spot Exchange Limited shall be done under the supervision of the Forward Market Commission and any order or direction issued by

the Forward Market Commission in this regard shall be binding upon National Spot Exchange Limited and any person, intermediary or warehouse connected with National Spot Exchange Limited, and for this purpose, the Forward Market Commission is authorized to take such measures, as it deems fit."

While, undoubtedly, the FMC has a mandate to supervise the settlement of all outstanding one-day forward contracts at NSEL, a plain reading of the above para also suggests that the FMC is supposed to take such measures as it deems fit for settlement of all outstanding one-day forward contracts at NSEL. Doesn't it also make clear that the authority of the FMC in this regard extends much beyond NSEL and also covers all such persons, intermediaries or warehouses connected with NSEL in the context of recovery and the FMC's orders will be binding on such entities? Despite such empowerment, the FMC has not visited any warehouse or interrogated any broker or defaulter to assist NSEL in recovery of settlement money.

Not enough instances exist of any measures taken by the FMC against the intermediaries (brokers) who sold NSEL contracts and whose role is now being probed by the investigative agencies. Whereas the FMC could have queried the relevant brokers (who are also acting as intermediaries of other exchanges regulated by the FMC and hence may not be "fit and proper") on their role in the NSEL matter just as it has sent several queries to NSEL since the crisis began.

It is also not clear of any measures taken by the FMC against the defaulting members (especially the top 7 defaulting members who owe 85 percent of the total outstanding) who controlled the warehouses where the commodities were supposed to be maintained. The FMC could have summoned the defaulting members to its office or ordered forensic audits of these defaulters. The Government of India in its notification of August 6, 2013 to the FMC had proposed actions to secure the warehouses, but the FMC did not act on that, instead it acted only on NSEL and FTIL.