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Evaluating Corporate Governance Fraud: A case of National Spot Exchange Limited

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Abstract
Organization: *NSEL (National Spot Exchange Limited) is the domestic level, institutionalized, electronic, apparent spot trading platform for commodities. It is an organized market place, set-up to make over the commodity market by way of minimizing the cost of intermediation and thereby optimizing marketing efficiency. It is first of its kind of institutes and right from the beginning it was acclaimed to be a tool to revolutionize the commodity market. But it did not lost long as just after five years from its evolution with the NSEL appearing as an institutionalized but opaque and secretive den of speculation and possibly fraud turned all acclamation to be a myth.*
Problem or Issue Addressed: *The problem which will addressed in this case study is about the fraud which erupted due to the regulatory negligence of government, auditor's inability and lack of corporate governance. The NSEL failed to pay to its investors who have invested in commodity pair contracts. And it was subsequently found that most of the of underlying commodities never existed and buying and selling of commodities like Steel, Paddy, Sugar, Ferrochrome etc. was being conducted only on paper. Later on it was found that some of the warehouses mentioned on NSEL website did not exist and even the SGF (Settlement Guarantee Fund) which was supposed to be about Rs 839 crores (about $ 140 Million) as on 29 July 2013 vanished into thin air.*
Goals: *The basic focus of the case to help understand the eruption and causes of a regulatory fraud. In this case study we are trying to evaluate eruption, causes, mechanism and consequences of 5600 crore rupees commodity market fraud. Further regulatory changes needed to be taken to avoid such kind of frauds in future are also debated upon.*
Results: *The basic cause for the eruption of such kind of frauds is lack of regulation in these types of commodity markets. The lack of regulation on behalf of our auditors who come out clean handedly from all such type of frauds are main causes for such type of frauds. Further, it is quite evident that there are only four persons in the board and two of whom belong to FTIL, so it was pretty obvious that most of the decisions will be taken in the interest of FTIL who is the promoter company and there is very mere chances that any of the directors are going to talk about the interest of the investors. This happened because of very weak corporate governance mechanism in place to keep in check the promoters of the exchange*
Lessons Learned: *The case strengthens the need of vigilant regulatory systems in both private and public institutes. Further there is an urgent need to improve corporate governance in these institutions so that decisions will not be taken in the favor of majority of shareholders. Also the case highlights that there is a strong need to redefine the role of auditors to avoid such kind of frauds in future.*
Key words: Regulatory fraud, Corporate Governance, Spot exchange.

I. Regulatory Fraud: A Case Study of National Spot Exchange Limited.

After 31st July 2012 National Spot Exchange Limited (NSEL) failed to pay to its investors who have invested in commodity pair contracts. And it was subsequently found that most of the of underlying commodities never existed and buying and selling of commodities like Steel, Paddy, Sugar, Ferrochrome etc. was being conducted only on paper Later on it was found that some of the warehouses mentioned on NSEL website did not exist and even the SGF (Settlement Guarantee Fund) which was supposed to be about Rs 839 crores (about $ 140 Million) as on 29 July 2013 vanished into thin air.. This is how the 5600 crore rupees commodity market fraud erupted.

History of NSEL

Just few years back India's desire to get benefit from economic and financial deregulations led to formation of a new market a commodity exchange called the National Spot Exchange Limited (NSEL). It was on Wednesday, 15 October 2008 the foundation of NSCL has been laid and the mission for developing such market has been puts as fallows "To develop a pan-India, institutionalized, electronic, transparent Common Indian Market offering compulsory delivery-based spot contracts in various agricultural and non-agricultural commodities with a reduced cost of intermediation by improving marketing efficiency and, thereby, improving producers' price realization coupled with reduction in consumer paid price."

NSEL commenced operations pursuant to gazette notification dated June 5. 2007 issued by ministry of corporate affairs, food and public distribution. Government of India, allowing it to conduct trading in commodities. Subsequently, the government has issued office order dated February 6 2012 to appoint FMC as the monitoring agency to overview the functioning of national spot exchange. In compliance with the Gazette Notification, NSEL submits relevant reports, returns and information to the Forward Market Commission. In addition NSEL obtains license from the state government under respective state APMC (agricultural produce market committee) act where it intends to launch farmer's contract for agricultural contracts. At present NSEL is operational in 16 states in India, providing a delivery based spot trading in 50 commodities. In 2010 NSEL added new dimensions to the commodity market by introducing investment products in commodities in Demat form. This was unique because for the first time in the history of Indian commodity market NSEL launched a series of unique investments known as "e-series" instruments. E-gold the first product under e-series was launched on March 17, 2010.

A. Milestones and Strategic Alliances inChronological Order.

2005

- In May 2005 NSEL incorporated as company limited by shares under companies' act 1956.

2007

- In May 2007 it filed a memorandum of association (MoU) with government of Madhya Pradesh for developing electronic market facilities in Madhya Pradesh.
- In June 2007 it got recommendations by Ministry of Agriculture, Govt. of India about the NSEL project. Also complied with the issuance of Gazette Notification by Ministry of Corporate Affairs, govt. of India under Section 27 of FCRA, 1952.
- In October 2007 NSEL has got an issuance of license by Got, of Gujarat under Gujarat APMC Act.
- In November 2007 NSEL signed a MoU with IL&FS for common service centers being set up under National E-Governance Project to be connected to NSEL. Also signed a MoU with Govt. of Rajasthan.

2008

- In January 2008 NSEL got issuance of license by Govt. of Maharashtra.
- In May 2008 issuance of license by Govt. of Karnataka for setting up spot exchange in state of Karnataka.
- In June 2008 signed a MoU with the Gujarat Agro- industries corporation limited (GAIC) to create a strategic alliance for developing of agri-business and providing an electronic market platform in state.

2009

- In January 2009 commenced cotton procurement in Andhra Pradesh under Price Support Scheme (PSS) operating on behalf of Nafed.
- In June 2009 signed a MoU with Maharashtra State Agriculture Marketing Board, to create linkage between rural primary agricultural cooperative societies (PACS) godowns and spot market facilities?
- In September 2009 signed a MoU with Government of Orissa, for developing electronic market facilities in Orissa.

2011

- In January 2011 signed MoU with Govt. of Gujarat under "Vibrant Gujarat 2011".
- Received Shariah certification for e-gold, e-silver and e-copper.

2012

- In January 2012 FOW award for "Best innovation by an exchange in the field of product design".
- In February 2012 received Shariah certificate for e-Lead, e-Zinc, and e-Nickel.
- In April 2012 launched e-Platinum under investment product category E-series.
- In July 2012 Honored with "Golden Peacock Eco-Innovation Award 2012" for the commodity exchange category in Delhi.
- In September 2012 Western Ghats Agro Grower Ltd, a joint initiative of Kerala farmers and NSEL was inaugurated by the honorable chief guest Prof. K. v. Thomas Minister of State for Consumer Affairs, Food and Distribution in Kerala.
- In November 2012 signed a MoU Belarusian University Commodity Exchange in the Republic of Belarus for developing bilateral deals between India and Eastern European countries especially Republic Of Belarus, Russia, Ukraine and Kazakhstan?

B. Services Offered

- Electronic spot trading facilities in various commodities. This facility is available at specific delivery centers.
- It offered trading in commodity based instruments in Demat form
- It also indulged in grading, quality certification and standardization of commodities.
- It helped in facilitating collateral financing against warehouse receipts.
- It bought a new wave by customizing services relating to storage transportation logistics and shipment.
- It provided procurement services to Corporate and Government agencies.
- It facilitated the auction process by introducing electronic auction of various commodities on behalf of FCI, MMTC, etc.
- It provided modern storage facilities including scientific storage of commodities with warehouse receipt financing.

C. Operations

Since the commodity market was a recent concept in India and to make it work was an achievement. The operations of commodity market include

- Trading
- Delivery, Clearance and Settlement.
- Risk management, Margining and Surveillance
- Settlement Guarantee Fund
- Technology

❖ **Trading**

Trading is done through online screen based trading system that is assessable through VSAT, leased line of internet. Trade is conducted through daily expiry commodities contracts. The position outstanding at the end of the day results into compulsory delivery. However during the day the transactions of offsetting nature are netted off and delivery is affected only with respect to the net quantity outstanding at the end of the day. Terms relating to quality specification, place of delivery, date of delivery and other conditions are specified by exchange in advance. All contracts executed on the system are based on such terms only. Market remains open for 10: am to 11:30 pm

❖ **Delivery, Clearance and Settlement**

All trades executed during the day are netted off at the close of the market hours as per the weighted average price of the last 30 minutes. The profit/Loss therein is settled on the basis of market to market (MTM) on either the same day or next day depending upon the contract condition. The net sellers have to give the delivery by the way of depositing goods in the exchange designated warehouse/storage tanks as specified in the circular. The buyers account is debited by exchange and delivery order is issued to him after ensuring that payment is complete. There after payout is credited to sellers account. In case the seller/buyer fails to honor his delivery obligation, the position is auctioned /closed out at risk and cost of defaulting party.

❖ **Risk Management, Margining and Surveillance**

The exchange has got a well versed mechanism for risk management and uses various tools for risk management, margining and surveillance to ensure market integrity. All positions outstanding the in the market are subject to margin payable by both buyers and sellers. However the sellers who have deposited the goods in exchange –designated warehouses/storage are exempted from the Margin and pledged with the exchange.

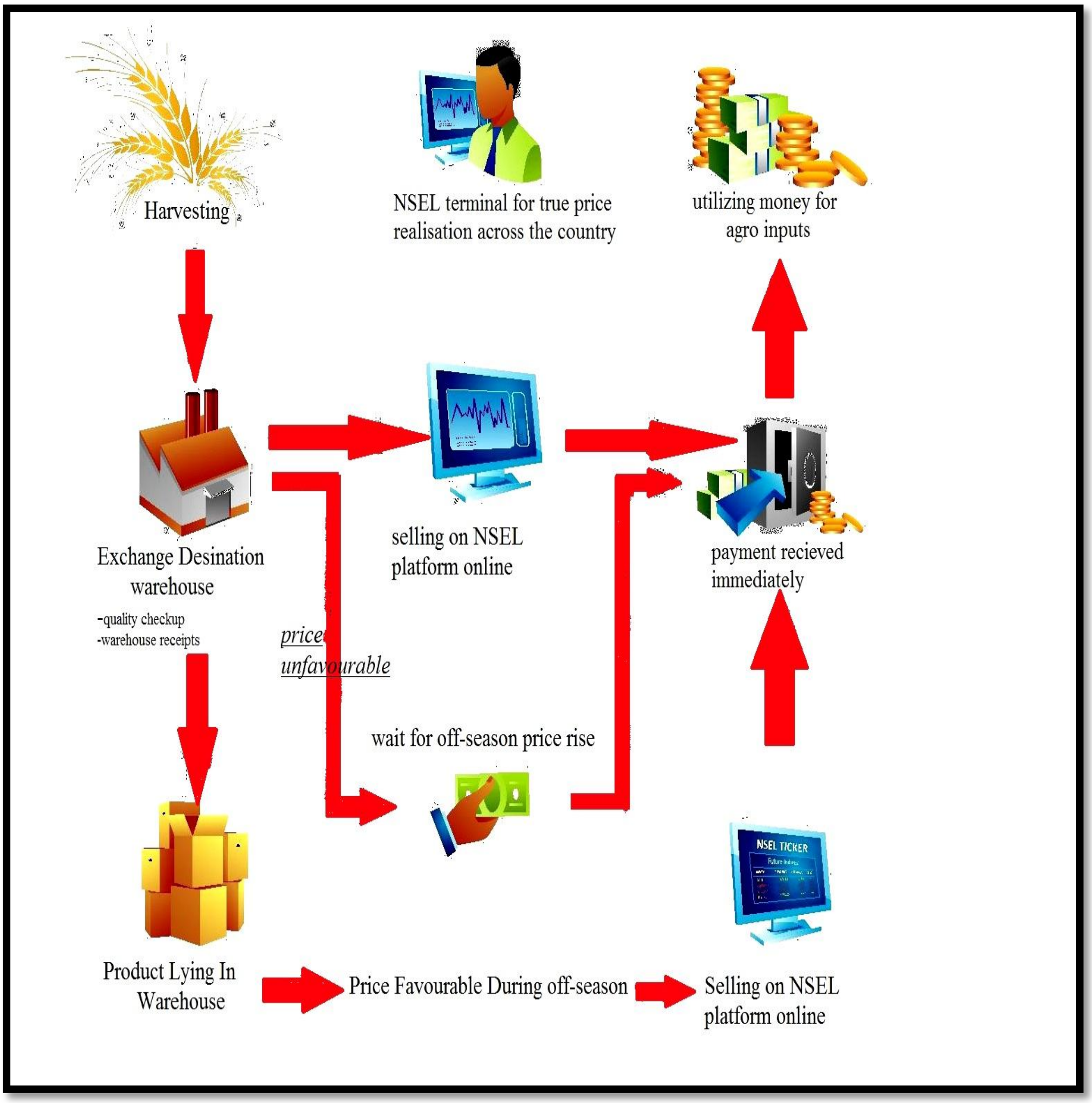
❖ **Settlement Guarantee Fund**

The exchange provides a guarantee to perform to all the contracts executed on exchange platform. For this purpose exchange maintains a settlement guarantee fund. Notwithstanding default of any member, payout is honored as per exchange schedule.

❖ **Technology**

NSEL has a strategic advantage of having Financial Technologies (India) Ltd. (FTL) as its technology partner for delivering technologically advanced solution to market participants. FTIL has provided a robust technology platform to multiple domestic and international exchanges. The exchange uses a client server application which can be accessed through VSAT, leased line, internet as well as mobile phones. The hardware hosting the trading and surveillance applications are fully fault tolerant systems with zero redundancy.

Operations flow chart regarding use of NSEL platform by a farmer.



D. Products

On NSEL platform commodities are traded in a structured and well documented contract form having standard quality specifications. All contracts are of single day duration having different settlement cycles depending upon the commodity and market prices.

Commodities traded on NSEL include agricultural commodities, bullions, metals, energy and minerals. The exchange also facilitates trading in coal and iron ore. It has introduced "e-series" investment products catering to retail investors. NSEL also plans to introduce industrial products in near future.

I. Types of Contracts

- Farmer's contract

These are mandi cess unpaid contracts in agricultural commodities which are traded quantity (such as 1 bag) to enable small and marginal farmers to sell their produce directly on pan India platform with a platform without any intermediary.

- Trader's contract

These are mandi cess paid contracts in agricultural commodities which are traded in multiple of truck cads (such as 10M). These contracts enable traders to access NSEL platform to sell their stocks in a risk-free and hassle-free manner.

- Forward Auction Contracts

These are specific contracts that serve the needs of specific series and enable them to electronically auction their produce on NSEL platform this also enhances the price realization due to the competitive bidding and brings transparency in the auction process. Most of the government companies such as Nafed, MMTC, etc. use their mechanism to sell various commodities on NSEL platform.

- Reverse Auction Contracts

These are specific contracts that serve the need of specific buyers and enable them to procure raw material at lowest possible price through competitive offers from large number of sellers.

II. Commodities Offered

NSEL provides a platform for trading in multiple commodities with multiple contracts. It also provides trading in such commodities, which are traded in future exchanges. They have enabled seamless process of cash future arbitrage, enabling investors to buy Exchange Certified deliveries. Besides there are some customized contracts to meet specific requirements of an institutional buyer or institutional seller. It has also launched a number of farmers' contracts to provide a service to small and marginal farmers, where it does not charge transaction fee from small and marginal farmers. As on December 2013 the exchange offers trading in 50 commodities.

S. No	**Commodity**	**Delivery Centre**
1	Areca nut	Shimoga, Channagiri (Karnataka)
2	Bajra	Jaipur (Rajasthan), HAFED Warehouses
3	Barley	Jaipur,Chomu, Sikar, Srimadopur (Rajasthan)
4	Basmati Rice (or Rice)	Jakhal, Ratia, Raina-HAFED warehouse (Haryana) Ludhiana (Punjab)
5	Basmati Paddy (or Paddy)	Karnal, Nilokhari, Thanesar, Ladwa, Pehowa, Sisra, Ismailabad, HAFED warehouse (Haryana), Warangal (AP) Ludhiana, Khamanaon (Punjab)
6	Black Pepper	Vandanmedu(Kerala) Saharanpur(UP)
7	Cardamom (Oil type and Splits)	Vandanmedu(Kerala)
8	Castor Seed	Palanpur, Kadi, Jagana, Mehsana, Patan, Chandisar, Gandhidham, Visnagar, Panthawada, Sidhpur (Gujarat)
9	Castor Oil	Kandla (Gujarat)
10	Chana/Desi Chana	Palanpur, Kadi, Jagana, Mehsana, Patan, Chandisar, Gandhidham, Visnagar, Panthawada, Sidhpur (Gujarat), Dhanera, Deesa, Harji, Vadali, Mundra, Himmatnagar, Deodhar, Thara, Khedbharma, Vadgam(Gujarat)
11	Chana Kantawala/ ChanaKabuli	Indore (Madhya Pradesh) Jalgaon (Maharashtra)
12	Coal	Mangalore (Karnataka)
13	Copra	Tiptur, Arsikere and Tumkur (Karnataka)
14	Coriander	Guna (MP)
15	Copper	Demat(e-copper) Delhi
16	Cotton Bales and kapas	Mumbai, Yeotmal, Nagpur, Wani, Amravati, Akola, Khamgaon, Dhule, Jalgaon, Aurangabad, Parbhani, Nanded, Parli (Maharashtra),Himmatnagar, Rajkot (Gujarat), Adilabad, Nizamabad (Andhra Pradesh)
17	Cotton seed wash oil	Kadi, Tamba (Gujarat), shamshabad (Hyd) (AP)
18	Gold	Ahmedabad, Rajkot (Gujarat), Mumbai (Maharashtra), Kolkata (West Bengal), Hyderabad, Vijayawada (Andhra Pradesh), Chennai (Tamil Nadu), Jaipur (Rajasthan), Delhi
19	Groundnut	Jaipur, Bikaner, Jodhpur (Rajasthan), MaliyaHatina (Gujarat)
20	Guar Seed	Bikaner, Jaipur (Rajasthan)
21	Guar Gum	Jodhpur (Rajasthan)
22	Jeera	Jodhpur (Rajasthan)
23	lead	Demat(e-lead)
24	Lemon Tur	Mumbai (Maharashtra)
25	Maize	Maheshkhoont (Bihar), Jalgaon, Khopate near Uran (Maharashtra) Umerkote (Orissa) Devangiri (Karnataka) Kota (Rajasthan)
26	Masoor/Lentil	Kolkata (WB) Mumbai (Maharashtra
27	Moong (green Gram)	Mumbai, Jalgaon (Maharashtra)
28	Mustard Oil	Jaipur Rajasthan
29	Nickel	Demat(e-Nickel)
30	pig Iron	Jaipur (Odhisa)
31	platinum	Demat (e-platinum) Ahmedabad, Jaipur, Delhi, Hyderabad, Mumbai
32	Rajma (kidney bean)	Ex-godown (AP)
33	Red Chilly	Saharanpur (UP) and Khammam (AP)
34	RBD Palmolein	Mundra- Adani, Kandla- Gokul, Kandla- GUJOIL
35	RM seed	Jaipur, Jodhpur, Kota Baran (Rajasthan), Narnaul and Rewari (Haryana)
36	Silver	Ahmedabad, Rajkot (Gujarat), Mumbai (Maharashtra), Kolkata (West Bengal), Hyderabad (Andhra Pradesh), Chennai (Tamil Nadu), Jaipur (Rajasthan)
37	Soyabean	GanjBasoda, Vidisha (Madhya Pradesh), Jalgoan, Nandurbar (Maharashtra)
38	Soyabean DOC	Kota (Rajasthan)
39	Soyabean oil (crude)	Kota (Rajasthan)
40	Soyabean oil (Refined)	shamshabad (Hyd) (AP)
41	Steel and Steel TMT	Raipur(chattisgarh) Jharsuguda (Orissa) Kurnool (AP) Mumbai (Maharashtra)
42	Sugar	Kolhapur (Maharashtra) Patna (Bihar) Kolkata(WB) Ex-HAFED SUGER MILLS

		ASSAND, Ambala (Haryana), Dadariya (Gujarat)
43	Sunflower Seed	Jalgaon (Maharashtra)
44	Sunflower oil	shamshabad (Hyd) (AP)
45	Urad FAQ	Mumbai (Maharashtra)
46	Wheat	Rajkot (Gujarat), Jaipur, Chomu (Rajasthan), Delhi, Vidisha (Madhya Pradesh)
47	wool (Raw)	Ludhiana (Punjab)
48	Wool (Top)	Ludhiana (Punjab)
49	Yellow Peas	Mumbai (Maharashtra)
50	Zinc	Demat (E-Zinc) Delhi (Zinc Ingot)

III. e-**SERIES**

The e-series was introduced as investment products for retail investors. It was the first investment product of its type in Indian history. These enabled investors to buy and sell commodities in demat form and hold them in demat account. Retail investors are now able to trade in commodities as they do in equities, particularly as cash segment in equities but offers commodities in demat form in small denominations. The clearing and settlement mechanism for these products is based on T+2 settlement cycle. E-series provides an opportunity for intraday trading, coupled with demat delivery in respect of positions outstanding at the end of the day. NSEL deals in e-Gold, e-Silver, e-Copper, e-Zinc, e-Lead, e-Nickel and e-Platinum. NSEL is in continuation to add more to this segment.

Investors who are willing to purchase e-Series products are required to open beneficiary accounts with NSEL-empaneled Depository Participants (DPs). National Securities Depository Limited (NSDL) and Central Depository Services (India) Ltd (CDSL) are the depositories for holding commodity units in electronic form.

IV. Industrial Products

NSEL provides a platform to sell proceeds/manufactured industrial products on its platform. The producer company gets listing of its products on NSEL platform through a formal agreement specifying the rights and obligations. The primary objective of allowing branded products on exchange is to provide an efficient marketability and mechanism to manage trading of branded products. At present Hindustan Zinc Ltd. Sells silver bars mined and refined at its factory on NSEL platform under such agreement. Similarly pig iron is also sold by NeelachalIspat Nigam Ltd. (NINL)

Regulation in NSEL

The board of directors of NSEL consists of four members only which included Mr. Shankarlal Guru (chairman), Mr. Jignesh Shah (vice chairman NSEL) who the chairman of FTIL, Mr. B D Pawar (Director) who is the director of CITA and Mr. RamanathDevrajan (Director) who also belonged to FTIL.

NSEL commenced its operations pursuant to gazette notification by ministry of consumer affairs on June 5, 2007. Spot contracts, by their nature, were deemed to be out of FMC regulation by a small notification in 2007 by the Department of Consumer Affairs. This exemption was given specifically for one-day duration contracts – or, technically those contracts that complete both delivery of goods and transfer of money within two days, called “T+2”.

It was not regulated by the SEBI as it does not belong to the financial market. So the sole regulator was ministry of consumer affairs which allowed it to complete both delivery of goods and transfer of money within two days, called “T+2”.

NSEL Fraud Bursts

NSEL is first of its kind of institutes and right from the beginning it was acclaimed to be a tool to revolutionize the commodity market. But it did not lost long as just after five years from its evolution with the NSEL appearing as an institutionalized but opaque and secretive den of speculation and possibly fraud turned all acclamation to be a myth. NSEL is a commodities exchange promoted by the Jignesh Shah-led Financial Technologies (FinTech).

For every spot exchange there are rules and regulations that a governing a particular stock exchange, and under these rules the spot exchange can perform its operations. These rules are regulated firmly by the Forward Market Commission (FMC). Under the Forward Contracts Regulation Act, any contract that is called “spot” must be settled within 11 days – that is, both delivery of goods and transfer of money must happen within 11 days (called “T+11”). The 11 days give the buyer and seller time to complete the contract. Thus, this would then not become a “forward” contract.

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A. What NSEL Really Did

What NSEL as spot exchange has to do is to make T+2 contracts, instead of just making T+2 contracts, the spot exchange designed multiple contracts. Some of them were T+2 settled, making them 'spot' in nature. Others were the same product but settled after 25 to 35 days, called T+25, or T+36 contracts. This was illegal – such contracts are forward contracts and NSEL was not authorized to execute these, but it did, and no one stopped it. The concept got worse; NSEL sold what seemed to be 'arbitrage'. You could 'buy' the T+2 contract and 'sell' the T+25 contract and the difference in prices gave you nearly 15 percent per year, annualized. Effectively, you would be the owner of half a ton of sugar or castor seeds or such commodities, for a period of about a month, which would get sold when you 'exited'.

The exchange practically removed all constraints from investors during this period – the goods would lie in the same warehouse and be sold from there, and the price difference included a 15 percent net return after storage charges, VAT, etc. This arbitrage was almost 'guaranteed'. NSEL as an exchange stood guarantee, or so investors thought. Brokers peddled this product to their customers for over two years. The number of customers ballooned to over 15,000, each of whom put in at least Rs 2 lakh to get their 'superior' returns.

The arbitrage was not genuine because the contracts were always sold in pairs. Brokers have reported that no one was allowed by the exchange to just take one side of any contract – you always had to have a 'buy' on the near contract and a 'sell' on the far side. A quick look at the Kadi contract for castor seeds, sold in pairs of T+3 and T+36, shows identical volumes and interest for both contracts in January 2013, and that's the case with every commodity that had a near and far contract. This is hardly possible in a real market, so it points to the fact that these contracts were always executed in pairs.

The fact that the contracts were executed in pairs indicates it was basically a financing program rather than a spot exchange. Something is placed as collateral to borrow money for a short period of time. This used to be commonly known as "badla financing" in the pre-2000 stock exchanges, where shares were collateral. (Badla is banned now; the financing has moved to the futures market.) Let's say I am a plant owner, and I can't get a loan from a bank. I can effectively borrow from you at 15-18 percent – much cheaper than I can borrow from banks. And if I'm smart, I know that the goods I sell you will remain at a warehouse inside my premises, so why not cheat a little and tell you that yes, I've added more goods to your warehouse, and you, on the other end of the phone agree. Most 'investors' rolled over their contracts. That is, when the contract was unwound after T+35, they would enter a fresh round of T+2 (buy) and T+35 (Sell). Meaning, the interest received was also ploughed back into further purchases; a 'borrower', on the other hand, was pretending to pay interest, but was simply creating warehouse receipts for the interest and trading them on the exchange, while rolling over the contract forever.Indeed, it turned out that some of these companies had poor balance sheets incapable of handling such large loans – loans of the size of Rs 900 crore. And the exchange did nothing.

B. How fraud erupted

All this had to stop sometime, and the circular from FMC stopped it. First, on 16th July the contracts were cut to T+10. But that would involve too many pair trades – from one a month to three a month, each of which had higher transaction costs. Next, some investors smelt a rat and didn't roll over their contracts. The lack of a rollover shuttered the exchange. When the 'borrowers' were told that they had to pay back all the money, they simply could not (or didn't want to). And it turns out they don't seem to have the goods to backed up either.

On July 31st 2013, NSEL issued a circular saying all future contracts would be stopped. And because there was a settlement problem, they would have to delay payouts for a while. Also, some investors had bought goods on a T+2 contracts, paying upfront. Now they expected that after their 25-35 days, the other contract would kick in and they would be paid back money at the higher rate on that contract. At this point, the exchange should have stood guarantee. That's the role of an exchange. But because it didn't get paid from the borrowers, it didn't have the capacity to pay.

The exchange started to lie. The CEO, Anjani Sinha said on August 1st that they had a 'Settlement Guarantee Fund' of over Rs 800 crore plus they had all the stocks in the NSEL warehouses. In a few days they changed that position, stating they had only Rs 60 crore in cash and the rest of the 'guarantee fund' was in stock. All entities were supposed to put a tiny amount – up to 5 percent – as margin until trade completion. This, too, was unavailable for some reason. Then after telling everyone that they would get their money back, the NSEL management said they had to auction stock to get the money. Soon, even that avenue was gone as there wasn't any stock.

Jignesh Shah, the founder of FinTech, which promoted the exchange, said in a press conference that they would have a high-powered committee, including an ex-SEBI chief, a senior police officer and the like, to ensure settlements happen. As it turns out, the committee was useless in actually enforcing the contracts. NSEL next created a complex settlement program. After a few days, NSEL management offered a 'settlement calendar' stretching 30 weeks where people would be paid back Rs 174 crore per week for 20 weeks, Rs 86 crore a week after that, and a big balloon payment at the end.

NSEL couldn't even make the first week's payments properly – it paid up just half. In the second week, to fend off investor aggression, FinTech dipped into its resources and paid Rs 177 crore to those with less than Rs 10 lakh outstanding. There have been three payments till now – of Rs 92 crore, Rs 190 crore (including small investor payouts) and then, this week on Tuesday, 3rd September, Rs 15 crore. But in the settlement program, NSEL had promised to pay Rs 174 crore on each of these three Tuesdays. In the middle of all of this, it turned out that many of NSEL's 24 Processor members were related to each other. One of the biggest borrowers, NK Proteins, is owned by the son-in-law of NSEL's chairman Shankarlal Guru. Then there was Indian Bullion Market Association, owned primarily by NSEL, which participated as a member, allowing parties in the bullion space to buy through them.

The whole thing began to stink. N Sundaresha Subramanian of Business Standard visited many of the defaulting members and found strange results. There was a mall in the place where 2 lakh tons of sugar was supposed to have been stored, at the address of a NSEL borrower called Mangla Shree Properties. In Ludhiana, where ARK Imports was supposed to have 12,000 tons of raw wool, there was apparently nothing. One borrower had vacated its premises months back, while another refused to admit they owed anything. NSEL's investors involved clients from nearly every major broker in the country. Even the Sahara Group, which is under RBI and SEBI fire, was found to have invested more than Rs 200 crore. And this was just the initiation of 5600 crore fraud that shook the commodity market.

C. What factors lead to fraud?

The FMC was supposed to control regulation of all forward contracts. Although NSEL had received an exemption, it was only for the T+2 contracts and definitely not the T+35 contracts. The new FMC Chief, Ramesh Abhishek followed this up since 2012, but what about those before him? The Department of Consumer Affairs was the de facto regulator when no one else was. It had been made aware of the situation over a year ago and should have taken action, and it didn't. Even after the scam was unearthed, and the scale of the borrowing discovered, regulators remain tight-lipped about action. SEBI has barred some of the 24 'borrowers' from trading on the stock exchange, and FMC has ring-fenced MCX (a commodities futures exchange which shares the same promoter, FinTech, with NSEL) from helping the beleaguered NSEL with its cash. However, any other actions have yet to come through.

Where is the RBI? Banks have lent to operations that involve stocks in warehouses. In fact, some photos of NSEL warehouses explicitly state that goods are pledged to certain banks. Are these goods there? Has the RBI asked banks to initiate a probe? How banks were able to provide finance without looking into whether the goods are present or not? Does it show lack of regulation on behalf of banks? Ernst and Young, a big name auditor, had supposedly checked NSEL warehouses and given them an okay of sorts. This kind of thing is now unsurprising; it just means that you should not trust anyone, even if they are a big name auditor or can we say auditors are not under any kind of supervision in our country. If they have given them okay of sorts this means they are also involved in the fraud. The Finance Ministry had noted, in 2007, that Financial Technologies, the owner of the defaulted NSEL, was potential not fit-and-proper for running a stock exchange, after Income Tax raids found unexplained amounts of Rs. 105 cr. This was disclosed to SEBI and they ordered an enquiry but all this drama lead to nothing interesting.

The problem, however, is that the NSEL, being a spot exchange, was not subjected to any such rules by any regulator. Being a spot exchange and not supposed to engage in mediating forward contracts, the NSEL was not under the scrutiny of the Forward Markets Commission. The Forward Markets Commission has presented three gazette notifications that specifically rule out exchanges like NSEL from its jurisdiction. These are damning; the government has singled out these exchanges to not be regulated under the FMC act, and one of them (NSEL) has gone on to cripple investors by delaying settlement by 15 days. Not being a financial market, it was not regulated by the Securities and Exchange Board of India or the Reserve Bank of India either. While it cannot be established whether this electronic exchange was set up to exploit this regulatory vacuum, the fact remains that it did in practice exploit that advantage. The NSEL not only adopted the 11 day settlement definition, but it was permitting contracts that had settlement periods in excess of 11 days, going up to 36 days, making it an unregulated futures market.

So we can say that the basic cause for the eruption of such kind of fraud is lack of regulation in these types of commodity markets and the lack of regulation on behalf of our auditors who come out clean handedly from all such type of frauds. As it is quite evident that there are only four persons in the board and two of whom belong to FTIL, so it was quite evident that most of the decisions will be taken in the interest of FTIL who is the promoter company and there is very mere chances that any of the directors are going to talk about the interest of the investors.

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