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An Insight Into Nsel Scam

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I. INTRODUCTION:

The financial crisis of 2008 created panic among investors throughout the world. The crisis once again lead investors to reason out the very basis for assessing the intrinsic values of the financial instruments and the various underlying truths or lies structured around these instruments. Indian markets have seen various panicky situations in the past, either due to regulatory limitations or due to regulatory loopholes. Systemic failures mainly the 1992- Harshad Mehta scam and Ketan parekh scam have questioned the safety of the financial markets in the past and haunted the investors in choosing financial investments has an avenue for making abnormal profits. Recent years have witnessed changing profile of the Indian economy with respect to lower GDP figures, higher inflation and higher interest rates. Rupee depreciation has added more smoke to this tailspin. Though recent years have been seen to be less scam tainted than previous years due to strict and stringent measures by the regulatory authorities, the NSEL scam questions the very fabric of these measures. The recent scam seems to be like a “new wine in a new bottle” kind of scenario to say. The NSEL scam is altogether in a different asset class and it requires scrutiny. These developments lead to slight change in guard for the investors to choose commodities markets and derivatives markets over spot markets with the added advantage of leveraged payoffs. The commodities markets are still in there nascent stage when compared to stock markets in terms of demand and supply variables. But the growth of commodities markets has been truly remarkable considering its ranking to world exchanges such Chicago Merchantile Exchange (CME), Chicago Board of Trade (CBOT), LIFFE, TIFFE etc. At present there exists four national commodity exchanges, out of which Multi-commodity Exchange (MCX) and National Commodity and Derivatives Exchange limited (NCDEX) have gained recognitions among the world top commodity exchanges. The recent crisis emerging from NSEL scam tries to brush through doubts of commodity markets to be efficient too. The suspension of trading and payout crisis once again point towards systemic failures and weaknesses of the financial market environment.

II. BACKGROUND OF THE STUDY:

The National Spot Exchange Limited started in October 2008 as a national level, institutionalized, electronic, demutualized and transparent spot exchange. This electronic spot exchange was poised to transform the rural economy by allowing farmers/sellers and processors/exporters/traders to meet and exchange produce electronically. NSEL would thus try to reduce the cost of intermediation and improve market efficiency, thereby helping farmers realize the price without increasing the consumer’s price. NSEL was found to be mainly promoted by Financial Technologies India Ltd (FTIL) and National Agricultural Cooperative Marketing Federation of India (NAFED) to provide a platform for auction and trading of agricultural products, bullion, metal and energy both in physical and also in electronic forms. The actual problem was realized with respect to the electronic spot exchange when the Rs.5600 Crore fraud came to light and when NSEL failed to pay out its investors in commodity pair contracts. Further investigations showed that, the underlying commodities never existed and buying and selling of commodities like Steel, Paddy, Sugar, Ferrochrome etc. was being conducted only on paper and not in reality. Under the Forward Contracts (Regulation) Act, 1952, a three tier regulatory structure would look into the commodities markets and Forward Market Commission (FMC) would have the regulatory powers. Under the Forward Contracts (Regulation) Act, 1952, 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”). Thus, this would then not become a “forward” contract. Spot contracts 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 “T+2”. But NSEL designed multiple contracts- some T+2 days making them ‘spot’ transactions and others were same but settled after 25 to 35 days which indirectly provided for ‘arbitrage’. This meant ‘buy’ the T+2 contract and ‘sell’ the T+25 contracts and make profits up to nearly 15 percent per year, annualized. Although NSEL had received an exemption, it was only for the T+2 contracts and not the T+35 contracts.

But investors who honored their T+2 payment obligation found that the NSEL neither had money nor commodities to honor their T+25 obligations. And about 24 borrowers were given the funds by NSEL without any underlying commodity deposited by them. Forward Market Commission though jumped in late into the matters is trying to unearth the truth beyond these frauds and lies of NSEL. Various questions are to be answered such as how did NSEL continue its operations since 2008? How could the existing laws of the FMC grant an exemption to NSEL to allow forward contracts (as against spot trading)? How did the brokers agree to the transactions without the physical stock verification?

III. CREATION OF NSEL:

The National Spot Exchange Ltd (NSEL) was formed as a national level institutionalized, electronic, transparent spot exchange with state-of-the-art unique market place providing customized solutions to various problems faced by the farmers, traders, processors, exporters, importers, and the investors. Thus NSEL provided a platform for farmers to sell their produce and on the other hand processors, exporters, traders and investors to buy produce electronically. This helped in price discovery in an efficient way. NSEL was a delivery based online trading exchange with standardized contracts having specified delivery places. The contracts had a single day duration and outstanding positions were meant for delivery at the end of the day. The delivery in normal cases allowed is two to eight days. The NSEL was supposed to help the farmers to access the national market and get the best price for their commodities. The NSEL would also increase the farmers holding capacity by creating a mechanism for warehouse receipt financing by the banks. When compared to previous system, NSEL found information technology to farmers price realization without increasing the retail prices for the consumers. The agricultural markets or mandis are regulated by respective state governments, which inturn have agriculture marketing acts or Agricultural Produce Market Committee (APMC) acts. The system found reasonable mistrust with the farmers since the produce were sold to mandis through authorized commission agents. The result was that the traders or agents would sell the produce at a higher price after buying from mandis. The main reason found for this mispricing was that farmers sold produce which was unsorted or ungraded to mandis which then was done by traders to sell further into the markets at higher prices. But NSEL assured this disadvantage to not prevail by grading and sorting the farmers produce at NSEL platforms itself helping farmers price realization. NSEL was considered to be missing link between the farmers and the futures markets. NSEL provided the link between drawbacks found in futures and agricultural markets/mandis. Futures markets though helpful in price discovery and risk management, actual delivery of underlying instruments was quite negligible. Mandis were found to be not efficient in price realization for farmers. When compared to other markets, NSEL reduced the parameters such as entry load, exit load and annual/recurring expenses drastically.

Table 1 and Table 2 help to understand this gap between the markets and in terms of expenses.

The NSEL Crisis:

The NSEL was incorporated to bring price transparency, better price realization for farmers and lot of arbitrage opportunities for investors and trading community. Thus NSEL was brought in to sync with existing markets and provide synergy among the existing marketing systems. NSEL was an electronic platform which would bring three entities together. The sellers of commodity, forward buyers and the investors, who were actually funding all the transaction. On settlement, the buyers would pay the differential (which usually came at a premium to the spot price) and settle the contracts. The eventual payout would ensure that the financiers or investors got their money. Investors got the benefit as they were receiving more than the amount of interest on the transaction they actually financed. As mentioned before, Spot exchanges, including NSEL, were allowed to offer one-day forward contracts provided that members would not resort to short sales and that outstanding positions at the end of the trading day would result in delivery. However, the FMC found that the exchange allowed trading on its platform without verifying whether the seller had stocks, in effect allowing short sales by members. At the end of July, 2013, the investigations by the FMC found that the contracts traded on the exchange for which the settlement period exceeded 11 days were non-transferable specific delivery contracts, which were violating the provisions of Forward Contract Regulation Act, 1952. This problem escalated further when The amount involved in unsettled payouts as on July 29, stood at around Rs 5400 crore. This lead to suspended trading and suspended launch of new contracts indefinitely. To make matters worse, it was found that demutualization concept was found to violated altogether as NSEL was found to be an entity owned by the

Financial Technologies promoted by Jignesh Shah. NSEL scam is found to loop in borrowers, sellers and investors in a puzzle altogether.

It was found through investigations that investors and speculators used forward contracts to make money. The forward contracts in the beginning involved some set of commodity stockists selling warehouse receipts to investors for immediate payment. These investors also entered into buyback arrangements by selling back the commodity to stockists after 25 to 35 day periods ignoring the forward markets regulation act. Thus earning atleast 12-14 percentage returns. Thus the deal helped stockists receive immediate money and investors their returns. It came to light that just 24 members of the exchange, called Planters or Processors or Borrowers existed. These members owned plants that processed commodities – or, at least, they said they did. NK Proteins owned a plant to process castor seeds in Kadi, Gujarat. The contract – the Kadi Castor Seeds contract – was settled at an NSEL warehouse located inside the Kadi plant of NK Proteins. Processors like NK Proteins (and there were 23 other such members) were on the other side of the trade. They would sell at T+2 and buy back at T+23, offering huge returns.

The actual problems arose when investors entered into arrangements without proof of underlying stock. The investors actually sold commodities without proof of underlying stock and entered into buyback arrangements. It is observed that the quantities of underlying commodities may be fictitious. Table 3 shows certain quantities of sugar and metals as well as other commodities to be practically out of sync with reality. Though Demutualization is an important aspect preventing such instances, the Financial Technologies group as a whole has been found to have had interests in the NSEL. According to reports, investors the settlement guarantee fund which has drastically come down from initial claim of Rs. 839.53 crore to just Rs. 65 crore has been under scrutiny. Thus investors not aware of structural intricacies of the instruments invested into these trade arrangements. Lack of knowledge of underlying instruments and lack of information lead to amount of Rs. 5400 crore unsettled payouts as on July 29th, 2013. The NSEL scam has once again raised doubts over investing opportunities and investment safety.

Efforts for Revitalization:

Trust in the law is what ensures trust among the investors. The recent scam has raised doubts on the role of exchanges, regulators and the government. The blame game has been found not to resolve in inordinately shorter period of time. Missing trail of the money, unauthorized trading of longer terms contracts, involvement of Financial Technologies, regulatory loopholes has destroyed the very objective of NSEL to set up a national level, electronic, transparent, institutionalized, demutualized market place for farmers and traders to meet. Though steps are taken by FMC and the government, gaining investor confidence would be the primary goal. The NSEL management have been given a schedule of repayment, according to which every Tuesday (commencing August 20, 2013) would see a payout of Rs 174.72 crore for the first 20 weeks and Rs 86.2 crore for the next 10 weeks. But as expected, the exchange has failed in the very first payout, having distributed just around Rs 92 crore against a commitment of Rs 174.72 crore. Now steps are to be taken by the Forward Markets Commission (FMC) which has remained silent until the last minute. It was only after the failure of the first payout that the FMC actually reprimanded the NSEL management; raising questions on the "fit and proper" grounds. The NSEL has also suspended trading in e-series contracts till further notice after the Forward Markets Commission, or FMC, banned new commodity futures contracts due to alleged violation of norms. Thus at this point the question to be asked is, what would this story further unveil.

Questions Still Unanswered:

- How did central government allow NSEL to not follow demutualization rule? How did Financial Technologies become the major stakeholder in the exchange?
- If the central government wanted the electronic spot exchanges in the country, why was there no regulators regulating the contracts traded with T+2 settlement period which were spot contracts. Is there no governing body responsible for spot contracts. If the scale of scam is so widespread, why there is no regulator for spot exchanges.
- How was liquidity not ensured by the regulators when considering the introduction of the spot exchanges? How is that only few members of the exchange did the actual business for so long years?
- How did NSEL prevent the regulators from faking the contracts with warehouse receipts?

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APPENDIX

TABLE 1: COMPARISION OF NSEL COSTS/EXPENSES WITH OTHER MARKETS

PARAMETERS	Benchmark Gold ETF	UTI GOLD ETF	KOTAK GOLD ETF	Reliance GOLD ETF	NSEL
Entry load	1.5%	0%	1.5%	1.5%	0%
Exit load	0%	2%	0%	0%	0%
Annual/Recurring Expense (storage insurance)	1%	1%	1%	2.5%	0.2%
Total	**2.5%**	**3%**	**2.5%**	**4%**	**0.2%**

SOURCE: www.karvyshare.com

TABLE 2: DIFFERENCES AND SIMILARITIES BETWEEN VARIOUS MARKETS

PARTICULARS	SPOT MARKETS/MANDIs	FUTURES MARKETS	ELECTRONIC SPOT EXCHANGE
Operates through	>9000 APMCs	3 National exchanges and 24 regional exchanges	NSEL and NCDEX spot exchange
Reach	Particular market place	Across the country	Across the country
Delivery	Immediate	At expiry	2-8 days
Leverage	No	Yes	Partial
Risk	Less	High	Average
Returns	Less	High	Average
Transportation	Required	Required	Required
Trading through	Mandis	Electronic platform	Electronic Platform
Quality	Varied	Standardized	Standardized
Regulation	State APMC acts	Forward Market commission	Forward Market commission and State APMC acts

SOURCE: www. Karvyshare.com

TABLE 3: COMMODITIES AVAILABLE IN VARIOUS WAREHOUSES

Name of Buyer	Commodity/Collateral	Quantity in MT	Warehouse location
N C S Sugars	Sugar	17055	Andhra Pradesh
Spin cot Textiles	Cotton	4137	Andhra Pradesh
Sankhya Investment	Red Chillies	1667	Andhra Pradesh
Juggernaut Projects	Steel	65250	Andhra Pradesh
Lotus Refineries	Refined Palmolien oil	4586	Andhra Pradesh
Metcore Alloys and Industries	Ferro Chrome	23074	Andhra Pradesh
MSR Food Processing	Paddy	8993	Andhra Pradesh
Mohan India	Sugar	216334	New Delhi
Tavish Enterprises	Sugar	110792	New Delhi
Swastik Overseas Corporation	Castor Seed	28625	Gujurat
N.K.Proteins	Castor oil/Castor seed/Cotton wash oil	7553/96581/84766	Gujurat
Yathur Associates	Sugar	143764	Haryana
P D Agroprocessors	Paddy	183090	Haryana
Namdhari Food International	Paddy	18870	Haryana
Namdhari Rice & General Mills	Paddy	3795	Haryana
Topworth Steels & Powers	HR coils	46292	Maharashtra
LDIL Health foods	Paddy	225835	Punjab

Source: Dalal Street Investment Journal, August 26-September 8, 2013, pp: 26