The Scam that NSEL Spells

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Less than five years back, in October 2008, India's experiments with economic and financial deregulation led to creation of one more new market: a commodity exchange called the National Spot Exchange Limited (NSEL). The promoters of the NSEL had declared their mission as follows: "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." Taken at face value, that was indeed a laudable objective.

Early in August 2013 this description turned out to be a myth, with the NSEL appearing as an institutionalized but opaque and secretive den of speculation and possibly fraud. To understand that we need to examine what the NSEL was supposed to do and what it was actually encouraging. As its name indicates, the NSEL was meant to be a "spot exchange". The term 'spot' is of relevance here. A commodities exchange can be the location for trade in the commodities themselves or in forward and/or futures contracts relating to those commodities. When a buyer and seller transact in a commodity with the former making a payment against delivery of the said commodity by the latter, the trade is in the nature of a spot trade. A forward trade is when a potential seller contracts with a buyer to deliver and accept payment for a certain quantity of a commodity at a specified price on a specified date in the future.

Forward contracts, however, are cumbersome. They require intending sellers of specific quantities of specific quality at specified times to find the appropriate number of buyers. This entails costs of search and inspection. Further, since there is no centralized market or exchange where the contract is drawn up, prices tend to vary and there is uncertainty about delivery. It is for this reason that futures contracts were evolved.

Futures contracts differ from forward contracts in important respects. Futures contracts are standardized contracts to buy or sell a standard quantity of a standard quality of a commodity. These are traded in exchanges, through brokers, with no need for the buyer and seller to meet and negotiate. An important feature is that a contract need not be settled by actual delivery. It can be matched by an offsetting contract taken by the buyer or seller, and the two can be squared at any point at some gain or loss. The administration of the exchange guarantees that contracts would be settled, and requires traders to pay up margins to cover ongoing losses, if any, to secure the viability of the exchange.

To return to our story, the NSEL was a spot exchange, and therefore unlike a futures exchange had to combine a trading platform with facilities such as warehousing and inspection, because all contracts that were being reported on the exchange were expected to be backed with actual supplies of the commodity concerned. These were required to be stored in the warehouses of the exchange and the trades were to be settled with delivery of the underlying commodity. Sellers deliver their produce to the warehouses of the exchange, which checks for quality and issues a warehouse receipt. This receipt is then posted on the electronic exchange allowing buyers to make bids.

Having won a bid they obtain the warehouse receipt that is exchanged for the commodity at a conveniently located warehouse close to them. Around 800 members at the NSEL, which had warehouses in 16 states, were reportedly trading more than 50 commodities.

Interestingly, in India the government decided to allow spot contracts to be settled with a lag. For example, spot transactions in currency and equity markets may require to be settled in two to three days (T+2 or T+3 in exchange jargon). In the case of commodities, however, a liberalizing government defined a "ready delivery" contract under the Forward Contract (Regulation) Act as "a contract, which provides for the delivery of goods and the payment of a price therefore, either immediately or within such period not exceeding eleven days after the date of the contract". In fact, The Forward Contracts (Regulation) Amendment Bill, 2010, which is yet to be passed, extends the ready delivery period to 30 days.

The problem, however, is that the NSEL, being a spot exchange, was not subjected to even 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](). 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.

Among the questionable transactions that emerged were a set of arbitrage transactions involving investors buying a commodity on the basis of a T+2 contract and simultaneously selling it under a T+25 contract. The investor in a T+2 contracted is expected to advance 10 per cent of the cost of the commodity bought on the trading day and the entire purchase value on settlement day, which is two days later. But settlement here is only the acquisition of the relevant warehouse receipt, which is held till the T+25 sale is executed. This amounts to the investor meeting the transaction charges for transportation and warehousing, insurance etc for the period between purchase and sale. But it transpires that despite incurring these costs investors were reportedly earning a return of around 14 per cent, because of the difference in price between the T+2 purchase and the T+25 sale. Why such a large price difference existed is not at all clear. But, the presumption was that physical goods in the warehouses matching the warehouse receipts backed all such trades. This, it appears was not true.

There are also suspicions that trades were being conducted against what were fake warehouse receipts, permitting traders to indulge in "short selling", or the sale of commodities that the seller did not own or possess at the time of signing the contract, in the hope that they would be able to acquire the required stocks at a lower price before the delivery date.

It appears now that the government was not unaware that the NSEL was engaging in transactions that were in the nature of futures and, therefore, illegal. But since the promotion of successful commodity exchanges was a key element of the liberalisation agenda, it chose to ignore this for long. Till, of course, it became clear that the volume of transactions in the exchange implied that some of the so-called spot contracts were "naked contracts" in the sense that they were not backed by actual commodities.

This appears to have occurred because there were a web of companies (N K Proteins, ARK Imports, P D Agroprocessors, Mohan India, Yathuri Associates, Lotus Refineries and Juggernaut Projects among them), which presumably were acting on behalf of NSEL and brokering contracts with warehouse receipts and collecting their fees and commissions, without being statutorily responsible for backing the contracts with physical stocks and financial guarantees. Payouts to investors reaching their sell dates were possibly being made from investors putting in money into new trades. If true this was nothing more than a Ponzi scheme.

Problems arose when the Consumer Affairs Ministry decided to intervene in mid-July, put a stop to contracts with settlement periods in excess of 11 days and require the NSEL to settle all such contracts, since legally it was the NSEL that was responsible. The result was a sharp fall in the volume of trading on the NSEL, which obviously made it impossible to keep the Ponzi-type scheme going and settle all due trades. On August 1 the NSEL suspended all excepting e-Series trades in the exchange and deferred settlement of contracts by 15 days. At that point NSEL claimed it had collateral (in the form of physical stocks and monies in the settlement guarantee fund) worth Rs. 6,200 crore against a settlement liability of Rs. 5,400 crore and was deferring settlement only to ensure an orderly unwinding of positions. Soon the settlement period required was raised to 20 and 30 weeks, with the NSEL claiming that it would occur in instalments. As of now payments against the first two instalments due have fallen far short of the required sum, and reports are that the NSEL is asking investors to take a large "hair cut" of around Rs. 1,100 crore.

Even as of now the sums involved in this scam that occurred either with or without the connivance of sections of the government seem bigger than the Harshad Mehta or Ketan Parekh scam. But the government does not seem to be giving it the notoriety it deserves, possibly because of the role of its own acts of omission and commission. But the scale of the scam may be bigger than known thus far because of the interpenetration of actors involved here with those in other commodity exchanges in the country.

NSEL was co-promoted by private sector Financial Technologies (India) Ltd (FTIL) and National Agricultural Cooperative Marketing Federation of India Ltd. FTIL was promoted by wonder boy Jignesh Shah in 1988 as a technology company engaged in providing technology products for financial markets. But it has since grown into a financial services company, which in its own words "operates a network of 9 exchanges" and "ecosystem ventures … in areas such as clearing and depository, information dissemination, warehousing and collateral management, payments processing and financial market education." Among the exchanges operated by FTIL is the Multi Commodity Exchange of India Ltd (MCX). Not surprisingly, there are apprehensions that there could have been some cross-exposures between these markets, resulting in increased scrutiny of the MCX as well. Losses could emerge at other locations linked to FTIL. Whether that occurs or not, it is quite likely that the integration of markets and services such as warehousing in the hands of a single promoter, can result in a significant escalation of the scale of fraud, when it occurs.

What is unclear is the extent to which the mater will be investigated, details placed in the public domain and violators brought to book, given the fact that it is the government's own unthinking deregulation and its own actions that proved to be fertile ground for this scam. With an election impending much could be swept under the carpet.

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