

**THE NSEL SCAM: BRIDGING THE
REGULATORY HIATUS AND ITS FALLOUT ON
THE CORPORATE SECTOR IN INDIA**

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ABSTRACT

The 5,400 crore NSEL scam exposed multiple chinks in our securities regulatory system. When it was brought to light in 2012, investors who had lost their money wanted to be reimbursed were hindered by a lack of laws enabling speedy restitution. What set this scam apart from others is that in this case, the scam was perpetrated by an Exchange as against individuals. Such a massive regulatory failure provided an impetus to the government to overhaul major portions of the securities framework by merging the Forward Markets Commission with the Securities and Exchanges Board of India, amending the Forwards Contract (Regulation) Act, 1952 and the Prevention of Money Laundering Act, 2002. The Central Government subsequently announced the forced amalgamation of the NSEL with its parent company, FTIL thereby breaking the corporate shell and holding FTIL responsible for the legal liabilities of its subsidiary. This has been contested as being

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illegal and arbitrary, and against the principles of limited liability and separate corporate identity. Since this scam was executed by the Exchange itself, the importance of demutualization as a principle that ensures greater transparency, and reduces the risk for such irregularities is increasingly being viewed as a way forward for stock exchanges around the world. This paper will analyse the features of the scam, the lack of regulation that allowed it to take place, the efforts taken to minimise the losses incurred through the scam and it will also address the regulatory and structural changes that the scam induced in our laws.

I. INTRODUCTION

The National Spot Exchange Limited (NSEL) went live in India on 15th October, 2008¹, as a subsidiary of the Jignesh Shah-promoted Financial Technologies (India) Limited (FTIL). The NSEL was designed to be an electronic trading platform providing spot exchange services for trading in commodities. It claimed that it would offer trading in varied commodity spot contracts across segments including bullion, metals and agricultural commodities to its registered trading members i.e. its brokers who executed the trades on behalf of their

¹See, *Press Release on National Spot Exchange Ltd. (NSEL) goes live today*, NATIONAL SPOT EXCHANGE (2008), http://www.nationalspotexchange.com/NSELUploads/PressReleases/2008/October/English/6/PR_NSEL_15oct08.pdf.

clients². The stated mission of the NSEL was to connect farmers to buyers, ensure price discovery for farmers, and to introduce a measure of synergy in India's commodity sector. This electronic spot exchange was poised to transform the rural economy by allowing farmers/sellers and processors/exporters/traders to trade their commodities electronically. The NSEL would thus try and reduce the cost of intermediation and improve market efficiency, thereby helping farmers realize an equitable value without increasing the consumer's price³. It was intended to be regulated by the Forward Markets Commission (FMC)⁴ and had, at its peak, more than 2000 members with about 4.5 lakh trading terminals spread across 1500 cities and towns with an average daily trading to the tune of Rs 500 billion.⁵

Such success was however, short-lived with massive lapses and irregularities in warehousing and trading structures having resulted in an ideal arrangement ending up becoming one of the largest market catastrophes in the past decade with a financial burden of Rs. 5,600 crores, whose comparisons have been drawn to the 1992 Harshad Mehta scam and the 2001 Ketan Parekh scam⁶.

This paper is divided into five parts. The first part discusses the various facets of the scam, and highlights the laws flouted in

² *About Us, NATIONAL SPOT EXCHANGE*, http://www.nationalspotexchange.com/abt_us.htm (last visited on Sept. 04, 2015).

³B.V Pushpa & R. Deepak, *An insight into the NSEL scam*, 3, INTL. ORGANIZATION OF SCIENTIFIC RESEARCH JOURNAL OF BUSINESS AND MANAGEMENT 18, 18-24 (2015).

⁴Mr. Ketan Anil Shah v. Forwards Market Commission & Others., Writ Petition (L) No. 2534 of 2013 (Bom.).

⁵ *The Truth about NSEL, NATIONAL SPOT EXCHANGE*, http://nationalspotexchange.com/Truth_About_NSEL.pdf [Hereinafter, *The Truth about NSEL*].

⁶*NSEL's warehousing receipts similar to banker's receipts of Harshad Mehta scam?*, MONEYLIFE (Aug. 27, 2013), <http://www.moneylife.in/article/nsels-warehousing-receipts-similar-to-bankers-receipts-of-harshad-mehta-scam/34239.html>; Joydeep Ghosh, *From Harshad Mehta to NSEL*, BUSINESS STANDARD (Sept. 5, 2013), http://www.business-standard.com/article/markets/from-harshad-mehta-to-nsel-113090500472_1.html.

furtherance of the scam. The second part will outline the regulatory system that was present, and its failures in doing so. The third part will enunciate the effects of the scam and the corrective steps taken by the government. The fourth part will discuss the NSEL-FTIL merger, its legality and its consequences for India Inc. and the fifth part will conclude the paper.

II. GENESIS OF THE SCAM

The NSEL was given permission to engage in spot contracts or ready delivery contracts only⁷, defined as ‘*a contract that provides for the delivery of goods and the payment of a price therefor, either immediately or within such period not exceeding eleven days after the date of the contract.*’⁸ It was later discovered that massive and guaranteed profits were being generated by certain trading members, who falsely interpreted such permission as a lack of complete regulation by the Government and the complicity of the Exchange itself. There were discrepancies found in the professed stock available at the warehouses (commodities like sugar, rice, jute) which were found to be empty or even non-existent, which meant that the stock being traded on the exchange floor did not exist. These irregularities ended up snowballing into a Rs. 5,600 crore default (according to conservative estimates). This section will discuss the facets of the scam in detail.

⁷*Exemption of forward contracts traded on NSEL-MCA Notification No. 12/3/2003-IT (Pt.), Forward Market Commission,* http://www.fmc.gov.in/show_file.aspx?linkid=gazette_notification_fcra-2007-506708308.pdf [Hereinafter, MCA Notification].

⁸Forward Contracts (Regulation) Act, 1952, § 2(i) [Hereinafter FCRA].

A. *Modus Operandi*

a) *Illegal Contracts being traded*

The most prominent feature of this scam was the illegal and unregulated contracts up for trading. The NSEL was only given assent by the government to engage in spot trades. It was allowed to offer one-day forward contracts as per an exemption granted by the Forward Markets Commission provided that members would not resort to short sales and that outstanding positions at the end of the trading day would result in delivery.⁹

The allegation made against the NSEL is that despite knowing the law, they sold illegal forward contracts that were executed anytime between 30-35 days.¹⁰ These contracts were known as *paired contracts*, where two simultaneous trades were being made on the same security (buying and selling), with a gap in the settlement period. Therefore, the same commodity was involved in two trade cycles; a 3-day buy contract (T+3) and a 35-day sell contract (T+35), or *vice-versa*. The peculiar thing about the paired contracts was that the second leg of the contract (which was always beyond the 11 day limit imposed by the FMC) was always higher than the first contract. This assured the investors of a steady 15%-16% profit each time they traded on the exchange. The contracts settled within T+10 days were defined as 'spot', but could be carried forward, dodging FMC regulations.¹¹ As a result, certain investors lined their pockets and due to the surge in trading volumes on the NSEL, the company made

⁹MCA Notification, *supra* note 7, at 2.

¹⁰Clifford Alvarez & Dev Chatterjee, *NSEL: Anatomy of a trade gone sour*, BUSINESS STANDARD (Aug. 26, 2013), http://www.business-standard.com/article/markets/nsel-anatomy-of-a-trade-gone-sour-113082600402_1.html.

¹¹Neeraj Mahajan & Anil Tyagi, *The NSEL Payment Crisis: The Price of Poor Regulation and Supervision*, MADHYAM BRIEFING PAPERS (2013), <http://www.madhyam.org.in/the-nsel-payment-crisis-the-price-of-poor-regulation-and-supervision/> [Mahajan & Tyagi].

massive profits. The average monthly trading volume rose to Rs. 28,000 crores, with its turnover increasing by 227% in 2011-12.¹² During the execution of the trades, the commodities stayed in the warehouse, with no actual delivery taking place, which was illegal as per the FMC guidelines that were provided along with the exemption.¹³ The trades were happening without any physical verification of the goods, which indicated that *most of the trades* happening were short term *two legged* trades, with the buyer simply not bothering to verify the stock, as he had already commenced the trade to sell it. Therefore, short selling (a sale of a security that a seller does not own or has not contracted for at the time of sale, and that the seller must borrow to make delivery)¹⁴ which was the antithesis of a spot trade, became prevalent. With this, the NSEL's stated mission of connecting buyers and sellers was undone, with brokers and High Net Worth investors making fortunes hedging crores of rupees on commodities like castor seed.

b) *Forged Warehouse Receipts*

Callous buying of commodities and a complete lack of regulation of the trading floor resulted in sales being made on a daily basis of commodities whose physical existence was not verified. The exchange allowed members to trade without any verification of the actual goods, and this, coupled with a lack of regulation by the government led to forged invoices, etc., with no surety of the stock being held at the warehouses. The FMC found out that the NSEL

¹² *Annual Report 2011-12*, FINANCIAL TECHNOLOGIES (INDIA) LIMITED, http://www.ftindia.com/investors/pdf/FTIL_AR_2011-12.pdf, last visited on Nov. 04, 2015 [Hereinafter *Annual Report*].

¹³ *Order in the matter of "Fit & Proper Person"*, FMC order no. 4/5/2013-MKT-1/B, http://fmc.gov.in/show_file.aspx?linkid=Order%20dated%2017-12-2013%20in%20case%20of%20Fit%20and%20Proper%20Status-185672116.pdf [Hereinafter, *Fit & Proper*].

¹⁴ BRYAN GARNER, *BLACK'S LAW DICTIONARY* 1456 (9th ed., 2009).

failed to carry out any diligence on the offer letter from the seller or maintain adequate documentation to support the existence of the stock at the designated warehouses. There was an absence of documentation for proof of any inward or outward movement of the stocks from the warehouses, which raised doubts on the very existence of the stocks that were the collateral to the trades being executed at the NSEL.¹⁵ Furthermore, none of the 79 warehouses associated with the NSEL had been accredited by the national warehousing regulator, the Warehousing Development & Regulatory Authority (WDRA).¹⁶

The real shock to the investor community were the findings of an audit of the warehouses by the Swiss regulatory firm SGS.¹⁷ Widespread discrepancies were found between what was supposed to be stored in those warehouses and what was present.¹⁸ In most cases, actual stocks did not tally with the quantities mentioned in the warehouse receipts.¹⁹ This implies that fake warehouse receipts were being used. For instance, one of the NSEL's stock position misleadingly showed, 11190.5 tonnes of raw wool — almost a quarter of India's annual wool production, stored in the warehouse of ARK Imports in Ludhiana, which was far from the truth.²⁰ This meant that the commodities being traded by the exchange existed only on paper, and the all the trades being executed weren't backed by securities.

¹⁵Fit & Proper, *supra* note 13.

¹⁶Sugata Ghosh, *E&Y may be roped in the NSEL probe over a warehouse report, firm says it had flagged risks*, THE ECONOMIC TIMES (Oct. 16, 2013), http://articles.economictimes.indiatimes.com/2013-10-16/news/43107157_1_nsel-probe-national-spot-exchange-ltd-ey-report.

¹⁷S. Sunil, *NSEL defaults again, starts warehouse audits*, LIVEMINT (Sept. 10, 2013), <http://www.livemint.com/Money/Z55xjDKN7XeRrMm1sEEU7N/NSEL-defaults-again-starts-warehouse-audits.html?ref=dd>.

¹⁸SGS Audit Progress Report, NATIONAL SPOT EXCHANGE, http://www.nationalspotexchange.com/nseluploads/pdf/sgs_audit_progress_report.pdf.

¹⁹Ashish Rukhaiyar, *Raids reveal empty warehouses; EOW summons Shah*, THE FINANCIAL EXPRESS (Oct. 5, 2013), <http://archive.financialexpress.com/news/raids-reveal-empty-warehouses-eow-summons-shah-others/1178480>.

²⁰Mahajan & Tyagi, *supra* note 11.

c) *No Risk Management System & Poor Managerial Standards*

The FMC in its order regarding the ‘fit and proper’ status of Key Management Personnel of the NSEL said that the NSEL failed to provide for a sound risk management system, effective audit of the internal control process, warehouses, accounts and other business of the Company and showed total apathy to take follow-up action to address concerns raised in these areas. There was no self-regulation or internal checks and balances on the part of the NSEL, despite it being responsible to the investors trading on its floor. Normally in exchanges, if a trader cannot meet his commitments, he is debarred from the trading floor unless his encumbrances are cleared. However, a company called NK Proteins, run by the son-in-law of the then-Chairman of the Board of the NSEL, Shanker Lal Guru,²¹ kept defaulting on certain payments, but the authorities turned a blind eye to it, allowing it to continue trading in contravention to the bye-laws of the NSEL.²² It has now become the largest single defaulter of the scam, with a total liability of Rs. 930 crore.²³ When companies like NK Proteins started defaulting, the NSEL, instead of taking stock of the situation, provided them with extended lines of credit without verifying if the companies had the assets to back up the money they were borrowing.

B. The Scam Unmasked, And Government’s Response

Soon, rumors regarding the NSEL’s malpractices resulted in the FMC serving a show-cause notice to the NSEL, seeking clarifications about

²¹*EOW arrests N.K. Proteins’ MD in NSEL scam*, BUSINESS STANDARD (Nov. 23, 2013), http://www.business-standard.com/article/markets/eow-arrests-n-k-proteins-md-in-nsel-scam-113102200893_1.html.

²²*Bye-Laws of National Spot Exchange Limited*, NATIONAL SPOT EXCHANGE, <http://www.nationalspotexchange.com/pdf/byelaws.pdf>.

²³ *N. K. Proteins Ltd.*, NSEL RECOVERY GROUP, http://www.nselrecoverygroup.com/defaulters/n_k_proteins_ltd.htm.

their methods of operation.²⁴ This was followed up on July 13, 2013, when the Ministry of Consumer Affairs, Food and Public Distribution (MCA) ordered the NSEL to settle all existing contracts by their due dates and not issue any further contracts, ensuring that all the settlements take place within the 11-day period under the ambit of the Forwards Contract (Regulation) Act, 1952 (hereinafter referred to as “**FCRA**”).²⁵ When the NSEL announced that all contracts will be restricted to an 11-day settlement structure, with all the trades being settled on a day-to-day basis and payments being made on delivery, the market ended up collapsing since the forward traders did not want the possession of the commodities and demanded immediate settlement of their dues.²⁶ That is how a Rs. 5,600 crore crisis emerged, simply because there were no reserves backing up the two-legged trades. The members refused to settle their obligations under the short leg of the contract due to the longer leg being rescinded, removing its profitability. No attempt was made by the exchange to verify the financial conditions of the traders, and measure their credit-worthiness. This introduced disequilibrium in the market, and the NSEL had to eventually suspend trading.²⁷

The NSEL had a Settlement Guarantee Fund (SGF) of Rs. 839 crore as of 29th July 2013,²⁸ which worked on the principle of self-insurance, being put in place to provide a cushion for any residual

²⁴The Truth about NSEL, *supra* note 5.

²⁵MADHYAM, *supra* note 11.

²⁶G. Chandrashekhar, *Getting to the bottom of the NSEL crisis*, THE HINDU BUSINESS LINE (Oct. 03, 2013), <http://www.thehindubusinessline.com/opinion/columns/g-chandrashekhar/getting-to-the-bottom-of-the-nsel-crisis/article4985927.ece>.

²⁷NSEL suspends trading in all one-day forward contracts, BUSINESS STANDARD (Oct. 1, 2013), http://www.business-standard.com/article/markets/nsel-suspends-trading-in-all-one-day-forward-contracts-113080100013_1.html.

²⁸Sundaresha Subramanian, *NSEL's settlement guarantee fund stood at only Rs 85 lakh*, BUSINESS STANDARD (Oct. 28, 2013), http://www.business-standard.com/article/markets/nsel-s-settlement-guarantee-fund-stood-at-only-rs-85-lakh-113082700914_1.html.

risks.²⁹ This fund, which is a Securities and Exchange Board of India (SEBI)-mandated statutory requirement,³⁰ was designed to be used as a contingency to settle a contract in case of default. It was supposed to minimize the risk of trading on credit. However, the exchange made the pay-out obligations against the pay-in shortage of paired contracts out of the available SGF cash balances, and it soon reduced to a paltry Rs. 88 lac³¹. When the defaults began *en masse*, it was realized that there is no money left to further indemnify the defaults, and the subsequent defaults spiralled into the current crisis.

III. REGULATORY FRAMEWORK FOR THE EXCHANGE

India's regulatory framework under the FCRA when the NSEL scam took place envisaged a three-tier regulatory framework for commodities exchanges: (i) the Central Government through Department of Consumer Affairs, Ministry of Consumer Affairs, Food and Public Distribution (MCA) being the ultimate authority; (ii) The Forward Markets Commission (FMC) providing regulatory oversight that has been delegated by the Central Government; and (iii) The exchanges/associations that shall regulate the business on a day-to-day basis, in the spirit of self-regulation³² The NSEL's warehousing structure stood unregulated which was unearthed in subsequent investigation. This section will discuss the three tier regulatory structure that was in place when the scam took place along with other factors involved like warehousing and investigation.

²⁹ *Guarantee*, NATIONAL STOCK EXCHANGE, <http://www.nseindia.com/Supra-global/content/nscl/guarantee.htm>.

³⁰ Securities Exchange Board of India, *Circular on Model Bye-Laws of Stock Exchanges*, Issued on Oct. 28th 2003, SEBI/MRD/SE/SK/Cir-41.

³¹ *NSEL's settlement guarantee fund stood at only Rs 85 lakh*, *supra* note. 27.

³² P. RAJIB, *COMMODITY DERIVATIVES AND RISK MANAGEMENT* 44 (1st ed., 2014).

A. *Antecedent Regulatory Structure*

a) *Ministry of Consumer Affairs, Food and Public Distribution*

The Ministry of Consumer Affairs, Food and Public Distribution (MCA) had the power to grant or withdraw recognition of the exchange, and the power to supersede the governing body of recognized association or exchange.³³ On June 5, 2007 the MCA published a gazette notification that exempted the NSEL from FCRA provided that a set of conditions are met by NSEL.³⁴ The MCA issued a show cause notice on April 27, 2012 to the NSEL asking why it shouldn't be brought under the FCRA Act, to which the NSEL claimed that the 2007 notification provided a general exemption from FCRA.³⁵ On July 12, 2013 the MCA ordered the NSEL to not launch fresh contracts and settle existing contracts on due dates.³⁶ A fifteen-month gap taken by the MCA before halting the exchange raises questions on the ministry's promptness in ensuring consumer protection amongst other objectives. A better approach would have been temporary suspension of the exchange and issuance of an expeditious order of investigation.

b) *Forward Markets Commission*

The second tier was the Forward Markets Commission (FMC), which was a statutory body set up under the FCRA,³⁷ as a part of the MCA.³⁸ Its functions included advising Central Government in respect

³³Forward Contracts (Regulation) Act, 1952, § 6, § 15 & § 13.

³⁴*MCA Notification No. 12/3/2003-IT (Vol. II)*, FORWARD MARKET COMMISSION, http://www.fmc.gov.in/show_file.aspx?linkid=Notification%20Dated%2007082013-501406145.pdf.

³⁵MCA Notification, *supra* note 7, at 2.

³⁶*MCA Notification No. 12/3/2003-IT (Vol. II)*, FORWARD MARKET COMMISSION, http://www.fmc.gov.in/show_file.aspx?linkid=Notification%20Dated%2007082013-501406145.pdf.

³⁷Forward Contracts (Regulation) Act, 1952, § 3.

³⁸Geevan Parsai, *Forward Markets Commission comes under Finance Ministry*, THE HINDU (Sept. 09, 2013), <http://www.thehindu.com/business/Industry/forward->

of grant or withdrawal of recognition of any association, observing forward markets, publishing essential information regarding such markets, inspecting books of associations and making recommendations for improving organization of forward markets.³⁹ The Commission had the power of a civil court.⁴⁰ It has been observed that the FMC was dependent on the government for finances and was under-staffed and technologically constrained to regulate and monitor the markets.⁴¹ Owing to it being a part of a three-tier system, the Commission was almost toothless, for its powers were overshadowed by the Central Government as the Commission had to mandatorily seek governmental approval before punishing violators.⁴² In the aftermath of the irregularities found, the FMC wanted to limit its exposure to the scam citing a gazette notification⁴³ by the MCA that exempted the NSEL from the FCRA. However, the introduction of coupled contracts brought the transaction under the FMC's ambit.

Since the FMC was a part of the regulatory system supervising future trading contracts, it should have had a mechanism to keep a closer watch on suspicious activities in the market and be expeditious in detecting such anomalies in the market.

markets-commission-comes-under-finance-
ministry/article5110111.ece?homepage=true.

³⁹Forward Contracts (Regulation) Act, 1952, § 4.

⁴⁰Forward Contracts (Regulation) Act, 1952, § 4A.

⁴¹Rajesh Bhaiyani, *Sebi-FMC merger: Soon, commexes may start equity trading*, BUSINESS STANDARD (Mar. 2, 2013), http://www.business-standard.com/budget/article/sebi-fmc-merger-soon-commexes-may-start-equity-trading-115030100548_1.html [Hereinafter, Bhaiyani].

⁴²Forward Contracts (Regulation) Act, 1952, § 21.

⁴³*FMC keen on washing hands off NSEL saga: Bombay HC*, MONEY CONTROL (Nov. 10, 2013), http://www.moneycontrol.com/news/business/fmc-keenwashing-hands-off-nsel-saga-bombay-hc_973555.html.

c) Commodities Exchange

The third tier was the commodities exchanges that were granted self-regulatory authority to ensure that their actions are in consonance with the FCR Act and Regulations. It was found that the NSEL did not carry out any diligence on offer letter from the seller or maintain adequate documentation to support the existence of the stock at the designated warehouses or their inward or outward movement.⁴⁴ It was also later discovered that the NSEL had no mechanism to check whether the underlying stocks had been pledged to a bank to ensure unencumbered title of obligations to meet its obligations.⁴⁵

B. *Warehousing*

An important facet of the crisis and a hole that must be filled by the administration is the lack of regulation of warehouses that resulted in empty warehouses and the forged warehouse receipts, which meant that there was no stock backing up the trades that were being executed.⁴⁶ This happened despite the formation of WDRA in 2010,⁴⁷ which has the responsibility of the inspection and accreditation of warehouses⁴⁸ and also has the power to inspect warehouses where errant practices are suspected.⁴⁹ Forging warehouse receipts is a separate offence under the act,⁵⁰ yet irregularities regarding forged receipts have been unearthed. Since the NSEL used the warehouse

⁴⁴Fit & Proper, *supra* note 13, at 13.

⁴⁵Fit & Proper, *supra* note 13, at 14.

⁴⁶Sugata Ghosh & Ram Sahgal, *NSEL saga: Audit by Swiss firm SGS reveals missing stocks amid fears of forged receipts*, THE ECONOMIC TIMES (Sept. 2, 2013), <http://economictimes.indiatimes.com/markets/stocks/nsel-saga-audit-by-swiss-firm-sgs-reveals-missing-stocks-amid-fears-of-forged-receipts/articleshow/22215415.cms>.

⁴⁷Shrimi Mukherjee, *Q&A: Dinesh Rai, Chairman, WDRA*, BUSINESS STANDARD (May 10, 2011), http://www.business-standard.com/article/economy-policy/q-a-dinesh-rai-chairman-wdra-111051000035_1.html.

⁴⁸Warehousing Development and Regulation Act, 2006, § 35.

⁴⁹*Id.* at Chapter VI.

⁵⁰*Id.* at § 43.

receipts as proof of ownership, the onus was on the WDR to inspect and regulate the warehousing structure of the NSEL, but it categorically failed to do so, increasing the investor's exposure to the scam.⁵¹

Recently, SEBI has proposed new rules for the country's warehouse service providers ("hereinafter referred to as "WSP") in a consultation paper suggesting that exchanges should carry out the accreditation of warehouses more transparently and only with the approval of the exchange's risk management committee⁵². Such accreditation will be subject to renewal every three years, the paper added. The paper lists eligibility criteria for a WSP: it has to be a corporate body, whose promoters have sufficient credibility, and have been in the business of public warehousing for at least three years. Furthermore, all exchanges will need to ensure that warehouses, which aren't registered with the WDR, are registered by WDR within six months from the date of accreditation⁵³.

C. Investigation

In the aftermath of the scam, the investigation that was to be carried out against the defaulters and the exchange itself was initiated by the

⁵¹Sucheta Dalal, *NSEL: Poor Regulation was not by chance*, MONEY LIFE (Sept. 2, 2013), <http://www.moneylife.in/article/nsel-poor-regulation-was-not-by-chance/34294.html>.

⁵² *Annexure A, CONSULTATIVE PAPER ON WAREHOUSING NORMS FOR AGRICULTURAL & AGRI-PROCESSED COMMODITIES TRADED ON NATIONAL COMMODITY DERIVATIVES EXCHANGES* (Securities & Exchange Board of India, 2016) http://www.sebi.gov.in/cms/sebi_data/attachdocs/1464860526503.pdf.

⁵³ *J(a), Annexure A, CONSULTATIVE PAPER ON WAREHOUSING NORMS FOR AGRICULTURAL & AGRI-PROCESSED COMMODITIES TRADED ON NATIONAL COMMODITY DERIVATIVES EXCHANGES* (Securities & Exchange Board of India, 2016), http://www.sebi.gov.in/cms/sebi_data/attachdocs/1464860526503.pdf.

Economic Offences Wing (EOW).⁵⁴ Aggrieved investors filed a petition before the Bombay High Court,⁵⁵ demanding a probe by the CBI alleging that the investigation by the EOW is turning into a “*farce and a sick joke on 13,000 helpless families*” alleging a breach in investigation.⁵⁶ It was also alleged that the EOW was going slow on Jignesh Shah, the promoter of FTIL.⁵⁷ On March 30, 2015, the Enforcement Directorate undertook prosecution against the NSEL officials and defaulters under Prevention of Money Laundering Act, 2002 (PMLA).⁵⁸ The NSEL Investors’ Action Group, which was an umbrella organization set up by and for the aggrieved investors demanded that the probe should be conducted by a joint investigation team of the EOW, Central Bureau of Investigation and Enforcement Directorate.⁵⁹

Involvement of more than one investigative agency has proved to result in more banes than boons, resulting in shoddy probes and problems on the demarcation of jurisdiction. An appropriate mechanism would be incorporation of an experienced team of experts under the FMC to look into investigations relating to commodity exchanges exclusively.

⁵⁴Aneesha Mathur, *Delhi, Mumbai cops engaged in turf war over NSEL scam*, THE INDIAN EXPRESS (July 29, 2013), <http://indianexpress.com/article/business/business-others/delhi-mumbai-cops-engaged-in-turf-war-over-nsel-scam/>.

⁵⁵*NSEL investors sue govt agencies, allege shoddy investigation*, BUSINESS STANDARD (Apr. 18 2015), http://www.business-standard.com/article/markets/nsel-investors-sue-govt-agencies-alleging-shoddy-investigation-115041800490_1.html.

⁵⁶Purba Das, *NSEL Investors Allege Foul Play, Seek Clarification*, BUSINESS INSIDER INDIA (Nov. 3rd. 2011), <http://www.businessinsider.in/NSEL-Investors-Allege-Foul-Play-Seek-Clarification/articleshow/45022087.cms> [Hereinafter Das].

⁵⁷*NSEL investors demand speedy probe in Rs 5,600-cr scam*, BUSINESS STANDARD (Mar. 25, 2015), http://www.business-standard.com/article/companies/nsel-investors-demand-speedy-investigation-in-rs-5-600-cr-scam-115032500765_1.html.

⁵⁸Shrimi Choudhary, *Enforcement Directorate starts prosecution in NSEL scam today*, DNA INDIA (Mar. 30, 2015), <http://www.dnaindia.com/money/report-enforcement-directorate-starts-prosecution-in-nsel-scam-today-2073019>.

⁵⁹Das, *supra* note 56.

IV. FALLOUT OF THE SCAM

The Rs 5,600-crore crisis has triggered widespread dialogue, often pointing out the government's incapability towards providing assurances to the 13,000 investors who have been impacted. On the regulatory front, the government's inability to form a sound structural framework to regulate the extensive network of the commodities market has been widely condemned. In response, the legislature has come up with a committed structure proposing a complete overhaul in the financial services sector. Such actions have been undertaken in the wake of the NSEL scam that highlights a serious breach of regulations.

Firstly, the FMC was transferred from the MCA to the Finance Ministry. Secondly, the Government announced the merger of the FMC with SEBI on 28th September, 2015 to plug regulatory loopholes and extend the scope of the financial market. Thirdly, the Central Government announced the NSEL-FTIL amalgamation under Section 396, The Companies Act, 1956. These steps shall be discussed in this section of the paper.

A. Transfer of FMC from MCA to Finance Ministry

In the wake of the scam, the Minister of Consumer Affairs, K.V. Thomas expressed the inability of the MCA to efficiently probe the scam due to a lack of investigative power and expertise, and handed over its responsibility to the Finance Ministry.⁶⁰ Subsequently, the FMC was transferred to the Ministry of Finance for a more

⁶⁰NSEL issue now responsibility of Fin Min: KV Thomas, MONEYCONTROL, Oct. 22, 2013, http://www.moneycontrol.com/news/current-affairs/nsel-issue-now-responsibilityfin-min-kv-thomas_974414.html.

‘coordinated action’⁶¹ and with the hope to strengthen the regulatory structure so that such a scam will not reoccur.⁶²

B. Finance Act, 2015

The ‘minor systemic failure’⁶³ induced legislators into adopting regulatory convergence as a principle in the financial services sector.⁶⁴ In 2015, a merger between FMC and SEBI was announced in the Finance Bill, 2015 in an amendment to the FCRA⁶⁵ which was concluded on the 28th of September⁶⁶ with the hope to put end to “wild speculation” in the market structure.⁶⁷ The merger is being regarded as a step closer to a single regulator for all securities and derivatives.⁶⁸ On the legislative front, the FCRA was repealed and the FMC was absorbed into the SEBI.⁶⁹

⁶¹Rajesh Bhayani, *FMC moves to the Ministry of Finance*, BUSINESS STANDARD, Sept. 13, 2013, http://www.business-standard.com/article/economy-policy/fmc-moves-to-the-ministry-of-finance-113091300836_1.html.

⁶²Shishir Sinha, *Finance Ministry to oversee Forward Markets Commission*, THE HINDU BUSINESS LINE, Sept. 10, 2013, <http://www.thehindubusinessline.com/markets/commodities/finance-ministry-to-oversee-forward-markets-commission/article5111389.ece>.

⁶³*Government panel finds ‘minor systemic failure’ at NSEL*, THE ECONOMIC TIMES, Sept. 20, 2013, <http://economictimes.indiatimes.com/markets/stocks/government-panel-finds-minor-systemic-failure-at-nsel/articleshow/22819257.cms>.

⁶⁴REPORT OF THE FINANCIAL SECTOR LEGISLATIVE REFORMS COMMISSION (Government of India, 2013) http://finmin.nic.in/fslrc/fslrc_report_vol1.pdf.

⁶⁵Forward Contracts (Regulation) Act, 1952, § 28A.

⁶⁶See, *Press Release on Finance Minister unveils merger of FMC with SEBI* (Sept. 8, 2015), http://www.sebi.gov.in/sebiweb/home/document_detail.jsp?link=http://www.sebi.gov.in/cms/sebi_data/docfiles/32029_t.html.

⁶⁷Reena Zachariah & Ram Sahgal, *Budget 2015: Proposal to merge Forward Markets Commission with Sebi to add teeth to commodities market regulation*, THE ECONOMIC TIMES (Mar. 1, 2015), http://articles.economictimes.indiatimes.com/2015-03-01/news/59642345_1_forward-markets-commission-fmc-ramesh-abhishek.

⁶⁸Dinesh Narayanan, *How the 12-yr-old idea of SEBI-FMC merger is finally becoming a reality this September*, THE ECONOMIC TIMES (June 30, 2015), <http://economictimes.indiatimes.com/markets/stocks/policy/how-the-12-yr-old->

a) FMC-SEBI Merger

It was after the Asian Currency scam of 1997 that the idea of a unified regulator was floated by the Government. In 2003, the Wajahat Habibullah report proposed the merger suggesting regulatory convergence.⁷⁰ However, the idea was shelved for over a decade.⁷¹ Meanwhile, the Financial Sector Legislative Reforms Commission whose purpose was suggesting ways to reform the unwieldy institutional framework governing the financial sector recommended unifying SEBI, Insurance Regulatory and Developmental Authority (IRDA) and Pension Fund Regulatory and Developmental Authority (PFRDA) observing that sectorial regulation tends to ignore worldview of their regulated entities. The idea was based on the view that mitigating systemic risk is avoiding the worldview of any one sector, and understanding the overall financial system.⁷² In pursuance of regulatory convergence, FMC was merged with SEBI.

b) Plugging the Legal Loopholes

The Finance Act 2015 stated that all recognized associations under the FCRA will be deemed to be recognized stock exchanges under the Securities Contracts (Regulation) Act, 1956.⁷³ This shall allow a commodity exchange to expand in segments permitted under a stock

idea-of-sebi-fmc-merger-is-finally-becoming-a-reality-this-september/articleshow/47873835.cms.

⁶⁹Shyamal Banerjee, *More power for SEBI is good; but some checks are needed*, LIVESMINT, Mar. 2, 2015, <http://www.livemint.com/Money/APHhcGaWXg9XyqtWwrzk3M/More-power-for-Sebi-is-good-but-some-checks-are-needed.html>.

⁷⁰ REPORT OF THE INTER-MINISTERIAL TASK FORCE ON CONVERGENCE OF SECURITIES AND COMMODITY DERIVATIVE MARKETS (GOVERNMENT OF INDIA, 2003) <http://fmc.gov.in/writereaddata/Links/report2-3783547565427437958.pdf> [Hereinafter, REPORT OF THE INTER-MINISTERIAL TASK FORCE].

⁷¹Bhaiyani, *supra* note 41

⁷²REPORT OF THE INTER-MINISTERIAL TASK FORCE, *supra* note 70, at 25.

⁷³Securities Contracts (Regulation) Act, 1956, § 28.

exchange and vice versa.⁷⁴ Stock exchanges will be able to become universal exchanges wherein equities, debt instruments and currencies are traded under the same roof as commodity derivatives. The need for new infrastructure will be eliminated, as Stock Exchanges already have depositories and clearing corporations that will cater to the needs of commodity traders.⁷⁵ The Act introduces financial derivatives including commodities derivatives and any other financial instrument as may be defined by the government.⁷⁶ Such a move, in accordance with Section 28A of the SEBI Act shall give exchanges the fungibility in penetrating each other's market segment. This means a commodity exchange can start currency derivatives and equity trading or, a stock exchange can launch commodity trading.⁷⁷

c) *Amending Prevention of Money Laundering Act, 2002*

Another realization that the NSEL scam caused was the need to change our laws dealing with financial crimes in a way that facilitates solving the problems on the ground. The investors had considerable difficulty in recovering the money due to them,⁷⁸ and it was observed that this was heightened as the assets of the defaulters were seized by the government⁷⁹ and there was a delay in putting forward the government's stand on the issue. The Prevention of Money Laundering Act, 2002, under which the assets were seized had no clause in it to ensure that duped people are repaid their dues, and there

⁷⁴Bhaiyani, *supra* note 41.

⁷⁵Rajesh Bhayani, *Two sides of the Sebi-FMC merger*, BUSINESS STANDARD (Mar. 24, 2015), http://www.business-standard.com/article/markets/two-sides-of-the-sebi-fmc-merger-115032401103_1.html.

⁷⁶Securities and Exchange Board of India Act, 1992, § 133B.

⁷⁷*Sebi-FMC merger: Soon, commexes may start equity trading*, *Supra* note 41.

⁷⁸*Negligible progress in dues recovery from NSEL defaulters: FMC*, LIVEMINT, (Sept. 8, 2014),

<http://www.livemint.com/Money/fSwdsoW5UiHyRDvTs6kltI/Negligible-progress-in-dues-recovery-from-NSEL-defaulters-F.html>.

⁷⁹*ED attaches assets worth R75 crore in NSEL crisis*, THE INDIAN EXPRESS (Dec. 2, 2013), <http://indianexpress.com/article/news-archive/web/ed-attaches-assets-worth-r75-crore-in-nse-crisis/>.

was no framework for allowing the government to sell the assets and use the proceeds to pay back the investors,⁸⁰ and as a result, in two years, only approximately 10% of the dues were cleared,⁸¹ resulting in a large section of the duped investors,⁸² and the NSEL itself⁸³ calling for the amendment in the PMLA that would allow the sale of the confiscated assets so that timely restitution can be made to the aggrieved investors.

Due to this, the government has decided to amend the PML Act in a positive manner in 2015 to the effect of - “(8) *Where a property stands confiscated to the Central Government under sub-section (5), the Special Court, in such manner as may be prescribed, may also direct the Central Government to restore such confiscated property or part thereof of a claimant with a legitimate interest in the property, who may have suffered a quantifiable loss as a result of money laundering.*”⁸⁴ This clause will ensure that the attached assets can be liquidated and that the proceeds from it can go to the aggrieved investors, and that the time-frame in doing so gets significantly reduced.

⁸⁰Virendrasingh Ghunawat, *NSEL scam: After a year, aggrieved investors write to PM, seek quick recovery*, INDIA TODAY (Aug. 8, 2014), <http://indiatoday.intoday.in/story/nsel-scam-narendra-modi-arun-dalmia-eow-ed-finance-ministry-corporate-affairs-ministry/1/375321.html>.

⁸¹Rajesh Bhayani, *Two years of blame game, legal tangles*, BUSINESS STANDARD (July 30, 2015), http://www.business-standard.com/article/markets/two-years-of-blame-game-legal-tangles-115073001808_1.html.

⁸²Virendrasingh Ghunawat, *NSEL scam: To recover lost money, investors want change in money laundering Act*, INDIA TODAY (Mar. 20, 2014), <http://indiatoday.intoday.in/story/nsel-scam-nsel-investors-enforcement-directorate-eow-money-laundering-gagan-suri-yathuri-associates/1/350402.html>.

⁸³*Truth about NSEL*, *supra* note 5.

⁸⁴Prevention of Money Laundering Act, §8.

C. Proposed NSEL-FTIL Merger

The Central Government, with the intention of minimizing the fallout of the scam has proposed the amalgamation of the NSEL with its parent company, FTIL, introducing a share swap ratio (ratio in which an acquiring company will offer its own shares in exchange for the target company's shares during a merger or acquisition) after assessment. Three fully paid-up equity shares of Rs 2 each of FTIL will be issued in exchange of eight fully paid-up equity shares of Rs 10 each of NSEL. The objective is to make FTIL liable for the scam at the NSEL, and to ensure that it has a statutory duty to pay back its dues.⁸⁵

The NSEL-FTIL merger was first recommended by the FMC, as it would help expedite the recovery of the defaults.⁸⁶ This was largely seen to be against the concept of limited liability and distinct legal identity of companies. The FMC countered this by saying that FTIL, along with its nominees held 99.9998% of paid up capital of the NSEL.⁸⁷ Another significant fact is that boosting trading volumes (via the introduction of coupled contracts promising guaranteed returns) would eventually lead to the NSEL making more profits, thereby benefiting FTIL, resulting in the NSEL recording a mammoth 277% increase in its turnover in 2011-2012.⁸⁸ Since, FTIL was almost the sole shareholder of the NSEL, the constitution of the Board of

⁸⁵Tarun Nangia, *Did FMC bosses go out of their way in recommending merger of NSEL-FTIL?* DNA, Feb. 7, 2015, <http://www.dnaindia.com/money/report-did-fmc-bosses-go-out-of-their-way-in-recommending-merger-of-nsel-ftil-2058730>.

⁸⁶Rajesh Bhayani, *FMC wants NSEL to be merged with FTIL, latter's management changed*, BUSINESS STANDARD (Aug. 19, 2014), http://www.business-standard.com/article/specials/fmc-recommends-govt-get-ftil-mgmt-changed-114081901087_1.html.

⁸⁷*Draft Order of Amalgamation of National Spot Exchange Limited (Dissolved Company) with Financial Technologies India Limited (Transfer Company) Under § 396 of the Companies Act, 1956*, MINISTRY OF CORPORATE AFFAIRS, http://www.mca.gov.in/Ministry/pdf/Draft_Order_of_Merger.pdf [hereinafter Draft Order].

⁸⁸*Annual Report*, *supra* note. 12.

Directors was entirely under its control.⁸⁹ Jignesh Shah, who was the managing director-cum-promoter of FTIL formed a part of the Board of NSEL as the vice-chairman. There were two other common members present on both, the boards of NSEL and FTIL. It is also a fact that minutes of board meetings of the NSEL were tabled before the board meetings of FTIL.⁹⁰ FTIL controlled, supervised and governed the NSEL. The events imply how the acts undertaken by the NSEL in floating coupled contracts were ignored, if not initiated by FTIL. The illegal contracts that promised assured returns boosted the volumes being traded on the exchange, which resulted in higher profits for the NSEL. This points out to the fact that the FTIL had a hand to play in the fraud that was being perpetrated by the NSEL.

The Central Government has been empowered to do so by the Companies Act, 1956 under Section 396 which states that “*the Central Government may, by order notified in the Official Gazette, provide for the amalgamation of those companies into a single company with such constitution; with such property, powers, rights, interests, authorities and privileges; and with such liabilities, duties, and obligations; as may be specified in the order*”.⁹¹ The initial step towards such an amalgamation involves issuance of a proposed order for merger that is sent to each of the companies concerned.⁹² The companies may send back suggestions and objections within a period as the Central Government may fix in that behalf which cannot be less than two months from the date on which the copy is received by that company, shareholders or creditors.⁹³ The Central Government is also responsible for ensuring that each member, creditor (including a debenture holder) is having nearly the same interest or rights in the

⁸⁹Draft Order, *supra* note 87.

⁹⁰Draft Order, *supra* note 87.

⁹¹Companies Act, 1956, §396.

⁹²Companies Act, 1956, § 396(1).

⁹³Companies Act, 1956, § 396(4)(b).

company resulting from the amalgamation as he had in the company of which he was a member or creditor of. If an imbalance exists, he shall be entitled to compensation, which shall be assessed by the prescribed authority. The amalgamated company shall provide the compensation.⁹⁴ Any person aggrieved by the compensation or assessment can make an appeal to the Company Law Board within thirty days of publication of the Official Gazette.⁹⁵ All orders passed under Section 396 will have to be laid before both the houses of the Parliament.⁹⁶

So far the Centre has invoked Section 396 four times in the past three decades. They were: Hatti Gold Mines, Chitradurga Copper with Karnataka Copper Consortium Ltd (1985); Chandpur Sugar Company with UP State Sugar Corporation Ltd (1989); Internal Aluminum Products with National Aluminum Company (2000); and Air India-Indian Airlines merger (2007).⁹⁷ What is worth observing is that all these companies were public companies. The merger between NSEL-FTIL is unique in the sense that this is the first instance of Section 396 of the Companies Act, 1956 being utilized to merge two private companies.⁹⁸

FTIL had filed a writ petition before the Bombay High Court, challenging the constitutional validity of Section 396 of the Companies Act, 1956 and praying for quashing of the draft merger order⁹⁹ contesting a gamut of violations, which will be discussed below.

⁹⁴Companies Act, 1956, § 396 (3).

⁹⁵Companies Act, 1956, § 396 (3A).

⁹⁶Companies Act, 1956, § 396(5).

⁹⁷K.R. Srivats, *NSEL-FTIL: A Sec 396 first for a private sector merge*, BUSINESS STANDARD (Oct. 21, 2014), <http://www.thehindubusinessline.com/markets/nselftil-merger/article6524212.ece>.

⁹⁸*Id.*

⁹⁹K. R. Srivats, *Can't specify timeframe for NSEL-FTIL merger: Jaitley*, THE HINDU BUSINESS LINE (Aug. 16, 2015), <http://www.thehindubusinessline.com/todays-paper/tp-news/cant-specify->

a) *Is the amalgamation in violation of Article 14?*

According to FTIL, Section 396 of the Companies Act, 1956 violates Article 14 of the Constitution, which espouses equality before the law. It suffers from excessive delegation, as there are no guidelines for the exercise of power by the Central Government under this section.¹⁰⁰

The MCA in a circular dated April 10, 2011 set out guidelines for amalgamation of two government companies: consent of 100% shareholders and 90% creditors is required.¹⁰¹ The NSEL and FTIL have been divested of such an opportunity owing to them being companies not owned by the government. According to FTIL, this clearly violates Article 14.¹⁰² In the Report of the Expert Committee on Company Law, it was suggested that the amalgamation should be allowed only through a process overseen by the Courts/Tribunals; therefore, instead of existing provisions of Section 396, provisions should be made to empower the Central Government to approach the Court/Tribunal for approval for amalgamation of two or more companies.¹⁰³ This is so, because even though the piercing of the corporate veil may be justified in this instance, guidelines/protocols must be put in place to ensure that the usage of a law as wide ranging and potentially powerful as Section 396 furthers the ‘public interest’ and is not misused by the government to further its own interest.

timeframe-for-nselftil-merger-jaitley/article7547897.ece; Financial Technologies (India) Ltd. v. Union of India, Writ Petition No. 2743 of 2014.

¹⁰⁰ *United Against The Proposed Forced Amalgamation Of NSEL With FTIL*, FINANCIAL TECHNOLOGIES, <http://www.ftindia.com/SHARE-HOLDER-LETTER-WITH-ANNEXURES.pdf>.

¹⁰¹ Ministry of Corporate Affairs, *Notification on Amalgamation of Government Companies*, Issued on April 20th 2011, 51/16/2011/CL-III, http://www.mca.gov.in/Ministry/pdf/Circular_16-2011_20apr2011.pdf.

¹⁰² *Id.*

¹⁰³ *Mergers and Acquisitions*, MINISTRY OF CORPORATE AFFAIRS, <http://www.mca.gov.in/MinistryV2/chapter10.html>.

The Court should come up with guidelines regarding amalgamations of companies under this section. Since, no two private companies have ever been forcibly merged before; the Court's decision here will set a precedent that may have a major impact in the near future.

b) *Does the merger lead to erosion of corporate law principles?*

FTIL alleges that a forced merger will erode the elementary principles of limited liability and corporate identity, implicitly making it responsible and legally liable for the scam, when such allegations are presently *sub judice* before the Bombay High Court.¹⁰⁴ However, under Section 396 of the Companies Act, 1956 the Central Government can *suo motu* merge companies in public interest. The public interest here is the interest of the investors who have been defrauded wherein such fraud was at least facilitated by the exchange. If we were to look into a situation where the Court is to adjudge lifting of corporate veil and ignore the NSEL's distinct legal identity, the parties will have to fulfil the statutory or judicial circumstances that allow such breaking of the corporate shell.

This merger will end up circumventing the principle of limited liability, which is defined as “*the legal protection limiting each shareholder to the par value of fully paid-up company shares to cover the financial liability of the company's debts and obligations in a privately or publicly owned corporation. As a legal entity, the company itself is liable for the rest.*”¹⁰⁵ Also, though the concepts of Corporate Personality and Limited Liability are distinct they operate in tandem and their impact is most evident when considered together.¹⁰⁶ The principle of limited liability is imperative to ensure a

¹⁰⁴*Id.*

¹⁰⁵BRYAN GARNER, BLACK'S LAW DICTIONARY 997 (9th ed., 2009).

¹⁰⁶Alex Magaisa, *Corporate Groups and Victims of Corporate Torts - Towards a New Architecture of Corporate Law in a Dynamic Marketplace*, 1 LAW, SOCIAL JUSTICE & GLOBAL DEVELOPMENT JOURNAL 1, 8 (2002).

positive corporate atmosphere and build the investor's confidence through diversification of assets.¹⁰⁷

It is well discussed that it is not possible to evolve a consistent and inflexible set of rules which can be invoked in determining the question as to whether the veil of the corporation should be lifted or not¹⁰⁸. However, it is noted that the veil on corporate personality, even though not always lifted, is becoming increasingly transparent in modern corporate jurisprudence. The ghost of the *Saloman*¹⁰⁹ case which upheld the doctrine of corporate personality still frequently appears in Company Law, however, now the veil has been pierced in many cases across jurisdictions.¹¹⁰ *Palmer* in his *Company Law Precedents* has categorized five categories of cases where the Courts have lifted the corporate veil and considered the merits of the case. They are: involving the relationship of holding company and its subsidiaries, ascertaining the controlling interest in matters relating to taxes, duties and the like, ascertaining the controlling interest where trading with the enemy is involved, in the law relating to exchange control and where shareholders are liable to creditors when the number of members of a company is reduced below the legal minimum. Mostly economic matters, especially those pertaining to tax evasion and circumvention of tax obligations, perpetuation of fraud and public interest doctrine have called for lifting the veil in decided Court cases.¹¹¹ The courts have enunciated that whenever the

¹⁰⁷Judith Freedman, *Limited Liability: Large Company Theory and Small Firms*, 63 THE MODERN L. REV. 317, 328 (2000).

¹⁰⁸P.C. Agarwala v. Payment of Wages Inspector, M.P. and Others, (2005) 8 S.C.C. 104.

¹⁰⁹Salomon v. Salomon, (1897) Eng. Rep. 33 (H.L.).

¹¹⁰State of Uttar Pradesh v. Renuagar Power Co., A.I.R. 1988 S.C. 1737 (India).

¹¹¹SIR FRANCIS BEAUFORT PALMER & GEOFFREY MORSE, PALMER'S COMPANY LAW 215 (24th ed., 1987).

medium of a company is used for committing fraud¹¹² or economic offences,¹¹³ courts have lifted the veil and looked into the realities behind the legal façade. It is settled law that the corporate veil can be pierced when it is found to be opposed to justice, against public interest and good conscience.¹¹⁴

The FTIL's control over NSEL implied a subsidiary-holding company relationship. The Hon'ble Supreme Court has enunciated that when a holding company owns enough voting stock in a subsidiary, it can control management and operation by influencing or electing the Board of Directors and be considered as a single economic entity,¹¹⁵ strengthening the arguments in favor of pushing through a merger between NSEL and FTIL, making FTIL liable for the NSEL's debts.

Thus, the lifting of corporate veil shall go on to reveal the true nature of the affairs between the NSEL and FTIL, and will expedite the repayment of the claims, justifying the FMC's suggestion to merge the companies in public interest. The concept of Limited Liability should not be used to shield parent companies from the liabilities it may incur due to fraudulent practices, and prevent compensation from reaching the people who have lost their money due to such activities.

V. THE WAY FORWARD

One of the marked differences of the NSEL scam with other scams like the Harshad Mehta or Ketan Parekh scam is that the exchange itself was at fault and it was against the exchange that the allegations of impropriety were leveled. An exchange can only work if the investor's confidence in the system is absolute, and the NSEL scam

¹¹²Gilford Motor Company v. Horne, (1933) Eng. Rep. 109 (C.A.).

¹¹³Santanu Ray v. Union of India, [1989] 65 Comp. Cas. 196.

¹¹⁴Workmen Employed in Assn. Rubber Industry Ltd., Bhavnagar v. Associated Rubber Industry Ltd., (1985) 4 SCC 114.

¹¹⁵Vodafone International Holdings B.V. v. Union of India, (2012) 6 S.C.C. 613.

has created a massive trust deficit.¹¹⁶ Generally, exchanges were owned and operated by the brokers that trade on it, as a not-for-profit body as a "club of brokers" offering services as monopoly operators operating under a mutual governance structure, as a co-operative.¹¹⁷ It was observed that such a system opens the doors for conflict of interests, and from this, the idea of demutualization was developed. This means, that the exchange would become a corporate entity with its own objectives.¹¹⁸ Moreover, it transforms from a non-profit organization into a profit-making company like any other corporate entity, with shares of its own that could be sold to or distributed to the stakeholders, with ownership and management differentiated from each other¹¹⁹. The incontrovertible advantage of demutualization is that the chances of a scam like this will be minimized if direct stakeholders in the market and its fluctuations are kept separate from its management. It will result in a large inflow of funds which can be used to modernize the exchange.¹²⁰ The governance and management will also be streamlined, as it will be in the hands of professionals with no conflicting interests, and not the brokers who used the system.¹²¹

¹¹⁶ *FMC takes steps to restore investor confidence in commodities market*, THE ECONOMIC TIMES (Jun. 8, 2014), http://articles.economictimes.indiatimes.com/2014-06-08/news/50421071_1_nsel-crisis-investor-confidence-trading-volumes.

¹¹⁷ SHAMSHAD AKHTAR, DEMUTUALIZATION OF STOCK EXCHANGES: PROBLEMS, SOLUTIONS AND CASE STUDIES 36 (1st ed., 2002).

¹¹⁸ *What exactly is demutualization?*, THE ECONOMIC TIMES (Jan. 21, 2002), http://articles.economictimes.indiatimes.com/2002-01-21/news/27334241_1_demutualisation-trading-rights-brokers.

¹¹⁹ United Nations Conference on Trade and Development, *Overview of the world's commodity exchanges, 2007*, UNCTAD/DITC/COM/2008/4, 6.

¹²⁰ *Indian Exchanges: The Final Countdown*, IDFC, http://www.idfc.com/pdf/white_papers/indian_exchanges.pdf.

¹²¹ *Demutualization - Implications for the Regulation and Governance of Securities Exchanges*, INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS, http://www.iosco.org/library/annual_conferences/pdf/ac25-23.pdf.

In the NSEL's case, however, FTIL owned around 99.99% of NSEL and was active in the management and operation of the company¹²², with no real distinction between the management and the ownership. The RBI in its Financial Stability Report of 2013 has stressed on the need to separate the two, stating that "*The (NSEL) episode has emphasized the need for ensuring that no single shareholder or a group of shareholders is permitted to dominate the functioning of the exchange or exercise managerial control*"¹²³ and it has observed that stricter regulatory control is necessary to protect public interest,¹²⁴ and attract more investment towards the sector.

Even though, in the aftermath of the NSEL scam the government has come under severe criticism for the lack of regulation, one must also look into the actions of the individual investors and brokers. No questions were asked before buying these products, and the investors (many of who were High Net Worth Individuals who have been active in the financial markets for years) did not try to understand how they were reaping such high fixed annual profits. There should be a higher level of investor scrutiny, and the fundamentals of the product, market, broker and regulator must be taken into account to assess the veracity of the product being invested in.

VI. CONCLUSION

In conclusion, the importance of a stringent regulatory structure cannot be overlooked. A strong regulatory structure minimizes risks

¹²²Anirudh Laskar & B.S. Sunil, *NSEL must separate ownership from management: Report*, LIVEMINT (Sept. 21, 2013), <http://www.livemint.com/Politics/vsFz2hekIIsPqvzbWQ8eIM/NSEL-must-separate-ownership-from-management-report.html>.

¹²³ RESERVE BANK OF INDIA, FINANCIAL SECTOR REGULATION AND INFRASTRUCTURE (2013).

¹²⁴*No promoter should control any exchange: RBI*, THE HINDU (Dec. 30, 2013), <http://www.thehindu.com/business/markets/no-promoter-should-control-any-exchange-rbi/article5518852.ece>.

of impropriety and induces investor's confidence, resulting in higher trading volumes, which are beneficial for the financial health of the country. The Maharashtra Government has decided to set up a special court to expedite the proceedings,¹²⁵ but still, no relief has been provided to the aggrieved investors. Recent changes, like the amendment of the PML Act to ensure that victims get their money back are a welcome sign, and victims must be spared from long, tedious litigation to get back the money due to them. Section 396 of the Companies' Act, which has not been used before to merge two privately-owned companies before must also be clarified, and a system of checks and balances must be formulated to ensure that such wide-ranging powers aren't misused by the government. The government must continue taking tough and contentious decisions like the NSEL-FTIL merger to ensure that the investors get back their dues and that confidence in the regulatory mechanism of commodities exchanges gets instilled amongst investors.

¹²⁵Ashish Rukhaiyar & Makarand Gadgil, *Maharashtra to set up special court to hear NSEL matters*, LIVEMINT (July 7, 2015), <http://www.livemint.com/Politics/5VbhWBq2L6Xouit8C1MkvO/Maharashtra-to-set-up-special-court-to-hear-NSEL-matters.html>.