

FORENSIC REVIEW OF NSEL FRAUD CASE- WHETHER CONCEPT OF DEMUTUALISATION & CORPORISATION EXISTS IN ACTUAL

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ABSTRACT

Forensic Audit is the application of accounting methods for tracking and collection of forensic evidence, usually for investigation and prosecution of criminal acts such as embezzlement or fraud. It further states that forensic audit could also be called as forensic accounting. Forensic Auditing has established itself as dynamic and strategic tool in combating corruption, financial crimes and frauds through investigations and resolving allegations of fraud and embezzlement. Thus, a new area of auditing, known as Forensic Audit, was needed to detect the frauds in companies that suspected fraudulent transactions.

Keywords: *Forensic Audit, Fraudulent, Embezzlement, Demutualization.*

Introduction

Demutualization refers to the conversion of an existing non-profit organization into a profit-oriented company. As far as stock exchange/commodity exchange is concern, this process involves the segregation of members' right into ownership rights and trading rights and accordingly it changes the relationship between members and the exchange. Members while retaining their trading rights acquire ownership rights in the exchange, which have a market value, and they also acquire the benefits of limited liability. So in reference of any stock or commodity exchange we can say that demutualization refers to the transition process of an exchange from a mutual form to a business corporation form. The above, in effect means that after demutualization, the ownership, the management and the trading rights at the exchange are segregated from one another.

Origin of Demutualisation Concept in Stock & Commodity Exchanges at India

As far as Stock Exchanges are concern SEBI had formed a Group on Corporatisation and Demutualization of Stock Exchanges under the Chairmanship of Justice M H Kania, former Chief Justice of India, for advising SEBI on corporatization and demutualization of exchanges and to recommend the steps that need to be taken to implement the same. The Group submitted its Report to SEBI on August 28, 2002. The Said report were accepted by SEBI vide their circular no. SMD/POLICY/CIR3 Dated 30/01/2003 and the basic concept was to separate Ownership, Management and Trading rights with each other. Sebi have also issued directions that no stock broker will become post bearer of any stock exchange ie. President, Vice president etc. Accordingly SEBI have asked all stock exchanges to submit their reports with in 06 months for implementation of the said scheme and it was found that many of the exchanges have not submitted their report and accordingly SCRA had been amended on 12/10/2004 to compel stock exchanges to get them selves corporatize and demutualize.

But on the other hand earlier the Forward Market Commission (FMC) does not have provisions for compulsory corporatization and demutualization of commodity exchanges. Realising the importance of empowering FMC and allowing trade in derivative products that are needed for the growth of the Indian economy, legislative action to amend the Act was proposed as early as 1998. However, despite the amendment bill being introduced thrice in successive LokSabhas, recommended by Parliamentary Standing Committees twice, passed as an ordinance once, and even though there was a broad political consensus on its passage, it had not been passed by the parliament. FCRA Amendment Bill 2010 (Bill)

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needs was supposed to be passed urgently, as it would not only strengthen FMC by rendering it the necessary autonomy, but would also pave the way to introduce new tools for hedging. But unfortunately the same did not happen and the legal framework to establish the concept of dematerialisation and corporatisation in the Commodity exchanges were kept pending for a long time and this pendency could be counted for one of the reasons of the huge scam of more than Rs. 5400 Crores at National Spot Exchange Limited.

Application of Forensic Audit for Verifying the Existence of Demutualisation and Corporatization in NSEL

Demutualization as a concept is neither a very new concept nor very sophisticated. The essence lies with the separation of ownership and management. Thus it is well driven by the good intentions of proper governance. Separation of ownership and membership is the fundamental ingredient of the demutualization as well as the essence of effective governance. The recent failure of the National Spot Exchange Limited (NSEL) illustrates the need for adequate capitalization, liquidity and complete separation of management and the interests of Trading Members. It was found that demutualization concept was found to violate altogether as NSEL was found to be an entity owned by the Financial Technologies promoted by Jignesh Shah and after going into detail research with application of forensic audit techniques many findings arise and the key point of the same could be summarised as under:

- The order of the Forward Markets Commission (FMC) dated 17th December 2013 held that certain promoters and directors of the National Spot Exchange Ltd (NSEL) were not fit and proper persons. One of the reasons was the common interest of these people in NSEL as Owner as well as in management of the same.
- The IBMA, a subsidiary of the NSEL (60.88% stake) was loaned several hundred crore by the NSEL as working capital and provided margin exemption to trade on the NSEL itself, a clear conflict of interest.
- The FMC, in its order dated 17th January 2013 has observed the following "...establish the fact that the entire governance of the Company including planning, directing and controlling of its activities was utterly lacking in transparency, integrity, competence, compliance with law, and most importantly an honesty of intent to meet its stated objectives of offering a platform for genuine trading in commodities." This reflects the lack of Corporate governance in the National Spot Exchange.
- Also brokers have also been accused of indulging in massive manipulation of client KYCs, large-scale modification of client codes for doing multiple deals and infusion of unaccounted money through their NBFCs and some of these brokers were found to be related & interested entity of the management of NSEL.
- In the year 2012 the EPS of National Spot Exchange Limited was Rs. 5.70 per share but it raised to Rs. 27.73 per share in the year 2013. This rise directly benefits the owner of the Exchange and thus this should be checked properly using substantive analytical procedures in order to find where things went wrong in the exchange and lead to such a huge fraud involving Rs. 5600 Crores.
- From the Balance Sheet it is reflected that around Rs 55 Crores were given as advance to related parties during the financial year 2012-13 while in the previous year it was just Rs. 2.08 lacs. This amount was paid to the Owner companies and their related companies, which again proves the absence of the concept of demutualization at NSEL.
- Also while analysing the Balance sheet it was found that the unsecured advances were increased by Rs.98.44 Crore which is also a huge amount which should have been checked whether such advances were given to related parties and also their credit rating should have been checked in order to find the amount of provision which can be made on such advances.
- Notes to accounts of FTIL claim the company, NSEL, being a separate and independent entity, it had no responsibility or liability towards the dues or claims against the NSEL (as filed on BSE) but on the other hand during research it came to our notice that Quarterly reports of NSEL were submitted directly to the FTIL board and used to discuss there. MMTC's contention was also that Jignesh Shah and other directors were trying to hide behind a corporate veil.
- Various transactions & activities done by NSEL and FTIL if studied combined then some time it put question marks that whether NSEL have worked as an agent of FTIL ?

- In a well-known case of *Smith, Stone and Knight v Birmingham Corporation* (1939): the parent company (plaintiff) held all the shares, except a few, of its subsidiary that was treated like a department and the parent was entitled to all the profits of the subsidiary. It was held therein that the ratio of *Salomon* does not apply to a situation where there is a specific arrangement between the shareholders and the company making the company an agent of its shareholders and where the business of the company is the business of the shareholders and the facts of this case are eerily similar to the accusation that FTIL controlled NSEL and can serve as a precedent in the ongoing battle.
- It is also find out that the parent (FTIL) defending its separate legal entity against petitions filed by the NSEL Investors Forum and MMTC demanding the unveiling of the 'corporate cloak' of NSEL on the grounds that it was only an agent of FTIL and the brain behind the entire operations being a director of FTIL, currently incarcerated. Lifting of the 'corporate veil' of NSEL to reach FTIL on the grounds of fraud is an outcome that would be keenly awaited.

After Steps & Conclusion:

After the commodity market was rocked by the outbreak of a multi-crore scam at National Spot Exchange (NSEL) unearthed two years back On September 29, 2015 the amalgamation of Forward Markets Commission (FMC), the erstwhile commodities regulatory body, with capital markets watchdog Securities and Exchange Board of India (Sebi) came into effect, marking the first major case of two regulators being merged. After merger, the capital markets regulator SEBI have fixed the long awaited major norms the commodities derivatives market will need to comply with include those related to net worth, shareholding structure, composition of board, corporatization and demutualization, setting up of various committees, turnover, infrastructure and so on.

Sebi decided to give three years for corporatization and demutualization of regional commodity derivatives exchanges from the date of merger of SEBI with FMC. Now this become similar to Sebi's existing norms for the country's stock exchanges. As per these norms After three years of the merger and demutualization, a commodity derivatives exchange will be required to avail of the services of a clearing corporation for trade clearing and settlement and Till then, clearing may continue through the current arrangement. However, all commodity exchanges will need to ensure a guarantee for the settlement of trades including good delivery. After this merger and taking example from NSEL Scam Sebi mentioned that Corporatization means converting an entity from being controlled and managed by a group of individuals to one being a company incorporated as per the existing laws for companies. Demutualization is the process through which a member-owned organization becomes a shareholder-owned company. An entity is required to split the membership into two parts — trading rights and ownership rights to demutualize itself.

The NSEL issue as brought out in the above paragraphs clearly illustrates the desperate need for ensuring that the management is independent of control and manipulation by traders and members of exchanges as well as the need for adequate liquidity and capitalisation for meeting exigencies of default so that systemic risks can be avoided. By conducting the primary research in line of the forensic audit, Upfront it could be find out that the concept of demutualisation and corporatisation was though there in NSEL in documents but in actual there were lack of the same which given air to huge scam where more than 13000 Investor have lost their money.

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