

CHAPTER V: MINISTRY OF COMMERCE AND INDUSTRY

MMTC Limited and PEC Limited

5.1 Blocking of funds due to lack of financial prudence

Blocking of funds amounting to ₹ 341.72 crore due to lack of financial prudence while trading on National Spot Exchange Limited (NSEL)

MMTC Limited and PEC Limited (Companies) were trading members on National Spot Exchange Limited (NSEL), Mumbai since May 2011 and December 2010, respectively. Ministry of Consumer Affairs Food and Public Distribution (Department of Consumer Affairs) vide Gazette Notification dated 5 June 2007 exempted the Forward Contracts of one day duration for sale and purchase of commodities traded on NSEL from the operation of the provisions under Forwarded Contracts (Regulation) Act, 1952 subject, *inter alia*, to the condition that no short sale by members of the exchange shall be allowed. NSEL offered spot contracts for purchase and sale of agro commodities with physical delivery of commodities which were settled on T+2 and T+25 days, respectively. MMTC and PEC both initially restricted the financial limits of trade to ₹ 10 crore and ₹ 50 crore, respectively, and dealt in trading of pulses. However, within a period of one year, both the Companies diversified into trade in paddy, edible oils, wheat, etc. The overall trade limit was also raised to ₹ 250 crore by both the Companies. MMTC and PEC continued trading on NSEL up to 26 July 2013 and 25 July 2013, respectively.

Pursuant to directions issued by the Department of Consumer Affairs, GOI, vide letter dated 12 July 2013, NSEL changed the settlement procedure for trades with effect from 23 July 2013. As per changed procedure issued by NSEL vide Circular dated 22 July 2013, all contracts being settled so far by delivery and payment beyond 11 days were to be settled with effect from 23 July 2013 on 'T+10' days basis. Subsequently, due to reduction in trade at NSEL there was a mismatch of obligations and as a result it suspended (31 July 2013) trading and postponed the settlement of all one day forward contracts.

An amount of ₹ 218.53 crore was still recoverable (November 2013) by MMTC from NSEL for the trading period of 26 June 2013 to 26 July 2013 whereas PEC was to recover ₹ 123.19 crore from NSEL for transactions falling between 25 June 2013 and 25 July 2013. The amount was recoverable due to the time gap between purchase payments and sales realization as per trade practice on the exchange. NSEL defaulted continuously in paying its dues to both the Companies from August 2013.

Audit observed that trade dealings of both the Companies with NSEL suffered from following infirmities and deficiencies:

- The Companies were trading and dealing on the NSEL which was a spot exchange under investment/financing mode where no effective delivery of goods was intended.
- Within one year of commencement of their trading on NSEL the Companies raised their financial exposure limit 5-25 times without any functional drill or standard operating procedure. Subsequently, MMTC prepared its Functional Drill on 30-11-2012 for trading of agro products on NSEL.
- Instructions for physical verification of stocks in NSEL warehouses were issued by MMTC in December 2012 after 18 months of commencement of trading whereas PEC did not conduct any physical verification of commodities at all.
- No risk insurance review was made while undertaking transactions with NSEL. As a result, no insurance cover was taken for the commodities traded on NSEL.
- Neither Company tried to ascertain the counter party details with whom they were trading.
- There were no documents of title received either from NSEL or from counter party against the purchase of commodities.

The comments offered by the Companies (MMTC-November 2013 and PEC January 2014) to the Audit observations were as follows:

- MMTC replied that NSEL was counter guarantor for delivery and payment schedule. Similarly PEC replied that for unsettled purchases, they were given delivery allocation indicating the warehouse receipt number, weight and location of warehouse which indicated that the trade was backed by physical goods and could be used to set out PEC's sales obligation.
- Financial exposure limit for trading at NSEL was enhanced stepwise to tap further risk free arbitrage opportunity available in the market.
- MMTC admitted that instructions were issued in December 2012 for monthly inspection of warehouse whereas PEC replied that commodity and warehouse management were always within the purview and responsibility of NSEL.
- Companies were assured that insurance of commodities was already taken up by NSEL and to avoid duplication, they did not go for insurance of the commodities.
- NSEL was the counter party/counter guarantor for delivery and payment settlement and it was not known to them as to who their counter parties were.

The reply of the Companies is not acceptable as:

- 'Buy' and 'sell' were done simultaneously with no supporting documents of title to underlying goods. Actual tendering of documents of title to goods covered by contracts was absent though each buying and selling transaction was to be settled

on 'trade to trade' basis resulting in compulsory delivery as per terms and conditions of NSEL on settlement procedure. Such delivery logic would involve physical verification of stock by the Companies.

- Increasing the financial exposure limit by 5-25 times within a small span of time without any risk analysis was against ordinary financial prudence.
- The Companies neither took any insurance cover for the commodities traded by them on NSEL nor requested NSEL for a copy of insurance undertaken by it. It was only after the default, that the Companies requested the Exchange for the insurance documents of unsettled trade.
- The Companies never tried to ascertain the counter party details with whom they were entering into trade. An independent and credible assessment of the counter parties was required.

From the above, it can be concluded that MMTC and PEC continued trading on the NSEL in spite of deficiencies which resulted in blocking of ₹ 341.72 crore of the two Companies. From the chain of events, recovery of the same appears remote.

The matter was reported to the Ministry in December 2013; their reply was awaited (March 2014).

The State Trading Corporation of India Limited

5.2 Unwarranted transfer of gain

Failure to safeguard the interest of the Company resulted in unwarranted transfer of gain of ₹ 31.94 crore to Associate, on cancellation of Forward Contracts

The State Trading Corporation of India Limited (Company) imports bullion for its associates from vendors (suppliers) under various schemes. One of the schemes under bullion business is '90 days Usance Letter of Credit Scheme'. It requires opening of Letter of Credit (LC) by the Company in favor of the foreign supplier, after receipt of proforma invoice from the foreign supplier for import of the quantity stated in the indent placed by the Company.

Forward Contracts (FCs) are instruments to hedge against fluctuations in foreign exchange rates. As per trading practice FCs are taken only after crystallization of liability (i.e., amount due on remittance date as per proforma invoice) in respect of import of bullion. Further, FCs are taken only after opening of LCs by the Company on foreign supplier on the basis of LC value and LC maturity date.

Import of gold was governed by the agreement dated 31 January 2011 between the branch office of the Company located in Kolkata and M/s. Lichen Metals Private Limited (LMPL), an Associate of the Company. The trading practice of opening LCs after receipt of proforma invoice was reiterated in clause 5 of the said agreement. M/s. LMPL placed an order dated 25 July 2011 on the Company for import of 2000 Kg of duty free gold on 'Usance LC/Stand By LC basis'. Accordingly, the Company placed indent of 1000 Kg

each on its foreign supplier's viz. M/s. Natixis Commodity Markets Limited (NCML) and M/s. MKS Finance (MKSF) on 25 and 26 July 2011 respectively with delivery period upto 30 April 2012. The Company purchased FCs from SBI on 26 July 2011 for USD 32 million (dates of remittance from 10 July 2012 to 13 July 2012) and on 27 July 2011 for USD 68 million (dates of remittance from 16 July 2012 to 26 July 2012). The purchase of the above mentioned FCs was confirmed by M/s LMPL on 26 and 27 July 2011 specifying that profit/loss on purchase of FCs would be on their account.

M/s. LMPL cancelled the said indent and the booking of related FCs on 25 September 2011. Accordingly, the Company's Branch Office at Kolkata cancelled its indent with the foreign suppliers on 26 September 2011 on the ground that the Company had already arranged import of the said quantity of 2000 Kg of duty free gold. The Branch Office at Kolkata also cancelled (26 September 2011) the FCs by intimating to SBI that it had already imported the said quantity of gold. On account of cancellation of FCs, a gain of ₹ 35.73 crore occurred representing the difference between the cancellation rate and the booking rate as given in the table below:

| Ref. No. | Currency | Amount (₹ in lakh) | Booking Rate | Cancellation Rate | Gross Profit | Passed on Profit | Discount Value | JV No. |
|------------------|----------|-----------------------|-----------------|----------------------|---------------------|---------------------|-------------------|--------|
| 0999811FS0000444 | USD | 40 | 46.4025 | 50.0470 | 145,78,000 | 13034645 | 1543355 | 2838 |
| 0999811FS0000443 | USD | 40 | 46.4000 | 50.0470 | 145,88,000 | 13043586 | 1544414 | 2839 |
| 0999811FS0000449 | USD | 80 | 46.3925 | 50.0570 | 293,16,000 | 26155646 | 3160354 | 2840 |
| 0999811FS0000448 | USD | 80 | 46.3975 | 50.0520 | 292,36,000 | 26112514 | 3123486 | 2841 |
| 0999811FS0000447 | USD | 80 | 46.4150 | 50.0495 | 290,76,000 | 25978985 | 3097015 | 2842 |
| 0999811FS0000452 | USD | 40 | 46.4075 | 50.0620 | 146,18,000 | 13028043 | 1589957 | 2843 |
| 0999811FS0000451 | USD | 80 | 46.4025 | 50.0595 | 292,56,000 | 26083305 | 3172695 | 2844 |
| 0999811FS0000450 | USD | 80 | 46.3975 | 50.0595 | 292,96,000 | 26128381 | 3167619 | 2845 |
| 0999811FS0000435 | USD | 80 | 46.6275 | 50.0395 | 272,96,000 | 24450378 | 2845622 | 2861 |
| 0999811FS0000434 | USD | 80 | 46.6225 | 50.0370 | 273,16,000 | 24477153 | 2838847 | 2862 |
| 0999811FS0000433 | USD | 80 | 46.6175 | 50.0345 | 273,36,000 | 24503948 | 2832052 | 2863 |
| 0999811FS0000442 | USD | 40 | 46.3950 | 50.0445 | 145,98,000 | 13057245 | 1540755 | 2864 |
| 0999811FS0000441 | USD | 40 | 46.3925 | 50.0445 | 146,08,000 | 13066190 | 1541810 | 2865 |
| 0999811FS0000436 | USD | 80 | 46.6575 | 50.0395 | 270,56,000 | 24226628 | 2829372 | 2866 |
| 0999811FS0000445 | USD | 40 | 46.4075 | 50.0495 | 145,68,000 | 13020998 | 1547002 | 2867 |
| 0999811FS0000446 | USD | 40 | 46.4100 | 50.0495 | 145,58,000 | 13012060 | 1545940 | 2868 |
| TOTAL | | 100 | | | 35,73,00,000 | 319379705 | 37920295 | |

Passed on Profit ₹ 319379705 Less ₹ 12000 Cancellation charges= ₹ 319367705 Credited on 28-09-2011

SBI deducted ₹ 3.79 crore on account of premium and margin on FCs and credited ₹ 31.94 crore to the Company. This said amount was transferred by the Company to M/s. LMPL.

Examination in Audit revealed that the following irregularities occurred in the booking of the above said FCs and transfer of gain of ₹ 31.94 crore to M/s LMPL by Kolkata Branch Office of the Company:

- (i) The indent dated 25 July 2011 could not be processed as M/s. LMPL terminated the order. As the transaction was never carried out due to default on the part of M/s. LMPL, transfer of the gain of ₹ 31.94 crore on account of cancellation of FCs to M/s. LMPL was unwarranted and questionable.
- (ii) The Branch Office, Kolkata made a false representation to the foreign suppliers for cancellation of indent for 2000 Kg gold as well as to SBI for cancellation of FCs. Available records did not support import of 2000 Kg gold against the indent dated 25 July 2011 for LMPL.
- (iii) Clause 5 of the contractual agreement with M/s. LMPL refers to opening of LCs after receipt of proforma invoice. Not obtaining proforma invoice from the foreign supplier led to non-crystallization of liability for purchase of 2000 Kg of duty free gold. Despite non-crystallization of liability, the Branch Office, Kolkata preferred to purchase FCs for USD 100 million.

The Company did not agree with the audit observations on unwarranted transfer of gain of ₹ 31.94 crore on cancellation of FCs to M/s. LMPL in its reply (September 2013) on the following grounds:

- (i) Prior to RBI circular dated 15.12.2011, proforma invoice could be submitted subsequent to booking of FC. Thus, FCs could be booked prior to receipt of proforma invoice.
- (ii) FCs were taken on specific request from the Associate and all costs/incidental expenses were to be borne by the Associate. STC was only to take a fixed trading margin on completion of transaction.
- (iii) The Associate, vide letters dated 26 July 2011 and 27 July 2011, confirmed that the exchange gain/loss on forward purchase would be on its account. As instructions of the Associate were acted upon, the same were part of agreement.
- (iv) The reason for cancellation of contract as received from the associate was communicated to foreign supplier & SBI.

Reply is not acceptable in view of the following:

- In the absence of proforma invoice, the value and dates indicated in FCs were without basis and hence speculative. Further, the agreement dated 31 January 2011 did not provide for cancellation of indented quantity by M/s. LMPL. It provides for an option only to STC to cancel the indented quantity on account of

ban, prohibition conditions, if any imposed by the Government on import of gold. Therefore, the cancellation of order by LMPL and consequent cancellation of FC was irregular. Failure to obtain proforma invoice from the supplier and subsequent cancellation of the indent and forward covers were, therefore not justified.

- Justification of the Company by giving references to M/s. LMPL's letters regarding their accounting of profit/loss of forward purchase is irrelevant and outside the agreement dated 31 January 2011. As such, remitting the gains on cancellation of FCs to M/s. LMPL consequent on M/s. LMPL's irregular cancellation of indent was beyond the terms of agreement.
- M/s. LMPL, at the time of cancellation of order, did not specify any reason for cancellation, whereas the Company specifically intimated the foreign supplier and SBI at the time of cancellation of contract that it had already imported the said quantity of 2000 Kg of bullion, which was not true.

The transaction points to speculative trade rather than genuine bullion purchase. It also points to compromise with the financial interests of the Company by its Branch Office at Kolkata as it failed in its treatment of gains in FCs under question which were taken before the liability had crystallised and therefore outside the agreement. The Corporate Office of the Company could have avoided occurrence of such lapses had it formalized the procedure on FCs through the Bullion Drill/ Circulars.

Thus, remittance of Company's gain to M/s. LMPL despite cancellation of indent resulted in undue benefit of ₹ 31.94 crore to M/s. LMPL and foregoing of revenue by the Company to the same extent.

The matter was reported to the Ministry in October 2013; their reply was awaited (March 2014).