

## TESTING THE LEGALITY OF OFFLINE NSE DEBT MARKET CONTRACTS ISSUED BY HOMETRADE

**The following Questions have been raised during the course of Investigation and need to be answered .**

Q1 . Whether mere withdrawal of trading facilities by NSE of its existing fully operating member would disqualify it from undertaking principal to principal trades or any other trade which does not require NSE terminal facility for execution of trade.

Q2. Whether the contract notes issued by such member are null and void abinitio or just an irregularity which can be regularized by the NSE.

Q3 .Is there any way out whereby NSE has to take cognizance of these contract notes and regularize the trades so that the arbitration clause mentioned in the contract notes can be invoked and the dispute can be referred to the arbitration committee of NSE in terms of NSE Bye-laws and the Arbitration Act.

**THE NOTE TO HELP FIND THE ANSWERES :**

**CHRONOLOGICAL ORDERS :**

**The note also gives a comprehensive chronology of events starting with Incorporation of the Company as Lloyds Brokerage , then renamed as Euro Asian Securities and then Hometrade Ltd**

**The Note also gives details on all application made to SEBI AND NSE for the name change**

**The note also deals with the legality of Hometrade issuing OFFLINE Contracts when its ONLINE TRADING Facility was withdrawn**

### **Incorporation and Promoters:**

Home Trade Limited (The Company) was originally incorporated as Lloyds Brokerage Pvt. Ltd. on 27/05/1993 as a private limited company and converted its status into a public limited company on 02/07/1993. The Company was promoted by Mr. Mukesh R. Gupta and Rajesh R. Gupta. The majority shareholding of the Company was with Mr. Mukesh R. Gupta and Lloyds group companies.

### **The Main Objects and Membership of the Stock Exchanges:**

The Main object of the Company was to carry on business as share and stock broker. In order to carry on the stock and share broking business the Company became member of the following stock exchanges and was also registered with the SEBI as a stock Broker.

S.No.	Name of Stock Exchange	Clearing number	SEBI registration number	Date of SEBI registration
1.	Bombay Stock Exchange(BSE)	417	INB010624639	07/06/1995
2.	National Stock Exchange (NSE)	05974	INB230597435	27/05/1994
3.	Pune Stock Exchange (PSE)	0191	INB110624638	21/07/1994
4.	Over The Counter Exchange of India (OTCEI)	20-01158-0	INB200597431	07/07/1995

The Company was registered with Public Debt Office ( PDO ) of Reserve Bank Of India under registration No. 6-H/82 and was entitled to deal in government securities.

### **Capital Structure and Ownership:**

The Authorized and paid up capital of the Company was Rs. 6.15 crores. Mr. Mukesh Gupta was holding shares worth Rs. 3.15 crores in his individual capacity which constituted about 51% of the total issued and subscribed capital. The balance shares worth Rs. 3 crores were held by Lloyds Group companies.

Mr. Mukesh R. Gupta, Mr. Yashpal Madan and Mr. Atul M. Khadelkar were designated as Whole Time Director to comply with the requirement of NSE Bye-laws.

### **Change in Management and Equity Capital (Ownership):**

The Company's name was changed from Lloyds brokerage Ltd. to Euro Asian securities Ltd. w.e.f. 31.01.1998

The Company issued further 1,78,11,000 equity shares of Rs. 10 each aggregating to Rs. 17,81,10,000/- to Mauritius based Overseas Corporate Body (OCB) - Euro Offshore Investments Limited (EOIL) (formerly known as S N Investments Ltd.). The allotment of shares to EOIL took place on 04/09/1998. The necessary approvals for the allotment of shares were obtained from Foreign Investment Promotion Board (FIPB) and the Reserve Bank of India (RBI). EOIL was owned by Mr. Dhananjay Agarwal, a Non Resident Indian based in USA. The operations of EOIL was carried on from Mauritius. Mr. Sanjay Agarwal was also a director in EOIL.

Mr. Mukesh Gupta who owned majority of the equity capital in the Company became a minority share holder due to allotment of fresh shares to EOIL. Therefore, he resigned from the Directorship of the Company w.e.f. 31.03.1998. During December 1998 he sold his and Lloyds group companies' entire holding in the Company to M/s Dalhousie Securities Pvt. Ltd. These shares were actually transferred in the name of M/s Dalhousie Securities Pvt. Ltd. on 15.04.1999 as per members register. Dalhousie Securities Pvt. Ltd. was a non banking finance company, its main object was to carry on investment activities.

After resignation of Mr. Mukesh Gupta as Whole Time Director, Mr. Sanjay Agarwal was appointed as the Chairman of the Company.

### **Compliance with the stock exchanges post change in management:**

As per the Bye-laws of Stock Exchanges any change in shareholding pattern and Board of Directors requires approval from the respective stock exchanges. Therefore, the Company made an application to BSE, NSE, PSE and OTCEI for the approval of following changes:

1. To change name of the Company from Lloyds Brokerage Ltd to Euro-Asian Securities Ltd.
2. To issue additional shares to EOIL which would result in change in the Ownership and Control of the Company.
3. Acceptance of resignation of the existing Whole Time Directors (Mr. Mukesh Gupta and Mr. Yashpal Madan) and appointment of the new Whole time Director ( Mr. Sanjay Agarwal).

**The BSE** approved all the changes on the payment of the prescribed fees and these changes were ratified by the SEBI. The Company started operating in new name and style of “Euro Asian Securities Ltd.”. All the contract notes and bills for BSE transactions were issued under the new name.

**The PSE** approved changes and the same were ratified by the SEBI.

**OTCEI**, when approached for the approval of the changes, asked for payment of fees, which Company thought unviable to pay since company never acted or operated on OTCEI. Therefore, it was decided by the management to maintain status quo as far as OTCEI was concerned.

**The NSE** asked the Company to comply with the following requirements before granting the approval:

1. To pay transfer fees of Rs.25 lacs since the changes in shareholding pattern were treated as transfer of the ownership of the Company’s NSE membership card by the NSE.
2. To pay additional deposit of Rs.50 lacs for Capital market segment membership.
3. To pay additional deposit of Rs. 50 lacs for whole sale debt market segment membership.

The Company disagreed to pay such a huge transfer fees and additional deposits because the Company was of the view that the ownership of the membership remained with the Company irrespective of the change in shareholding because the Company owned this membership card in its capacity of a corporate legal entity.

In response, NSE assured the Company that they will take up this matter with the highest decision making authority in NSE, i.e. the Governing Board. In the interim it was technically and legally not possible for the Company to act and operate in two different names for NSE and BSE operations. Therefore, in consultation with NSE's officials it was agreed amicably that, the Company will request NSE for withdrawal of trading facility **and will continue to use only view screen facility to get live quotes form NSE. Accordingly, the Company wrote a letter in September 1998 to NSE to implement the above.**

After few months, the Company was informed by NSE that the Governing Board has taken the following decision and to that extent NSE's Bye- laws stand modified:

1. To collect a transfer fees of Rs. 10 lacs instead of Rs. 25 lacs.
2. To waive additional deposit of Rs.50 lacs on capital market segment membership.
3. To demand additional deposit of Rs. 50 lacs on Wholesale Debt Market segment membership.

The Company during that period was expanding and innovating its existing business operations, therefore, it was decided to differ additional payment of deposit to NSE.

#### **Offer for Sale and Listing of Company's Equity on the Stock Exchanges:**

In September, 1999, EOIL an OCB share holder offered 5990250 equity shares of the Company of Rs. 10/- each at a price of Rs. 50/- per share to the Indian public under the "offer for sale". The offer was fully subscribed and the shares were allotted to the Indian public as per SEBI guidelines. Subsequently, the shares were listed and traded on the Pune and Bangalore stock exchanges.

### **Change of Company's name to Home Trade LTD.:**

The Company's name was again changed to 'HOME TRADE LTD.' On 24<sup>th</sup> November, 1999. All the concerned stock exchanges were informed about the change of name and the new name was incorporated by the SEBI on the registration certificates pertaining to each stock exchange except the NSE, since the Company's application for changes were pending with NSE.

### **Application to NSE for Restoration of Trading Terminal:**

In October, 2000 Home Trade Ltd. was granted approval by the NSE for change of name, change of shareholding and change in the Board of Directors after payment of Rs. 10 lacs towards transfer fees. The formal application dated 5<sup>th</sup> October, 2000 was submitted to the NSE to obtain SEBI clearance. The application was cleared by SEBI and a new certificate of registration dated 10<sup>th</sup> November, 2000 was issued to the Company. Pursuant to this, the Company was enabled to trade on Capital Market Segment. Debt market segment terminal was not enabled due to non payment of additional deposit of Rs. 50 lacs.

### **The Alleged Default on the Part of the Company and Criminal complaint:**

**During the period of 1999 to 2002, the Company issued Offline contract notes to the various parties including co-operative banks in the capacity of NSE member for the Debt market transactions. The Company honored its commitment of delivering Government securities from time to time. All these transactions were principal to principal trade and were neither reported to NSE nor routed through NSE terminal.**

During April 2002, the Company could not give delivery to few banks due to huge volatility in the Whole sale debt market. Therefore, one of the clients M/s Nagpur District Co-operative Bank registered a criminal complaint against the Company Under section 406, 409, 420, 468, 471 read with section 34 of Indian Penal Code. The main charges against the Company were:

1. The Company fraudulently issued contract notes with respect to Debt Market Trades without being a member of NSE.
2. The Company instead of using funds for buying government Securities, diverted the funds for its own business expansion expenditure thereby misappropriated the amount received from the client
3. The Company cheated its client by selling government securities without having the same in its stock (short sale) on the date of issuance of contract notes.

**The facts to be examined and evaluated :**

**A.** In a couple of transactions, the Company issued contract notes as a member of the Pune Stock Exchange. Per se the Pune Stock Exchange doesn't deal in Government securities. However, aggrieved party filed a complaint against the Company in the Pune Stock Exchange for non delivery of the government securities for which consideration was already paid. All these trades were neither reported to nor routed through PSE. However, since the Company was a member of PSE, the exchange took cognizance of the contract notes and passed an arbitration award in favor of the complainant. This established that merely non-routing and non-reporting of the trades to the stock exchange doesn't invalidate the contract notes issued by the member. At the most, it can be treated as an irregularity on the part of the member.

**B.** The other important fact that there is a considerable difference in the debt market transactions' per day volume reported by NSE with the per day volume reported by Public Debt Office (PDO) of RBI. The volume reported by RBI's PDO is higher than the volume reported by NSE. This indicates that not all the trades relating to debt market were routed and reported to NSE by its members. All these deals were a part of 'off market trades' or what is called as 'C group trades'. Most of these deals were on principal to principal basis. These trades were never invalidated and no action was taken against the member for this violation or irregularity.

C. It is very important to understand the procedure and the practice followed by the Brokers/ the Company in execution and completion of the debt market transactions:

1. After receiving an enquiry from the client, the Company used to send them quotation, clearly mentioning the delivery period.
2. After getting confirmation from the client, the Company used to issue deal confirmation to the client and get their acknowledgement on the deal confirmation itself or by a separate letter. Once the deal was confirmed the Company issued contact note and party made the payment.
3. Based on the agreed delivery period and availability of the securities, the Company would book securities in physical form from the banks at a competitive rate. Then send the security for conversion to RBI in electronic form (d-mat) or for split or for consolidation as per the requirement of the contact note and terms of the trade. Usually RBI takes 30- 45 days for conversion and split/consolidation. Therefore, to avoid any dispute, the delivery period was agreed at the time of sending the quotation itself.

Most of the client with whom the Company used to deal, preferred to have the securities in the physical form. Therefore, the Company developed its niche in physical market. Normally, in debt market, government securities in SGL (D-Mat) form command premium compared to the same securities in physical form. The profit margin would improve if one buys securities in physical and sell/deliver them after converting in SGL. Most of the brokers/clients were well aware about this market practice and the time lag involved in procurement and conversion. Therefore, most of these deals were done without having securities on hand. In most of the cases procurement was done subsequent to deal confirmation and receipt of payment, which was an acceptable market practice.

### **The Company's credentials and track record:**

The Company was dealing in government securities since 1994-95. The annual turn over of the Company in debt market used to be in thousands of crores. The Company never defaulted on its commitments. Most of the clients were dealing with the Company for more than 3-5 years. The Company never had any intention or motive to defraud the clients. If criminal complain would not have been filed against the Company, it would have honored its commitments. Due to this criminal complaint, Company's bank accounts and its offices were sealed this forced the Company to shut down its business operations.

### **Current status:**

As on date more than 25 criminal cases are filed against the Company, its Directors and officers. The clients to whom the post dated cheques were given towards settlement of contracts have also filed cases under section 138 of N.I. Act., civil cases are also filed against the Company for recovery by its clients.

All assets of the Company are in the custody of State CID, Nagpur.

### **Effect of NSE taking cognizance of the contract notes issued by the Company:**

If the validity of contract notes is established the various clauses mentioned in the contract notes will get invoked and therefore all the matters per forced will be referred to the arbitration committee of the NSE with jurisdiction being Mumbai. This will ensure speedy redressal and recovery as compare to civil cases.

The most important facts are the Company heavily invested in the knowledge based assets especially in information technology and intellectual properties. The value of all these assets can be unlocked only with the active co-operation and the help of the management. The companies operating in the same segments and product line enjoy a market capitalization of more than Rs.2000/- crores. Thus, if the assets of the Company are well utilized it will definitely help in initiating the repayment process which is the ultimate aim of all the proceedings initiated against the Company.