

SECURITIES AND EXCHANGE BOARD OF INDIA**ORDER**

Under Section 12 (3) of SEBI Act, 1992 read with Regulation 27 of SEBI (Intermediaries) Regulations, 2008 in the matter of Paterson Commodities Private Limited.

NOTICEE	SEBI REGISTRATION NO.
Paterson Commodities Private Limited	INZ000075933

BACKGROUND

1. Paterson Commodities Private Limited ('Paterson' / 'Noticee') is registered with Securities and Exchange Board of India ('SEBI') as a stock broker under the SEBI (Stock Brokers) Regulations, 1992 ('Stock Broker Regulations'). Paterson is a member of the Multi Commodity Exchange of India Ltd. ('MCX'). The Noticee was earlier a member of the National Spot Exchange Limited (NSEL). The office of the Noticee is at Bhavani Mansion, No.3, 4th Lane, Nungambakkam High Road, Chennai-600034.
2. NSEL was incorporated in 2005 as an electronic platform for spot trading of commodities. On June 05, 2007, the Ministry of Consumer Affairs, Government of India, issued a Notification under Section 27 of the Forward Contracts (Regulation) Act, 1952 ('FCRA') granting conditional exemption from the provisions of FCRA for forward contracts of one day duration for sale and purchase of commodities traded on NSEL. The conditions, *inter alia*, placed an absolute bar on short sales and stipulated that all outstanding positions at the end of the day, must result in delivery of commodities. It was also stipulated that all information or returns relating to the trade as and when asked for shall be provided to the

Central Government or its designated agency. Thereafter, NSEL commenced operations in October 2008.

3. In September 2009, NSEL introduced, on its platform, the concept of '*paired contracts*', which involved buying and selling the same commodity through two different contracts at two different prices wherein investors could buy a short duration settlement contract and sell a long duration settlement contract and vice versa, with the same counterparty at the same time. In other words, paired contracts involved two simultaneous transactions being undertaken at the same time with the same counterparty- one being a purchase transaction (settling at T+2 or T+3) and the other being a sale transaction (settling at T+25 or T+36) at different prices on the platform of NSEL.
4. On February 6, 2012, the Department of Consumer Affairs, Government of India, vide Gazette Notification S.O. 228(E) partially amended the Notification dated June 05, 2007, to the effect that "*all information or returns relating to the trade as and when asked for shall be provided to the Central Government or Forward Markets Commission, Mumbai*"
5. Pursuant to the said notification, Forward Markets Commission ('FMC') called for trade data from the NSEL. On analysis of the data received from NSEL, FMC observed that "*55 contracts offered for trade on NSEL were with settlement periods exceeding 11 days and all such contracts traded on NSEL were in violation of provisions of FCRA*" and "*the condition of 'no short sale by members of the exchange shall be allowed' was not being met by NSEL*".
6. Subsequently, FMC, vide order No.4/5/2013-MKT-1/B dated December 17, 2013, inter alia, held that the contracts traded on NSEL violated the following conditions stipulated in the aforesaid notification SO906(E) dated June 05, 2007:

a. **Short Sale**

NSEL had not made it mandatory for the seller to deposit goods in its warehouse before taking a sell position. Hence, the condition of “*no short sale by members of NSEL shall be allowed*” was not being met by NSEL.

b. **Contracts with Settlement Period going beyond 11 (eleven) days**

Some of the contracts offered for trade on NSEL had settlement periods exceeding 11 days and such contracts were “*non-transferable specific delivery*” contracts under the FCRA. As per the FCRA, the “*ready delivery contracts*” were required to be settled within 11 days of the trade and hence, the contracts traded on the NSEL which provided a settlement schedule for a period exceeding 11 days were not allowed under the aforesaid notification.

7. As the Noticee was a member of NSEL and had participated in / facilitated trading in paired contracts on the NSEL platform, SEBI initiated enquiry proceedings against the Noticee under Chapter V of the SEBI (Intermediaries) Regulations, 2008 (‘Intermediaries Regulations’) and appointed a Designated Authority (‘DA’) vide order dated September 21, 2018, to enquire into whether the Noticee was ‘*fit and proper*’ to continue to hold the certificate of registration as Trading and Clearing Member in terms of Regulation 5 (e) read with Regulation 27 (iv) of the Stock Broker Regulations.
8. Upon completion of the enquiry, a Report (DA Report) dated July 31, 2019, was submitted by the DA to the Designated Member (‘DM’) recommending that the Noticee was not a fit and proper person in terms of Regulation 5(e) read with Regulation 27(iv) of the Stock Broker Regulations and Schedule II of the Intermediaries Regulations and the registration granted to the Noticee as a commodities derivatives broker be cancelled.

9. Pursuant to this, a post enquiry SCN (P-SCN) dated September 17, 2019, was issued to the Noticee, under Regulation 28(1) the Intermediaries Regulations, to show cause as to why action, as recommended by the DA or any other action as considered appropriate by the Designated Member, should not be taken against the Noticee. A copy of the DA's Report was also forwarded to the Noticee along with an advice to file a reply, if any, within 21 days from the date of receipt of the notice. The P-SCN issued to the Noticee *inter alia* highlighted the observations made by the Hon'ble Supreme Court and Hon'ble Bombay High Court in respect of paired contracts offered on the NSEL platform. The Noticee filed a reply dated October 14, 2019. A hearing was thereafter scheduled to be held on May 19, 2020. However, vide email dated May 14, 2020 the Noticee requested that the hearing be scheduled after restrictions on travel due to the COVID-19 Pandemic are eased. Subsequent to this, an opportunity of personal hearing was given to the Noticee on September 8, 2021. Thereafter, the Noticee filed additional written submissions vide letter dated September 9, 2021.
10. The summary of the submissions made on behalf of the Noticee during the course of the oral hearing and in the written submissions is given below:
- a. The Noticee stated that it had not participated and/or facilitated its clients' trading on NSEL in alleged paired contracts during the relevant period with malafide intent.
 - b. The Noticee is engaged in the business of commodity trading activities for 12 years and their track record with respect to compliance was never founding to be wanting at any point of time.

- c. The legitimate expectation of a stock broker is that if a product is introduced by a stock exchange, being “*paired contracts*” in the present case, it must be taken as legal and valid. A stock broker/ commodity broker cannot be suspicious about the conduct of the exchange to assume that a contract on the platform of stock exchange, on which the trades are undertaken in the regular course of business, was illegal.
- d. The Noticee was allotted a trading membership code on December 24, 2012 without applying for it. They were forced to take the membership by the MCX and they submitted the documents later.
- e. The total clients enrolled during the period of 3 years was only 41.
- f. The total number of clients whose money got stuck was 19 and the amount outstanding was Rs. 5.39 crores. Out of this amount, over Rs. 3,15,57,512.99 was from their own funds which constituted 58% of the balance outstanding and only 15 outside clients were affected. The brokerage earned by them was only Rs. 13,05,733/- for 3 years which is a pittance when compared to other broking houses.
- g. The SCN is general in nature and does not have specific charges as to their role.
- h. The basis on which they are stated to have participated or facilitated “paired contracts” is not shown in the SCN.
- i. The Noticee requested that it be allowed to surrender its membership.

11. Having considered the allegations levelled against the Noticee in the P-SCN, the submissions made on behalf of the Noticee and other materials available on record, I note that the limited issue that arises for consideration is whether the Noticee, having traded/facilitated trading of its clients in paired contracts offered on the NSDL platform, is 'fit and proper' to continue to hold the certificate of registration as a stock broker in terms of Schedule II of the Intermediaries Regulations read with Regulation 5 (e), 9 (b) and 9(f) of the Stock Broker Regulations.
12. I note from the material available on record that the Noticee was a member of NSEL and had allowed its clients to trade on the NSEL platform. I note that the Noticee has stated that only 41 clients, out of which only 19 had amounts due to them. It was also submitted that 58% of outstanding amount which was receivable by their clients was from Paterson's own funds.
13. In this regard, even accepting the submissions made by the Noticee, the fact remains that the Noticee had provided a trading platform, which allowed/facilitated its clients to take exposure to the paired contracts offered on the NSEL platform. Since the paired contracts were violative of the conditions stipulated in the Government Notification dated June 05, 2007, I am of the opinion that once as a member of NSEL, the Noticee executed trades either on its own behalf or on behalf of its clients, the quantum of such trades or number of occasions on which such trades were executed becomes immaterial, for the purpose of determining the compliance of the Noticee with the 'fit and proper' criteria.
14. The criteria for fit and proper person which has to be complied by registered securities market intermediaries is provided under Schedule II of the Intermediaries Regulations. Regulation 5(e) read with regulation 9(f) of the Stock Broker Regulations mandate

that fit and proper criteria are not just an eligibility criteria that need to be satisfied when an entity seeks registration with SEBI, but also a continuous requirement that has to be complied with as long as the entity is registered with SEBI. The relevant extracts of these provisions are reproduced below:

Stock Broker Regulations

“Consideration of application for grant of registration.

5.The Board shall take into account for considering the grant of a certificate, all matters relating to trading, settling or dealing in securities and in particular the following, namely, whether the applicant,-

.....

(e) is a fit and proper person based on the criteria specified in Schedule II of the Securities and Exchange Board of India (Intermediaries) Regulations, 2008;

Conditions of registration.

9. Any registration granted by the Board under regulation 6 shall be subject to the following conditions, namely,-

.....

(f) he shall at all times abide by the Code of Conduct as specified in Schedule II;”

Intermediaries Regulations

Schedule II

“Criteria for determining a ‘fit and proper person’

For the purpose of determining as to whether an applicant or the intermediary is a 'fit and proper person' the Board may take account of any consideration as it deems fit, including but not limited to the following criteria in relation to the applicant or the intermediary, the principal officer, the director, the promoter] and the key management persons by whatever name called –

(a) integrity, reputation and character;

(b) absence of convictions and restraint orders;

(c) competence including financial solvency and networth;

(d) absence of categorization as a wilful defaulter.”

15. The criteria provided in Schedule II of the Intermediaries Regulation are not exhaustive; they are more in the nature of indicative parameters that determine the 'fit and proper' aspect of entities. These parameters include *a) integrity, reputation and character; (b) absence of convictions and restraint orders; (c) competence including financial solvency and networth; (d) absence of categorization as a wilful defaulter.*

16. The Hon'ble Securities Appellate Tribunal ("SAT") in the matter of Jermyn Capital LLC v. SEBI had interpreted the scope of fit and proper criteria laid down by SEBI and observed that,-

“Good reputation and character of the applicant is a very material consideration which must necessarily weigh in the mind of the Board in this regard. Reputation is what others perceive of you. In other words, it is the subjective opinion or impression of others about a person and that, according to the Regulations, has to be good. This impression or opinion is generally formed on the basis of the association he has with others and/or on the basis of his past conduct. A person is known by the company he keeps. In the very nature

of things, there cannot be any direct evidence in regard to the reputation of a person whether he be an individual or a body corporate. ...”

17. I note that this issue has also been considered by the Hon’ble Tribunal in the matter of Mukesh Babu Securities Limited vs. SEBI (Appeal No. 53 of 2007), wherein it held that,-

“It is true that these are only allegations made in the charge-sheet and we are conscious that these are yet to be established in a court of law but from what is stated in the charge-sheet liaison between Shri. Mukesh Babu and the chairman of the Bank prima facie appears to be established. The CBI has alleged that there was criminal conspiracy among all the accused and that they have committed illegal acts which have resulted in wrongful loss to the depositors of the Bank and corresponding gain to the accused. The charges levelled are indeed serious and if established, they involve moral turpitude. We are unable to agree with the learned counsel for the appellant that the criminal case pending against Shri. Mukesh Babu and others has no concern with the securities market. It is through the terminals of the company that the chairman of the Bank had traded and incurred losses through speculative trading which losses have been made up by overdrawing money from the Bank. In these circumstances, the Board was entitled to take the view that the company was not a fit and proper person. It could not be said that Shri. Mukesh Babu or the company enjoyed good reputation within the meaning of the Fit and Proper Person Regulations.”

18. I, therefore, note that the Hon’ble Tribunal has held that good reputation and integrity are critical facets of the ‘fit and proper’ criteria laid down in the Intermediaries Regulations. It has also been held by the Hon’ble Tribunal that while determining whether an entity enjoys a good reputation, the observations, even if prima facie, made by Courts and other regulatory authorities would be relevant. I note that it is not disputed that the Noticee was a member broker of NSEL and was providing a trading platform enabling its clients to access the NSEL platform. It is also noted from the material available on record that by

2013-14, paired contracts represented 99% of the turnover of NSEL (excluding e-series).

The details of the same are given in the table below:

(Rs. crores)

Type of Contract	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14 (April - July)
Turnover excluding e-series	763	3,359	14,032	59,981	73,390	38,520
Paired contracts	0	848	6,207	18,100	71,127	38,204
% of paired contracts turnover	0%	25%	44%	30%	97%	99%

19. The role of NSEL in the matter of paired contracts has been examined by multiple agencies and Courts, extracts of which are reproduced below:

i. Observations of the FMC

FMC, vide order dated December 17, 2013, *inter alia* observed the following:

“.. It has also come to the knowledge of the Commission from the report of the forensic auditor that a large number of NSEL exchange trades were carried out with paired back-to-back contracts. Investors simultaneously entered into a “short term buy contract” (e.g. T+2 – i.e. 2 day settlement) and a “long term sell contract” (e.g. T + 25 – i.e. 25 day settlement). The contracts were taken by the same parties at a pre-determined price and always registering a profit on the long-term positions. Thus, there existed a financing business where a fixed rate of return was guaranteed on investing in certain products on the NSEL.....

NSEL conducted its business not in accordance with the conditions stipulated in the notification dated 05.06.2007 granting it exemption from the operation of FCRA, 1952, with regard to the one-day forward contracts to be traded on its exchange platform. As noted in the SCN, the condition of 'no short-sell' and 'compulsory delivery of outstanding position at the end of the day' stipulated in the notification were violated by NSEL. NSEL Board allowed launching of paired back-to-back contracts on its exchange platform comprising a short-term buy contract (T+2 settlement) and a long-term sell contract (T+25 settlement) with predetermined price and profit for the buyer and seller, which violated the very concept of spot market of commodities and the transactions ultimately were in the nature of financial transactions....." (emphasis supplied)

ii. Observations of Department of Economic Affairs, Ministry of Finance

Department of Economic Affairs, Ministry of Finance vide letter dated December 30, 2014 observed that *"This department is in agreement with FMC that NSEL has violated the first two conditions of exemption granted to it under section 27 of FCRA making it liable for appropriate action including penal action under section 21 of FCRA. Further, this department is also in agreement with the observations of Special Team of Secretaries that by offering contracts having settlement beyond 11 days, without obtaining recognition and/or registration, NSEL has also violated the Provisions of sections 5, 6, r/w 14A also making it liable for appropriate action including penal action under section 21 of FCRA."*

iii. Observations of Economic Offences Wing

Economic Offences Wing, Mumbai, vide letter 789 dated April 04, 2015, had forwarded an interim report on the investigation conducted to identify the role played by broking houses in NSEL Case (EOW C.R. No. 89/2013). EOW in its report had mentioned that a settlement obligation amounting to Rs. 5403.59 crore was due on the date of the closure of the business of NSEL. Relevant extracts of the report are as follows:-

“IV. Objectives of this investigation into the brokers’ role:

A scam of this magnitude would be difficult to continuously occur for 3 years without some of the large brokers’ gross negligence or perhaps active participation.

The actual role of the brokers was:

- *To bring in investors to invest in ‘pair trades’ promising them assured returns and the investors got about 13-16% p.a. for investing in the commodity*
- *The sellers got finance at 18-20 or more % by pledging their commodity in NSEL warehouses*

They got brokerage from investors on the NSEL platform, and those brokers who had their NBFCs got additional revenue by financing investors for investing on NSEL.

Though the matter is still under investigation, brokers have also received back from exchange certain charges collected from investors such as transaction fees, delivery and warehousing charges, etc. It is suspected that these are indirect motivation incentives for brokers to generate huge volumes. It is also possible that brokers may have benefitted from or compensated by the sellers or defaulters.

The higher the trading turnover, the higher revenues for the exchange and the brokers. Therefore, both wanted to increase turnover at the exchange.

In light of the foregoing, the objective of EOW in investigating brokers was to inquire whether they had been involved in any wrongdoing connected with trading on NSEL. Specifically to determine whether they participated in:

- a) Any activities which were detrimental to the investors, NSEL, or third parties. To determine whether they had made false and misleading representations, offered*

inducement, financing and deliberately made wrongful assertions purely to get brokerage and facilitate NSEL in generating higher volumes.

- b) Whether they had any illegitimate personal enrichment, or, there has been knowing dereliction in their duties as clearing and forwarding agents towards the commodities and protect the investors.*
- c) It was also deemed necessary to ensure that their activities were within the framework of law.”*

iv. Observations of the Hon’ble Bombay High Court

Hon’ble Bombay High Court, while deciding Writ Petition No. 2743 of 2014 dated December 04, 2017, in the matter of 63 Moons Technologies Limited v. Union of India observed:

“85] The very offer of T+18, T+25 or T+36 contracts by NSEL prima facie constituted breach of the condition that the exemption from applicability of FCRA was only in respect of contracts of one day's duration. There is really no dispute, either in facts or in law on this aspect because even FTIL in its list of dates and events at entry 4 against date 05.06.2007, accepts this position...

86] Further, apart from the note against entry 8 (November 2011 onwards) in the list of dates and events of FTIL, there is ample material on record which establishes that NSEL offered 'paired contracts' at its exchange from 2009 itself. Further, the record indicates and it has not been disputed that by the year 2013 the volume of paired contracts constituted almost 99% of the turn over at the NSEL exchange. In monetary terms, this turn over from 2009 to 2013 was in the region of Rs.1,34,000/- crores. Therefore, to say that all this was without the involvement or even knowledge of FTIL and NSEL and to attempt to blame 'certain trading clients, commodities sellers or brokers' is just not prima facie acceptable.

....

88] *The material on record, including in particular the presentations made by and on behalf of NSEL and the Grant Thornton Report establish that this modus operandi of paired contracts, was in reality, nothing but financing transactions. These contracts were invariably at predetermined prices and the long terms sell contract, was always at a profit, the difference effectively being the cost of lending. These paired contracts were obviously in breach of the conditions of the exemption notification and consequently the FCRA itself. Under the guise of offering spot delivery or ready delivery contracts, the NSEL Exchange indulged not just in forward trading but in financing unhindered by any regulatory checks which would, but for the exemption notification dated 5th June 2007 have applied to such operations.*

.....

90] *The FTIL in its pleadings as well as the list of dates, is really in no position to factually dispute the manner in which the operations were held at the NSEL Exchange. The NSEL itself has not even instituted any petition to question the impugned order, which takes cognizance of such facts. The learned counsel for NSEL when requested to comment on the operations at NSEL Exchange simply chose to submit that since the impugned order is based only on one ground or reason, namely, facilitating NSEL in recovering dues from the defaulters, there is no point in offering any comments or explanations about the operations at the NSEL Exchange. Even otherwise, there is extensive material on record in the form of Grant Thornton Report etc. which establishes that the operations at the NSEL Exchange were inconsistent with the conditions of the exemption notification dated 5th June 2007 and consequently the FCRA itself.*

...”

Further, the Hon’ble Court in the matter of Jignesh Prakash Shah v. The State of Maharashtra (Criminal Bail Application No. 1263 of 2014) observed that “... *the brokers*

through whom the so-called trade transactions were entered into, do have their own legal team and a full knowledge of how the market operates...”

v. Observations of the Hon’ble Supreme Court

These paired contracts were entered into between the same counterparties at a pre-determined price in such a manner that it always resulted in registering a profit on the long term position. The Hon’ble Supreme Court in the matter of 63 Moons Technologies Ltd. and Ors. v. Union of India (UOI) and Ors.¹ had observed that *“There is no doubt that such paired contracts were, in fact, financing transactions which were distinct from sale and purchase transactions in commodities and were, thus, in breach of both the exemptions granted to NSEL, and the FCRA”*.

20. It can, therefore, be noted from the above that multiple authorities, including the Hon’ble Supreme Court, have observed that NSEL was in effect running a financing transaction assuring a fixed rate of returns under the garb of paired contracts. Further, as stated above, such paired transactions represented an overwhelming majority of the trades on NSEL by 2013-14 and the Noticee was one of the commodity brokers that facilitated clients to trade paired contracts on the NSEL platform.
21. In this regard, I note that the admissibility of the prima facie observations as valid ground while determining the compliance with the fit and proper criteria has been accepted by the Hon’ble Securities Appellate Tribunal in the matter of Mukesh Babu Securities and the relevant portions of the Hon’ble Tribunal’s Order have already been reproduced in para 17 above.

¹ (2019)18SCC401

22. It is further noted that the long leg of the paired transaction involved contracts being settled on a T+25 or T+36 basis whereas the exemption granted by the Ministry of Consumer Affairs permitted NSEL to only offer spot delivery contracts. The notification issued by the Ministry was available in the public domain and even basic due diligence would have shown that the paired contracts were per se in violation of the said notification. The Noticee, by providing a platform for taking exposure to paired contracts has exposed its clients to the risk involved in trading a product that did not have regulatory approval, thereby raising doubts on the competence of the Noticee to act as a registered securities market intermediary.
23. The confidence of the investors in the integrity of the securities markets is critical for its orderly functioning. Stock Brokers play a vital role in this regard as they are not just the first point of contact for ordinary investors, but are also entrusted with clients' monies and securities. In view of the same, it becomes imperative on the part of the SEBI to ensure that only entities enjoying good reputation and having competence, i.e. satisfying the *'fit and proper'* criteria, act as stock brokers. The Noticee by allowing its clients to trade paired contracts which were ex facie illegal, as noted above, and that too for a period of a year, has failed in conducting its business in conformity with the standards expected to be maintained by registered securities market intermediaries.
24. In view of the aforesaid, I note that the reputation, competence, fairness, honesty, integrity and character of the Noticee is put into question by such dealings. The Noticee has fallen short of satisfying the aforesaid criteria, to the extent of its association with NSEL and the consequent exposure of its clients to paired contracts. I, therefore, find the Noticee not fit and proper in terms of Schedule II of the Intermediaries Regulations.

25. I also note that the Noticee has submitted that it has ceased operations and has requested that it be allowed to surrender its membership.

ORDER

26. I, in exercise of powers conferred under Section 19 of the Securities and Exchange Board of India Act, 1992 read with Regulation 27 of the SEBI (Intermediaries) Regulations, 2008, hereby cancel the certificate of registration granted to the Noticee, namely, Paterson Commodities P. Ltd. (SEBI Registration No. INZ000075933).
27. The Noticee shall, after receipt of this order, immediately inform its existing clients about the aforesaid direction in paragraph 26 above.
28. Notwithstanding the direction at paragraph 26 above, the Noticee shall allow its existing clients to withdraw or transfer their securities or funds held in its custody, within 60 days from the date of this order. In case of failure of any clients to withdraw or transfer their securities or funds within the said 60 days, the Noticee shall transfer the funds and securities of such clients to another registered stock broker within a period of 30 days thereon, under advice to the said clients.
29. This order shall come into force with immediate effect.
30. A copy of this Order shall be served on the Noticee and upon all recognized Stock Exchanges and Depositories.

Place: Mumbai

Date: October 13, 2021

G. MAHALINGAM

WHOLE TIME MEMBER

SECURITIES AND EXCHANGE BOARD OF INDIA