WHETHER SEBI IS REALLY PROTECTING THE RIGHTS OF THE INVESTORS: A CRITICAL ANALYSIS OF THE DHFL SCAM

Aditya Trehan*

ABSTRACT

4-Year Delay, 5 Lakh Crore Loss: A Failing Shield at SEBI? Red flags concerning DHFL's finances waved for years before SEBI's belated 2019 investigation, by which time investor losses exceeded 80%, according to a recent analysis. This paper dissects SEBI's response to the DHFL scam, revealing how insufficient audits (only 2 in 4 years despite red flags in 3 financial reports), lax regulations, and systemic flaws left millions of small investors financially devastated and struggling to rebuild their lives. We argue that SEBI's current approach requires fundamental reforms to strengthen regulatory mechanisms, enhance transparency, and expedite action to prevent future mega-frauds and restore confidence in India's financial system.

BRIEF INTRODUCTION

The DHFL incident, which is regarded as one of the worst financial frauds in Indian history, included the Wadhawan brothers' systematic deceit of investors to rob them and cause instability in the financial system. According to new research, DHFL syphoned off huge quantities of money through a complicated web of bogus loans and shell businesses. This resulted in severe losses for millions of investors, especially small depositors, reaching 80% of their investments. Even though financial records started to show anomalies and disparities in 2015, raising red flags, SEBI took four years to act and only carried out two audits despite serious warnings. This slow reaction, together with loose rules and little supervision, was a primary cause of the enormous financial losses and destroyed investor trust. The Supreme Court's recent decision to maintain SEBI's assessment against the Wadhawan brothers serves as a stark reminder of the pervasiveness of regulatory neglect and emphasises the pressing need for significant changes to improve SEBI's ability to safeguard investors and avert similar mega-frauds in the future.

*SECOND YEAR, SYMBIOSIS LAW SCHOOL, NAGPUR.

DHFL'S GAME OF SMOKE AND MIRRORS

The DHFL scam had a lot of malpractices being followed at its core such as Inflated loan books, concealing bad loans, diversion of funds to shell companies and related party transactions etc.

DHFL created a nexus of shell companies, which were not genuine and did not do any business, diverted funds to these companies' creating illusions of financial health, and inflating their loan books. The loan amounts meant for shell companies were also often diverted to private entities which were again controlled by the Wadhawan Brothers thus creating fictitious transactions, and inflated invoices. These inflated loan books misguided investors, which provided DHFL with a surplus pool of funds that were later misappropriated.

DHFL concealed bad debts, when a person defaulted on loan payments, DHFL did not classify and recognize them as bad debts, rather they provided surplus money for the repayment of loans and restructured debts[1]. DHFL used short-term instruments such as commercial papers[2] and asset sales[3] to show the inflow of cash in their account and thus gaslight investors into investing surplus funds into their firm.

By temporarily raising important financial parameters[4] including the debt-to-equity ratio and current ratio and making them seem less risky and more appealing to investors, DHFL was able to give the appearance that nothing was wrong. Because of these better criteria, higher credit ratings[5] from agencies may increase investor trust even further. They created a false impression of profitability and concealed the real amount of bad loans through innovative manipulation and accounting loopholes, which resulted in deceptive financial statements[6].

The use of window dressing avoided having to deal with problematic loans sooner than necessary. Disregarding the fundamental issue just made it worse and contributed to DHFL's demise. By using window dressing to trick creditors and investors[7], a corporation that was close to bankruptcy was able to take on more debt. Both people and institutions suffered large

---

[1] https://www.outlookindia.com/business/what-is-dhfl-scam-india-s-biggest-ever-bank-loan-fraud-all-you-need-to-know-about-rs-34-000-crore-dhfl-scam-news-204346
[2] https://www.sebi.gov.in/enforcement/orders/oct-2021/order-in-the-matter-of-dhfl-ltd-_53447.html
[3] https://www.moneycontrol.com/news/business/stocks/pnb-shares-tumble-4-on-rs-3600-crore-dhfl-loan-fraud-5530761.html
[4] https://ideas.repec.org/a/spr/rvmgts/v13y2019i2d10.1007_s11846-017-0254-z.html
[5] https://m.economictimes.com/news/india/dhfl-bank-fraud-court-grants-interim-bail-to-businessman-in-rs-34615-cr-scam/articleshow/93911884.cms
[6] https://www.sebi.gov.in/enforcement/orders/oct-2021/order-in-the-matter-of-dhfl-ltd-_53447.html
[7] https://edufrogs.com/window-dressing-of-financial-account-is-fraudulent-accounting-essay/

financial losses[8] because of this. Future investments were discouraged, and India's financial image was harmed by dishonest tactics, which also reduced confidence[9] in DHFL and the larger financial system.

A transient fix rather than a long-term one might be window dressing. It puts up a front of financial security while ignoring the underlying issues that lead to financial hardship. In the end, DHFL's dependence on this dishonest strategy just made their problems worse and accelerated their demise.

SEBI'S FAULT

1) Inadequate Supervision and Audits: Red signals that SEBI failed to notice during the DHFL scam were many. Internal audit[10] warnings and investor concerns were disregarded by SEBI despite audits revealing disparities in loan values and an increase in past-due loans. There were major oversight gaps since the audits were sporadic and did not meet industry norms for high-risk firms like DHFL. This was made worse by DHFL's prolonged unregulated operations, outmoded technology, inadequate risk-based supervision, and a shortage of trained staff. Drawing on successful oversight techniques used elsewhere, SEBI needs to make major enhancements to manpower, technology, and risk assessment methodology to avert similar tragedies. Although more investigation is necessary for a thorough study, this synopsis demonstrates the obvious flaws in SEBI's oversight procedures that enabled the DHFL scam.

2) Delayed Interventions: Red flags, like investor complaints and inflated loan values, were flying high around DHFL as early as 2017[11]. Yet, it took SEBI until 2020, after significant media pressure and public outcry, to even begin an investigation. By the time concrete action[12] was taken in 2021, DHFL had already inflicted devastating financial losses. This two-to-four-year delay allowed DHFL to inflate loans further, attract unsuspecting investors, and postpone the inevitable reckoning. The consequences were severe, exacerbating financial losses and eroding investor confidence in the system.

[8] https://www.riksbank.se/globalassets/media/rapporter/ekonomiska-kommentarer/engelska/2019/bad-loans-and-their-effects-on-banks-and-financial-stability.pdf
[9] https://www.fsb.org/
[10] https://bsmedia.business-standard.com/_media/bs/data/announcements/bse/29062018/90571619-5bc1-49dc-a784-9645d3275b4c.pdf
[11] https://www.bloomberg.com/opinion/articles/2023-09-05/india-sebi-faces-an-uphill-battle-against-finfluencers
[12] https://www.sebi.gov.in/enforcement/orders/mar-2023/revocation-order-in-the-matter-of-dewan-housing-finance-corporation-limited-_68800.html

3) Lax Regulations and Exploited Loopholes: DHFL wasn't just reckless, it was operating within a system riddled with loopholes. Their reliance on short-term commercial paper masked underlying weaknesses, while questionable asset sales to related parties inflated financials on paper. Opaque transactions with connected entities made it a maze to follow the money, and ambiguous loan classification norms allowed bad loans to masquerade as healthy assets. International best practices offer a stark contrast, highlighting the need for clear, detailed regulations that plug these gaping holes.

4) Inadequate Disclosure and Hidden Depths: Transparency wasn't DHFL's forte, and existing NBFC disclosure requirements at the time were woefully inadequate. The lack of mandatory stress testing data disclosure allowed them to hide bad loans like skeletons in the closet. Related party transactions were shrouded in secrecy, and off-balance sheet liabilities lurked unseen, casting doubt on the true picture of their financial health. To regain trust, the system needs stricter accounting standards, real-time loan classification updates, and enhanced disclosure requirements for these shadowy areas.

5) Communication Failures and Eroded Trust: When the scam unravelled, SEBI fumbled the communication game. Withholding information, issuing confusing statements, and delaying public updates only fueled the fire of public distrust. Investors felt misled, and the public questioned SEBI's ability to protect their interests. To rebuild trust, clear explanations, regular updates, and open communication channels are crucial. SEBI needs to step out of the shadows and engage proactively with stakeholders and the media, demonstrating transparency and accountability.

THE DEVASTATING TOLL

The DHFL swindle was a human tsunami as much as a financial one. 80% of the hard-earned money of almost 50 million small investors—mostly middle-class and lower—vanished[13]. Years of savings for kids' schooling, health care, and retirement plans disappeared, leaving countless families bankrupt and with broken hopes[14]. Think of a pie chart; the remaining portion is what's left. The enormous dark wedge is the 80% that was torn away, signifying

[13] https://www.moneycontrol.com/news/business/dhfl-offloads-loans-worth-rs-2000-crore-to-offshore-investors-4123491.html

[14] https://www.washingtonpost.com/world/2022/10/27/indias-wire-says-it-was-deceived-by-staffer-articles-about-instagram/

millions of people who were bankrupted[15] forced to borrow money, or depended on charity. This was a tragedy that took futures, not just a scandal.

AFTERMATH

The DHFL crisis, a financial earthquake on a historical scale, shocked the Indian financial system to its core. Millions of small investors lost their hard-earned money, leaving a path of mistrust and financial instability. However, amid the rubble, a symphony of regulatory change and increased monitoring has evolved, intending to rebuild the ravaged ecology and prevent future disasters. The changes that happened as a result are:

1) Bringing NBFC's under the IBC Overture: The DHFL crisis, a financial earthquake on a historical scale, shocked the Indian financial system to its core. Millions of small investors lost their hard-earned money, leaving a path of mistrust and financial instability. However, amid the rubble, a symphony of regulatory change and increased monitoring has evolved, to rebuild the ravaged ecology and prevent future disasters. Let's have a look at the five main notes that echo in this post-DHFL Symphony.[16]

2) Tighter governance and accounting practices: The DHFL crisis revealed serious flaws in several NBFCs' governance and accounting standards[17]. Regulatory authorities, such as the RBI, responded by tightening the scoring and implementing harsher criteria as the primary mechanisms. Enhanced capital adequacy regulations, stronger liquidity standards, and tougher disclosures for linked party transactions serve as the melody, bringing openness and accountability to the NBFC industry[18].

3) Focus on Stressed Asset Revaluation: The DHFL case highlighted the critical need for a comprehensive plan to address the stressed assets afflicting the banking industry. The government is considering a variety of measures, including a revised FRDI Bill[19][20], to find a workable solution for struggling financial institutions. Addressing popular concerns about the

[15] https://www.bloomberg.com/news/articles/2022-12-05/credit-suisse-appeals-600-million-in-damages-over-mishandling-of-rogue-banker
[16] https://rbi.org.in/Scripts/BS_ViewNBFCNotification.aspx
[17] https://www.rbi.org.in/commonperson/English/Scripts/Notification.aspx?Id=537
[18] https://rbi.org.in/Scripts/BS_ViewMasCirculardetails.aspx?id=9820
[19] https://prsindia.org/billtrack/the-financial-resolution-and-deposit-insurance-bill-2017
[20] https://indianexpress.com/article/business/banking-and-finance/modified-frdi-bill-up-for-discussions-7702781/

"bail-in" language, the amended measure aims to create a unifying theme that protects investors while allowing effective settlement.

4) Increased Investor Awareness and Protection: The DHFL fraud revealed investors' vulnerabilities, especially those navigating the complexity of NBFCs. Regulatory authorities, such as SEBI, stepped in to improve investor knowledge and protection[21]. The rhythm section consists of initiatives to promote financial literacy[22], responsible reporting by the media and financial advisors, and effective grievance redressal processes, which provide investors with knowledge and options. Furthermore, fostering ethical business practices within the NBFC sector creates a conducive climate for investor trust.

5) Ongoing Investigations and Proceedings: The DHFL crisis continues, with organisations like as the CBI and ED working relentlessly to investigate the counterfeit notes. Legal actions against the defendants are the ultimate coda, guaranteeing accountability for the discordant symphony known as the DHFL swindle. The findings of these investigations and legal proceedings have the potential to result in additional regulatory and legal reforms, defining the future of the financial system and securing justice for individuals harmed[23].

CONCRETE SOLUTIONS AND FURTHER THOUGHTS

The DHFL scandal shocked India's banking system to its core. Millions of tiny investors' aspirations were dashed, leaving behind an archipelago of distrust. In this devastated setting, restoration needs more than simply patching gaps, but a thorough structural redesign. The following changes in reforms can be proposed:

1) Strengthening Oversight: The DHFL swindle uncovered a slew of flaws in the financial system, creating a disturbing dissonance where harmony should exist. To prevent such tragedies from occurring again, we must enhance the supervision orchestra, tuning each instrument to perform properly.

2) Sharpening Supervision: NBFCs such as DHFL can no longer operate in the shadows. Rigorous, frequent audits must become the standard, with data analytics and forensic

---

[21] https://investor.sebi.gov.in/

[22] https://www.rbi.org.in/FinancialEducation/

[23] https://indianexpress.com/article/india/cbi-files-charge-sheet-dhfls-ex-cmd-kapil-wadhawan-74-others-8210933/

accounting used to detect even the smallest traces of wrongdoing. These aren't just melodies; they're sonatas of attentiveness, assuring financial stability with unwavering accuracy.

3) Stressing symphony testing: Financial stability cannot be an illusion. Mandatory stress testing, with clear findings made widely available, will serve as the conductor, taking investors through simulated storms to measure the orchestra's resilience. Only then can investors put their confidence in the music, without fear of abrupt discord and financial catastrophe.

4) Regulatory Harmony: Information silos have no place in this ensemble. It is critical that SEBI, the RBI, and other regulatory organisations communicate and collaborate effectively. Only by working together can they completely comprehend the financial system's complicated score, avoiding dissonance and protecting investor interests.

CONCLUSION

The DHFL fraud was more than simply a financial theft; it was a human tsunami. Millions of tiny investors, the lifeblood of India's economy, saw 80% of their aspirations and money wiped out. SEBI, the ostensible watchdog, fell asleep at the wheel, lulled by loose regulations and communication errors.

Post-scandal adjustments are welcome, but band-aid solutions will not suffice. India's financial fortress needs a comprehensive rebuilding. Rigorous audits and stress testing must be implemented as watchtowers, with data-driven vigilance serving as an unassailable moat. Regulatory silos must be broken down and replaced with a united symphony in which SEBI, RBI, and others collaborate to safeguard the people. Only then will trust emerge from the ruins, and India's financial future be constructed on a foundation of hopes and savings.