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DUE DILIGENCE EXERCISE: DEMYSTIFYING THE DUTY OF MERCHANT BANKERS IN INDIAN SECURITIES LAW REGIME

Mansi Mishra*

Abstract

The Securities and Exchange Board of India, after much deliberation, adopted a disclosure based regulatory regime. This framework rests on the disclosure of relevant details by issuers, acquirers and intermediaries about their products, themselves and the regulations for facilitating informed decision making by potential investors. Adequate, timely and fair disclosures form the cornerstone of any disclosure mandated by the Board. In this regard, merchant bankers have been vested upon with the solemn onus of exercising due diligence by examining veracity of disclosures made by issuers in securities' transactions. This duty has attained gravity because it decides the fate of companies inclined to enter the securities' market. It is a means of preventing unscrupulous companies from defrauding investors and other stakeholders. Consequently, it becomes essential to regulate the duty of due diligence and prevent collusion by merchant bankers with issuer companies. This gives rise to various questions: - What is the statutory framework that governs due diligence by merchant bankers? What is the standard of this due diligence? How to determine the threshold of materiality of disclosures to be made by merchant bankers? What are the penalties for negligence in due diligence? Are there any factors that mitigate such penalties? In this article, the author shall provide answers to all the aforementioned questions. The author shall further provide analytical insights as to whether the interpretations and approaches adopted by the Regulator are effective in regulating due diligence exercise and furthering the aim of investors' protection.

INTRODUCTION

Since the inception of Securities and Exchange Board of India ("*SEBI*") in 1992, the capital markets in India have witnessed systematic reforms for protection of interests of investors.

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The most beneficial reform from investors' perspective has been the shift to a disclosure based regulatory regime. This framework involves disclosure of relevant details by issuers and intermediaries pertaining to themselves, the market, the products and the regulations in order to facilitate the investor to take informed investment decisions.[1] As such, SEBI is mandated to protect the interest of the investors and the securities market, and in pursuance of the same, it monitors both initial and continuous disclosures. In order to obtain assistance in smooth functioning of the disclosure based regime, SEBI enacted the SEBI (Merchant Bankers) Regulations, 1992 ("*Merchant Bankers Regulations*"). Merchant Bankers play a unique role in advancing the aim of investor protection by ensuring veracity of disclosers made by an issuer or an acquirer in the offer documents and other public documents. This process is termed as due diligence. Thus, the importance of due diligence conducted by merchant bankers cannot be over-emphasized.[2] This article seeks to discuss the obligation of conducting due diligence vested upon merchant bankers in Indian securities law regime and scrutinize certain aspects pertaining to it. Part I discusses the statutory framework providing for merchant bankers' duty of exercising due diligence in various securities transactions. Part II delves into the aspect of the standard of care and caution required to be exercised by merchant bankers while discharging responsibilities related to due diligence. Part III elucidates upon the importance of determining materiality of information for disclosure during due diligence, and the test prescribed for assessing such materiality. Part IV seeks to identify and examine the factors that result in mitigation of penalty for negligence by merchant bankers due diligence. Part V concludes the article and stresses upon importance of clarification of anomalies.

Statutory Framework

SEBI monitors the authenticity and adequacy of disclosures by casting solemn onus on merchant bankers to conduct due diligence before an offer document or other public documents are made available to potential investors. Currently, the legislation forming the foundation of merchant bankers, statutory duty of due diligence is the prescribed Code of Conduct under the Merchant Bankers Regulations, adherence to which is mandatory[3]. The Code of Conduct requires a merchant banker to protect the interests of the investors and to fulfill its obligations in a prompt, ethical and professional manner[4], while exercising

1 *Office of Investor Assistance and Education*, Securities and Exchange Board of India,(May 2, 2020, 11:00AM), https://investor.sebi.gov.in/ipms.html.

2 *In the Matter of IPO of PG Electroplast Limited in Respect of M/s. Almondz Global Securities Limited*, 2012 SCC OnLine SEBI 117, ¶9 (India).

3 Securities and Exchange Board of India (Merchant Bankers) Regulations, 1992 §3.

4 Securities and Exchange Board of India (Merchant Bankers) Regulations, 1992, Code of Conduct §3.

due diligence and independent professional judgment at all times.[5] The aim behind such an obligation is the adequate supply of true information to the investors and making them aware of the underlying risks associated with an investment decision.

The Code of Conduct further requires merchant bankers to make timely disclosures to the investors in a timely manner in accordance to the applicable regulations and guidelines to enable investors to make a balanced decision.[6] In the words of the Securities Appellate Tribunal ("*SAT*") in the matter of *Enam Securities Private Limited v. SEBI*[7]:

"*The Code of conduct places an onerous duty on a merchant banker not only of protecting the interest of the investors but also of ensuring that adequate disclosures are made in a timely manner without making any misleading or exaggerated claims and to render best possible advise to the clients. A merchant banker is required to maintain high standards of integrity, dignity and fairness in the conduct of its business and is required to promptly inform the Board any violation or non-compliance of the regulatory framework that come to its notice*".

While Merchant Bankers Regulations is a blanket legislation governing the merchant bankers' duty of due diligence, there are regulations pertaining to specific securities transactions requiring merchant bankers to conduct due diligence. When acting in the capacity of an underwriter, SEBI (Underwriters) Regulations, 1993 mandate merchant banker to exercise of due diligence, independent professional judgment and proper care.[8] In a buy back transaction, the merchant banker appointed by the company under the SEBI (Buy Back of Securities) Regulations, 1998 is required to verify the contents of draft letter of offer as well the public announcement to ensure that they are true, fair and adequate by performing due diligence. The same has been incorporated in the provisions[9] of the SEBI (Buy Back of Securities) Regulations, 2018 as well. Furthermore, the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009 provide for appointment of merchant bankers as lead managers to the issue who are required to conduct due diligence and satisfy themselves about the veracity of disclosures made in the offer documents.[10] Additionally, merchant bankers are obligated to carry out due diligence and verify the

5 *Id.* §4.

6 *Supra* note 5, §8.

7 *Enam Securities Private Limited v. SEBI*, 2012 SCC OnLine SAT 29, ¶3 (India).

8 Securities and Exchange Board of India (Underwrites) Regulations, 1993, Code of Conduct for Underwriters §5.

9 Securities and Exchange Board of India (Buy back of securities) Regulation, 2018 §16, §25(viii).

10 Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009 §121 §24(3).

disclosures under the SEBI (Issue and Listing of Debt Securities) Regulations, 2008[11]. The same has been reiterated under the SEBI (Substantial Acquisition of Shares and Takeover) Regulations, 2011[12].

Despite such regulations in place for merchant bankers' duty of due diligence, there is no statutory framework laying down binding due diligence norms governing and elaborating upon the said duty. The blanket legislation and the detailed legislations for each securities transactions simply provide for the duty, instead of giving clear directions as to the necessary steps that the Regulator expects the merchant bankers to take in the due diligence process. Furthermore, there are no basic guidelines that could clarify the essential requirements of the process, neither is there any codified minimum threshold which, if not met with, would amount to negligence. SEBI recognized the same in 2011, and approached the Association of Merchant Bankers of India ("*AMBI*"), now Association of Investment Bankers of India ("*AIBI*"), to frame guidelines for due diligence for its members.[13] The Regulator had instructed AMBI to include norms for verification of corporate records and specific instructions on the method of conducting due diligence of promoters, company management and group companies for protecting investors' interest. Thereafter, AIBI brought out the Due Diligence Manual ("*Manual*") in 2012.[14] However, the Manual is merely indicative in nature and does not have the force of law, as stated in the Manual[15] itself. Even so, no steps have been taken till date towards imparting to it the imperative binding value so as to provide merchant bankers with guidelines recognized by SEBI. Another limitation of the manual is that it has set out guiding principles for due diligence to be performed only within the scope of SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009. Interestingly, even though formulated on the behest of SEBI itself, the Manual has never been cited as a recognized or generally accepted set of rules of due diligence by SEBI, SAT or any Court of law, which could be useful for merchant bankers in understanding SEBI's

11 Securities and Exchange Board of India (Issue and Listing of Debt Securities) Regulations, 2008 §26(2) (India).

12 Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 §12; *see SEBI v. Meghraj SP Corporate Finance*, 2006 SCC OnLine SAT 632, ¶3.11(India).

13 Mehul Shah, *Regulator Wants Due Diligence Norms for Merchant Bankers*, Business Standard (Jan. 20, 2013, 10:58 PM), https://www.business-standard.com/article/markets/regulator-wants-due-diligence-norms-for-merchant-bankers-111070800042_1.html; Bijith R, *AMBI Gets Cracking on Due Diligence Guidelines for Merchant Bankers*, Financial Express (Aug. 31, 2011, 07:13 AM), https://www.financialexpress.com/archive/ambi-gets-cracking-on-due-diligence-guidelines-for-merchant-bankers/839377/.

14 *About Us*, ASSOCIATION OF INVESTMENT BANKERS OF INDIA,(Apr. 30, 2020, 09:00AM), http://www.aibi.org.in/about.asp

15 *Due Diligence Manual*, Association of Investment Bankers of India (Aug12, 2012, 09:00AM), http://www.aibi.org.in/AIBI%20Due%20Diligence%20Manual.pdf, p.6.

stance. Therefore, there continues to persist unavailability of detailed guidelines of binding character prescribing basic steps to be followed by merchant bankers which SEBI would consider to constitute proper due diligence.

Standard of Due Diligence

The disclosure based regime in Indian securities market is not static, but possesses an evolving character. As a result, the process of due diligence itself is dynamic and complex in nature. Whilst due diligence is not defined in any statue, in practice the phrase generally constitutes collection of information about the acquirer or an issuer that would assist the merchant bankers in drafting and assessing the disclosures made in the offer documents.[16] The particulars which are required to be disclosed are intended to give a clear picture to a member of the company or prospective investors to the purpose for which the securities are being transacted and by whom.[17] However, both the Manual and the Code of Conduct are silent as to what is the standard of due diligence that is expected from merchant bankers involved in securities transactions.

This gap with respect to the requisite standard created by the silence has been attempted to be filled by the judicial precedents, which reveal that due diligence is concerned with efforts made, *bona fide* conduct of the merchant banker concerned and the facts and circumstances amid which such merchant banker acts.[18] There is no prescribed strait-jacket formula or fixed benchmark of due diligence and the law requires only 'reasonable diligence' even from the experts including merchant bankers.[19] In order to better put forth the standard of due diligence, it would be pertinent to mention the case of *Chander Kanta Bansal v. Rajendar Singh Anand*[20], wherein the Honorable Supreme Court had held that due diligence in law means reasonable diligence and doing everything reasonable and not everything possible. The meaning of the expression "due diligence" was elaborated upon by the Apex Court in the following words:

> *"According to Oxford Dictionary (Edn. 2006) the word "diligence" means careful and persistent application or effort. "Diligent" means careful and steady in application to one's work and duties, showing care and effort.*

16 *Supra* note 16 at 30.

17 *Shirish Finance and Investment (P.) Ltd. v. M. Sreenivasulu Reddy*, 2002 (1) BomCR 419, ¶58 (India).

18 *Imperial Corporate Finance & Services Pvt. Ltd. v. SEBI*, 2005 61 SCL 197 SAT, ¶21(India).

19 *Almondz Global Securities Ltd. v. SEBI*, 2016 SCC OnLine SAT 219, ¶39; Shadi Lal Batra v. Unknown, AIR 1968 Delhi 283, ¶17(India).

20 2008 (5) SCC 117.

> *As per Black's law Dictionary (18 Edn.), "Due Diligence" means the diligence reasonably expected from, and ordinarily expected by, a person who seeks to satisfy a legal requirement or to discharge an obligation. "Due Diligence" means reasonable diligence; it means such diligence as a prudent man would exercise in the conduct of his own affairs".*

In another case of *SEBI v. JM Morgan Stanley Private Limited* [21], SAT had placed reliance upon the dictionary meaning of the said words as defined in the Law Lexicon (2nd Edition) which provided that diligence implies the care and prudence as is usually by persons of common or average care and prudence. Whether or not there is a lack of due diligence runs from the facts of each case and ultimately, there is no hard and fast rule as to what constitutes lack of due diligence.[22] In fact, it has been held that the merchant banker cannot be expected to look at each and every statement and information provided by the issuer with suspicion unless the facts and circumstances at the relevant time so demand.[23] In order to prove a fault in due diligence, there must be a convincing preponderance of evidence, as held by the Supreme Court in the case of *Pandurang dattatray Khandekar v. Bar Council of India* [24]. The Apex Court further clarified that before any violation of the concept of due diligence is found, there must be an enquiry and the finding must be sustained by a higher degree of proof than that required in a civil suit, but falling short of the proof required to sustain a conviction in a criminal prosecution.

However, upon observation, it becomes evident that this standard of reasonableness has acquired a stricter enforcement in the current regime. That is to say that the reasonableness cannot be equated with immunity from exercising due care. In fact, the disclosure based regulatory regime has resulted in imposition of heavier responsibility on merchant bankers of issuers of securities in respect of the accuracy and completeness of the information disclosed by them.[25] The premise underlying such a standard of due diligence is that the access to securities market for issuers and acquirers, as per the case, is conditional upon the disclosures verified by the merchant bankers. Probably, that is the reason why SEBI has tightened its approach in interpreting the established standard of prudence. It follows from the above that a merchant banker is not required to assume the role of a detective and look at every statement or document possible. In other words, the job of due diligence performed

21 2005 SCC OnLine SAT 79, ¶6.

22 *Supra* note 19.

23 Order in matter of *M/s. Karn Merchant Bankers Limited,* AO No. EAD/BJD/BKM/99/2017-18, ¶15.

24 AIR 1984 SC 110, ¶6.

25 Ad-Interim Ex-Parte order in the Matter of *Bharatiya* Global *Infomedia* Ltd., 2011 SCC OnLine SEBI 155, ¶2.9.

by merchant banker cannot be limited to mechanical perusal of documents submitted to it. Neither can it be equated to disclosing whatever is given to it by the issuer. Rather it involves exercise of reasonable diligence to ensure adequate, true and fair disclosures in an offer document, prospectus or other public documents. This standard has been rightly set at reasonableness expected from a prudent person. However, the push of the Regulator towards stringency and stricter enforcement has tended to dissolve the element of reasonableness, even though the orders and judgments continue to pay lip service to it. This has given rise to the need of codification of the standard in the Code of Conduct itself in order to provide a clear picture to the merchant bankers with regards to the dynamics of the role that SEBI expects them to perform. Such codification also becomes imperative for assisting merchant bankers to differentiate between what could amount to a negligent conduct and what kind of actions by merchant banker could give rise to charges of collusion.

Materiality of Disclosures

The guiding principle in any disclosure-based regulatory regime is the need for the issuers of securities to provide the potential investors with full, accurate and timely disclosure of all relevant information in respect of the issuer and the security being issued.[26] The underlying object of disclosure provisions in Merchant Bankers Regulations is to ensure that the offer document contains all disclosures that are material for the applicants permitted to participate in the transaction to take an informed investment decision.[27] The merchant bankers discharge the duty of ensuring that the aforementioned requirement of adequacy of material disclosure is met with. Hence, it becomes pertinent to analyse the concept of materiality, which assists merchant bankers in determining as to what is material enough to disclose. The analysis of materiality serves the purpose of shaping the content of mandatory disclosures. Additionally, it crystallizes the content of non-mandatory disclosures made for the sole purpose of clarification in order to avoid misstatements. While the mandatory disclosures are straightforward in nature and do not involve exercise of professional judgment on part of the merchant banker, it is the clarifying disclosures whose absence can result in potential misstatements. The Merchant Bankers Regulations do not provide any threshold of materiality of disclosures. This glaring absence of a threshold renders scope for conflict between the judgment of materiality of a particular disclosure by SEBI and by the merchant banker. Another plausible consequence constitutes merchant bankers getting away with omissions in disclosures resulting from collusion with issuer companies, on the

26 *Supra* note 3.

27 *Kotak Mahindra Capital Company Limited v. SEBI*, 2016 SCC OnLine SAT 201, ¶14 (India).

pretext that in that their reasonable and professional judgment, the particular information was not material enough to be disclosed.

The vacuum around the position with regards to materiality of disclosures in offer documents by merchant bankers was put to an end in 2016 in the SEBI Adjudication Order in the matter of *M/s Electrosteel Steels Limited ("ESL") and M/s Electrosteel Castings Limited ("ECL")*.[28] ECL was the parent company of ESL and the former had promoted the latter in 2006 post a Memorandum of Understanding (MoU) with the Government of Jharkhand for setting up a steel manufacturing plant. Iron ore being a core raw material in the manufacturing process, ECL had applied to Ministry of Environment and Forests ("*MoEF*") for project clearance for obtaining iron ore mining blocks in Jharkhand. The said application got rejected in January, 2009. However, the matter of rejection was being reconsidered by the MoEF on request made by the Government of Jharkhand in July, 2009. In the meanwhile, ESL floated an Initial Public Offering ("*IPO*") in March, 2010 and completed the same in September, 2010. The MoEF gave the clearance only after the completion of the IPO. The substantive legal question for consideration before SEBI was whether the rejection of the application made by ESL to MoEF with regards to project clearance constituted 'material' information which ought to have been disclosed in the offer documents pertaining to ESL's IPO.

SEBI *vide* its Adjudication Order penalized, among other parties, the merchant banker in the case for failure to exercise due diligence by not disclosing the rejection of the said application which constituted 'material' information for prospective investors. With regards to the materiality of disclosures by merchant bankers, SEBI observed the following:

> "*Assessment of the materiality of an event or development requires a contextual determination that takes into account all of the relevant circumstances, including the nature of the event or development and its consequences to the issuer's business.… Thus, true and adequate disclosure is said to be made, if the disclosure is accurate and not misleading and does not omit a fact that is either material itself or is necessary to understand the facts that have been disclosed, so as to enable the investors investing in the issue to take an informed investment decision*".

SEBI further clarified that the subjective assessment or optimistic views of the issuer do not have any role to play in materiality analysis done by merchant bankers. Instead, the test of materiality is of objective nature. SAT, while upholding SEBI's finding with respect to the

28 Adjudication Order in the matter of *M/s Electrosteel Steels Limited and M/s Electrosteel Castings Limited*, AO No. AK/AO- 8-12/2016 (2016).

materiality of information, observed that the letter and spirit of the disclosure requirement is such that by disclosing every material event in clear terms, there is no scope left for judging the degree of materiality.[29] The emphasis has to be placed on disclosure, not otherwise. In other words, the merchant banker has to disclose even when the issuer has doubts regarding existence of element of materiality in the information concerned. The only facts that can be ousted from the purview of disclosure are those which the issuer is undoubtedly sure of lacking relevance to the issue.[30]

While SEBI favored the assessment of materiality from the perspective of a reasonable investor, SAT limited the scope of subjective analysis and shifted the onus upon the issuer to be sure about any piece of information being irrelevant. Furthermore, the SAT order mandating to disclose all information that is relevant to the issuer without determination of the relevance of that information to the investors runs contrary to the mandate of Merchant Bankers Regulations. In this regard, the Code of Conduct explicitly provides that merchant banker has to ensure that adequate disclosures are made in order to achieve the aim of enabling investors in making a balanced and informed investment decision.[31] Another significant observation, in the opinion of the author, is that the principle enunciated by SAT requiring blanket disclosure of all the information is also in contrast with the established standard of due diligence requiring exercise of care, caution and analysis on merchant bankers' end instead of mechanical disclosure by them. Hence, there is an anomaly in interplay of materiality and standard of due diligence expected from merchant bankers by law.

The emphasis on disclosure is justified; but disclosure of information of dubious significance has been held to accomplish more harm than good.[32] The vice of dubious disclosures lies in the fact that this leaves the potential investors with analyzing a bulk of information and nuanced task of identifying the material information on their own. Unlike merchant bankers, who are technical experts, the investors might suffer from high risk of over passing the material information amidst the dubious disclosures owing to their lack of expertise. Such an outcome is in sharp contrast to the aim that SEBI sought to achieve through a disclosure based regime. Not only does dubious disclosure undermine the sanctity of investors' protection, it also undermines the exercise of independent professional judgment that merchant bankers are envisaged to exhibit under the Merchant Bankers Regulations.

29 *Electrosteel Steels Limited* v. *Securities and Exchange Board of India,* 2019 SCC OnLine SAT 244, ¶16 (India).

30 *Id.*

31 *Supra* note 5 §6.

32 *TSC Industries, INC. v. Northway, INC.*, 1976 SCC OnLine US SC 119, ¶19(India).

Therefore, use the objectivity test while determining whether or not any information is material enough to be disclosed in a due diligence exercise is well founded. However, lack of clarity continues to exist because of the inconsistency created post SAT's ruling in *Electrosteel Steels Limited* case. It shall be interesting to see the degree of reliance that shall be placed on this case in future cases involving the question of materiality.

Factors Mitigating Penalty for Faulty Due Diligence

When merchant bankers fail to exercise due diligence, SEBI exercises its powers vested upon it under Section 11B of the SEBI Act, 1992 by imposing monetary penalty for violating due diligence requirement. Section 11B(ii) empowers SEBI to issue directions to intermediaries if the regulator deems it fit in the interest of the securities market and the investors. In some cases, the penalty may take the form of merchant bankers being restrained from accessing the securities market under the aforementioned provision read with Section 11A. The question arises as to whether there are any mitigating factors that result in exoneration of merchant bankers from penalty, or do all due diligence violations result in heavy penalties irrespective of any circumstance whatsoever. The following three factors have been identified for the purpose of this analysis:

i) violation of due diligence requirement on account of an inadvertent error;
ii) non-cooperation by company in providing information; and
iii) absence of harm to investors despite non-disclosure

Violations Due to Inadvertent Errors

The first factor essentially denotes the situation wherein the merchant bankers conducted the due diligence in a *bona fide* manner, and omitted to disclose certain information owing to a genuine error. The question arises as to whether the law has underlined any difference of treatment between mere inadvertent or technical lapse and deliberate non-disclosure by the merchant bankers. This was answered in the affirmative by the Supreme Court in *Hindustan Steel Ltd v. State Of Orissa*[33] by observing that a penalty for failure to carry out a statutory obligation cannot be ordinarily imposed unless the party obliged acted deliberately in defiance of law. Furthermore, refusal to impose penalty shall be justified if the breach is venial that flowed from a *bona fide* belief. SAT placed reliance on this judgment in 2003 in the case of *Doogar & Associates Ltd. v. SEBI*[34], where the merchant banker in the case

33 1970 SCR (1) 753, ¶7.
34 2003 48 SCL 115 SAT, ¶6.

was penalized by SEBI for filing the public announcement required to be filed with SEBI after it was already published in the public domain. SAT overturned the penalty imposed by the Adjudicating Officer and the merchant banker was let off because "*it had acted bona fide*". However, in another case in *J.M. Financial Investment Consultancy Services Ltd.* v. *Ananta Barua*[35], SAT refused to entertain the contention that the failure to exercise proper due diligence was not intentional. Interestingly, yet another change in approach was observed in 2004 in a subsequent judgment in the case of *SEBI v. Cabot International Capital Corporation*[36] where the Bombay High Court pronounced that if a breach was merely technical and unintentional, it does not merit penal consequence, and it ultimately depends on the facts of each case. In the same year, i.e. 2004, SAT placed reliance on the aforementioned judgment in the case of *Reliance Industries Ltd. v. SEBI* [37] and absolved the merchant bankers of penalty on the ground that the breach could not be called deliberate.

Ultimately when the Supreme Court was met with this question in 2006 in the matter of *Chairman*, *SEBI vs. Shriram Mutual Fund*[38], the Court held that penalty is attracted as soon as the contravention of any obligation as contemplated by SEBI Act and the Regulations framed hereunder is established and hence, the intention of the parties committing such violation becomes wholly irrelevant. The aforementioned ruling was further relied upon by SEBI in *Corporate Strategic Allianz Ltd*. Order[39] where the merchant banker acting as lead manager had failed to disclose track record of public issues managed by it and certain intangible assets of the issuer on its website. SEBI did not agree to the contention that the breach was not willful, and penalized the merchant banker for failing to exercise proper due diligence.

Hence, erroneous interpretation and error in judgment were earlier recognized as a mitigating factor especially if such interpretation was honest and bona fide to the knowledge of the merchant banker. As per the author's observation, there has been a shift in approach to a more stringent imposition of penalty in disregard of absence of element of deliberateness. This shift is a welcome one in furtherance of SEBI's aim of investor protection. Since the merchant bankers cater to the securities law regime critically by preventing unscrupulous companies from accessing the market, it calls for measures for propelling the merchant bankers in discharging their duties with utmost care and caution, leaving no scope for connivance and negligence. A minor inaccuracy, intentional or not, might result in massive

35 (2001) 30 SCL 357 SAT), ¶15.

36 *SEBI v. Cabot International Capital,* (2004) 2 CompLJ 363 Bom, ¶31(India).

37 2004 SCC OnLine SAT 69, ¶11.

38 (2006) 5 SCC 361, ¶15.

39 Order in the Matter of *Corporate Strategic Allianz Ltd*, AO No. NP/AS/AO/20/2017 (2017), ¶20.

losses to the potential investors who rely on due diligence reports and the offer documents certified by merchant bankers. However, care must be taken to keep this strict regulatory approach balanced out in order to avoid overregulation, which is turn deincentivizes independent judgment. Nonetheless, the norm of disregarding the element of intention and tightening the standard while examining the violations of due diligence norms by merchant bankers has been rightly adopted by the Regulator in India.

Non-Cooperation by Company in Providing Information

The second factor deals with question as to whether non-cooperation by a company in providing information to merchant bankers during the due diligence process can mitigate the penalty for omission of the information withheld by the company. Perusal of approach by SAT[40] in this regard disseminates that merchant bankers cannot merely escape the responsibility by shifting the blame on the company without verifying the veracity of information. The allegation by merchant banker that the company concerned did not cooperate does not hold much weight while disproving lack of care while exercising due diligence on part of the merchant banker[41]. Furthermore, absence of anything on record to show that merchant banker took any proactive step to find out the correct information or made a specific query in this respect from the right source of such information weakens the plea of non-cooperation by company.[42] This leads to the observation that passively disclosing whatever is provided by a company and not independently exercising reasonable diligence to ensure adequate, true and fair disclosures amounts to failure comply with the Code of Conduct. The regulator considers the mitigating circumstance of non-cooperation only when the circumstances reveal that merchant banker did not have any means of knowing or reasonably anticipating of the existence of any information or document[43]. Another factor that has lead SEBI to exonerate merchant bankers was that the information withheld by a company could not have been obtained in public domain.[44] On the other hand, the argument of non- production of documents by company has been observed to hold no ground when the information captured by available disclosures made to merchant banker could have led to the concealed information.[45] Interestingly, even the case of an information

40 Order in matter of *M/s. Karn Merchant Bankers Limited*, AO No. EAD/BJD/BKM/99/2017-18 (2017), ¶15.

41 Order in the Matter of *Medicamen Biotech Limited,* AO No. Order/KS/VB/2019-20/4864 (2018), ¶14.

42 *HSBC Securities & Capital Markets (India) Pvt. Ltd. v. The Whole Time Member,* SEBI, 2008 SCC OnLine SAT 25, ¶12 (India).

43 *Almondz Global Securities Ltd. v. SEBI,* 2016 SCC OnLine SAT 219, ¶38.

44 *Supra* note 42, ¶13.

45 *Supra* note 44.

asymmetry combined with non-availability of information in public domain does not put an end to exercise of independent judgment. In such cases, merchant bankers are expected to bring the violations and gaps in disclosures made by the company to SEBI's notice.[46]

However, SAT's ruling in the case of *SEBI v. Imperial Corporate Finance & Services Pvt. Ltd*.[47] has highlighted another facet of this independent duty of merchant bankers. In this case, the promoter of the issuer company concealed his criminal records from the merchant banker. Later, the merchant banker was anonymously tipped about the pending criminal litigation just a few days before the issue and there were no available means to verify it. Additionally, the concerned promoter refused to cooperate. As a result, the offer letter did not contain the information about the litigation and the merchant banker was penalised by SEBI. When the case came before SAT, it overturned the penalty by holding that the merchant banker duly discharged the independent duty of verifying the anonymous tip of criminal records. Merely because the verification could not be completed before the issue was complete was out of merchant banker's control. While criticizing the levy of penalty by SEBI, SAT also remarked, "*one must not carry the concept of due diligence to ridiculous levels*".

Hence, it can be deduced that by virtue of exercise of independent judgment, merchant bankers are vested with additional responsibility of verifying the information provided by the company. Additionally, they are entrusted with vigilance of corporate entity they're offering services to and act as a point of contact between the regulator and the corporate entity. Therefore, non-cooperation on part of a company in providing information leads to condoning of penalty only in extreme circumstances where there is an absolute absence of means of gathering the information withheld. In other cases, the success of plea of non-cooperation depends upon the extent of independent pro-active steps taken by merchant banker for verifying information. To understand this with the help of an illustration, assume that there are two merchant bankers- A and B. Both of them erred in conducting due diligence by not disclosing about a pledge on shares of the companies they were acting for. Subsequently, both of them claimed that the respective companies failed to provide them with the pledge documents. The fact that A tried to obtain the documents independently from the Registrar of Companies, unlike B, shall strengthen A's plea of non-cooperation, compared to B's plea. This is yet another interpretation by the Regulator for providing incitement to merchant bankers in discharging their duties with utmost prudence.

46 *Supra* note 45, ¶9.

47 2005 61 SCL 197 SAT.

No Harm Caused to Investors

This factor refers to a situation wherein even though a merchant banker omitted to include any information from the offer documents, etc., but such omission did not cause any harm to the investors concerned. Whether or not such a situation would warrant overturning or reduction of penalty has been answered by SAT on various instances, but after taking account of factual circumstances. A significant case in this regard is *SEBI v. Imperial Corporate Finance & Services Pvt. Ltd.*[48] In this case, the matter concerning the criminal case pending against Chairman and Managing Director (CMD) of the issuer was not disclosed in the letter of offer, and merchant banker was suspended from accessing securities market for three month. It was alleged that merchant banker acted negligently while exercising due diligence. A pivotal fact was that the omitted information was subsequently revealed in a clarification letter issued by the merchant banker to the investors after the issue was closed for subscription. Additionally, an exit option was given to the investors before allotment. Considering the fact that potential harm to the investors was averted because of the clarification letter, SAT reduced the penalty from suspension for three months to just fifteen days. SAT reiterated the aforementioned approach in a subsequent case[49] where the merchant banker had omitted to disclose a detail in the public announcement but disclosed it through another remedial announcement. The penalty was overturned and the merchant banker was let go with a warning in view of no harm causes to the investors.

However, a shift in approach can be observed in *Electrosteel Steels Limited* case discussed in Part III, where SAT refused to condone a technical violation despite the fact that no loss was caused to investors because ultimately, the license was obtained post the IPO. A possible repercussion of the approach in *Electrosteel Steels Limited* case being followed in the future might be unnecessarily harsh consequences for the merchant bankers in some cases. Furthermore, it might cause an imbalance between the twin objectives of investor protection as well as development of securities market because merchant bankers are an essential part of the securities market. Nevertheless, the lack of harm being caused to investors is more often than not an unintentional result of a merchant banker's faulty due diligence. Thus, it should not be overlooked by the Regulator. Corporate governance practices in companies shall take a backseat if non-disclosures by merchant bankers would be condoned where the investors do not suffer from a monetary loss by pure coincident. Even though the absence of harm caused to investors has been previously treated as a strong

48 *Id.*

49 *SEBI v. JM Morgan Stanley Private Limited*, 2005 SCC OnLine SAT 79, ¶16; *see Chona Financial Services Pvt. Ltd.* v. *SEBI*, 2005 SCC OnLine SAT 100, ¶16; *also see SATCO Securities and Financial Services Ltd.* v. *SEBI*, 2005 SCC OnLine SAT 7, ¶18 (India).

mitigating factor against penailising merchant bankers, the approach has righty been taken a divergence from. However, *Electrosteel Steels Limited* case is an isolated one and has not been relied upon by any other case till date. Therefore, it shall be entrancing to see SEBI's treatment of such situations in cases in the future.

Conclusion

While the different transactions and clients requiring customized styles of conducting due diligence calls for flexibility for merchant bankers, regulation cannot be disregarded. The need for regulation of merchant banker stems from the imminent role they play in the market. In pursuance of the same, the Merchant Bankers Regulations and the Code of Conduct has provided for indicative principles that are to be adhered to at all times. Even so, there persists a lack of any legally binding and codified course of action indicating the course of due diligence. This gap has been attempted to be filled by SEBI and SAT through their rulings by establishing standard of due diligence, threshold of materiality and factors condoning penalty. The analysis of these rulings sheds light upon a shift towards stringent approach of tackling instances of inaccuracies and misdemeanors by merchant bankers. This tightening of due diligence norms seems promising in reinforcing the aim of investors' protection and combating collusion by merchant bankers with issuer companies. However, measures should be taken to increase clarity with regards to what the Regulator expects from merchant bankers while discharging duty of due diligence, in form of indicative guidelines having the force of law. Till then, the steps prescribed in Due Diligence Manual of AIBI can prove helpful to merchant bankers in conducting efficient due diligence.