

## ERGO

*Analysing developments impacting business*

### LESSON IN DUE DILIGENCE | SEBI PENALISES MERCHANT BANKER FOR NON-EXERCISE OF DUE DILIGENCE IN OPEN OFFER

5 December 2019

The Securities and Exchange Board of India (SEBI) has recently imposed a monetary penalty on the merchant banker to the open offer (Merchant Banker) made to the public shareholders of Medicamen Biotech Limited (Target Company). The penalty was imposed on account of failure of the Merchant Banker to exercise proper diligence in respect of the compliance record of the promoters of the Target Company, thereby contravening the provisions of the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 (Takeover Regulations) and the SEBI (Merchant Banker) Regulations, 1992 (Merchant Banker Regulations).

#### Background

As part of an open offer process, the merchant banker to the open offer is required to carry out a due diligence exercise on changes in capital structure of the target company, and trading activities of the acquirer and promoters of the target company. This is undertaken to ascertain the acquirer's and promoters' compliance track record with applicable disclosure and open offer requirements under the Takeover Regulations. The merchant banker is required to submit its findings with SEBI, while submitting the draft letter of offer, highlighting any non-compliances identified in its diligence exercise.

In the instant case, the Merchant Banker submitted to SEBI (as part of its diligence findings) that one of the erstwhile promoters of the Target Company had made delayed public disclosures under the Takeover Regulations, in relation acquisition of certain shares of the Target Company. On further review of this delayed disclosure by SEBI, it was noted that as a result of the aforesaid acquisition, the requirement to make an open offer under the Takeover Regulations had been triggered.

As the Merchant Banker had failed to highlight the aforesaid non-compliance in its diligence findings, SEBI had issued a show-cause notice (SCN) to the Merchant Banker. In response to the SCN, the Merchant Banker, *inter alia*, submitted as follows:

- it missed looking into further applicability of certain provisions of the Takeover Regulations i.e. Regulations 3(1) and 3(3)), with respect to acquisition of shares;
- it had substantially complied with provisions of law, and there was only one inadvertent omission, which did not have any impact on the open offer;
- there was a lack of cooperation from the Target Company / BSE Limited in relation to the information sought by the Merchant Banker for the build-up of promoter share capital; and

- the above non-compliance by the promoter had already been settled between the promoter and SEBI.

## SEBI's view

Post considering the Merchant Banker's submission to the SCN, in its order, SEBI held that:

- the Merchant Banker had failed to exercise due diligence and care on its part, and thus violated provisions of the Takeover Regulations and Merchant Banker Regulations;
- the Merchant Banker's arguments in relation to (a) failure to disclose the non-compliance of the promoter not having an impact on the open offer, and (b) the non-compliance having already been settled with SEBI, were not tenable in the context of the present case;
- diligence was an independent duty of the Merchant Banker and given that all the information required by the Merchant Banker to identify the non-compliance was already available in the public domain, the Merchant Banker was aware of the details of the impugned transaction and had failed to disclose the same.

Finally, relying on the order of the Hon'ble Supreme Court in the case of *Chairman, SEBI v Shriram Mutual Fund* [(2006) 5 SCC 361], SEBI was of the opinion that a penalty is attracted at the instance of contravention of a statutory obligation and intention of the parties committing the violation is irrelevant.

Accordingly, SEBI imposed a monetary penalty on the Merchant Banker for its failure to comply with its diligence obligations under the Takeover Regulations and the Merchant Banker Regulations.

## Comment

SEBI has taken a strict view on the duty of care owed by the merchant banker to present a true and complete picture of the target company, as the disclosures and details in this document impacts the shareholders' decision to tender shares in an open offer.

This order reiterates the onus of diligence cast upon the merchant banker who is required to independently assess the compliance status of the acquirer and promoters, irrespective of whether these details are being provided in a timely manner by the target company or stock exchanges. SEBI has also noted that neither the intention of the merchant banker nor the possible impact of any violation is a relevant consideration; a penalty is attracted as soon as contravention of a statutory obligation is established.

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