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1. Learning Outcomes

After studying this module, you shall be able to

- Know what Merchant Banking is and how it is different from Commercial banking.
- Learn the Registration requirements of Merchant banking.
- Understand the various statutory norms related to Merchant banking.
- Learn the qualities required by Merchant banks.
- Analyse the various challenges face by Merchant banking

2. Introduction

MERCHANT BANKING

A Merchant banker is an intermediary specializing in the business of advising the issuing company for raising finance through the issue of securities to public known as initial public offer. All the services offered and undertaken by a merchant banker are known as Merchant banking.

The need for merchant banks was increasingly realised with the increase in the number and size of issues made in primary market over time.

Today merchant banking services are provided by variety of institutions

- Commercial banks (public sector, private sector and foreign banks) for ex. SBI cap etc.
- Development banks For ex. ICICI securities
- Private merchant banks like Kotak Finance

Difference between Merchant banking and Commercial Banking

Merchant banking Vs Commercial banking

Since the name of Merchant banking contains the word banking, many people gets confused it with commercial banking. However, both are entirely different kind of activities

The main function of bank is to ‘accept money from the public, for the purpose of lending or on demand and withdrawal on request by cheques, drafts, or others.

Banking Regulation Act of 1949

A banking company to internal underwriting support and to manage any issue. This support includes insuring, guaranteeing, underwriting, participating in managing and carrying out of any issue, public or private of state, municipal or other loans or any kind of securities of any company, corporation or association and the lending of money for the purpose of any such issue”

- A bank can undertake merchant banking business, but merchant bank can not undertake banking business which primarily includes acceptance of deposits repayable on demand or otherwise.

2. Registration requirements

Registration of Merchant banker

Every merchant banker before initiating its activities must seek the permission of regulatory authority SEBI through registration. Registration with SEBI is mandatory to carry out the business of merchant banking in India. An applicant should comply with the following norms.

- ✓ The applicant should be a body corporate.
- ✓ which should not carry on any business other than those connected with the securities market
- ✓ The applicant should have necessary infrastructure like office space, equipment, manpower etc.
- ✓ The applicant must have at least two employees with prior experience in merchant banking.
- ✓ The applicant must not have any associate company, subsidiary or Group Company already registered as a merchant banker.
- ✓ The applicant should not be proved guilty for any offence in the financial services industry.
- ✓ The applicant seeking permission for SEBI to become a merchant banker should have a minimum net worth of Rs.5 crore.

Based on the net worth, the merchant banking has been classified in to 4 categories:

1. One crore is the net worth and capital adequacy requirement. These merchant bankers are allowed to carry on the activity of managing public issue and act as advisor, consultant, manager, underwriter or portfolio manager.
2. For category 2, net worth and capital adequacy requirement is 50 lakhs. These are allowed to act as advisor, consultant, manager, underwriter or portfolio manager.
3. For category 3, the net worth and capital adequacy requirement is 20 lakhs. These are allowed to act as underwriter or consultant to the issue.
4. For category-4, there is no net worth and capital adequacy requirement. These are allowed to act as advisor and consultant to the issue.

'Net Worth' means

In case of a Partnership firm – the capital contributed by partners to the business

In case of a Body corporate – paid up capital + free reserves, at the time of making the application to SEBI.

4. SEBI Regulations

4.1 Appointment of lead merchant bankers

- 1) For all issues there must be at least one merchant banker who act as the lead merchant banker:
- 2) Every lead merchant banker shall before taking up the assignment relating to an issue must enter into an agreement with the company.

Restriction on appointment of lead managers

SEBI permits larger number of lead merchant bankers for the larger size of the issue.

Size of issue	No. of Merchant Bankers
(a) Less than rupees 50 crores	Two
(b) Rupees 50 crores but less than rupees 100 crores	Three
(c) Rupees 100 crores but less than rupees 200 crores	Four
(d) Rupees 200 crores but less than rupees 400 crores	Five
(e) Above Rupees 400 hundred crores	Five or more

4.2 Responsibilities of lead managers

- 1) Responsibilities of merchant banker related to disclosure, refund allotment should be clearly defined. Such document stating responsibilities should be furnished to the Board at least one month before the opening of the issue for subscription
- 2) No lead merchant banker is allowed to manage the issue which is an associate of the lead merchant banker.
- 3) All Lead merchant banker to act as merchant banker must be registered with SEBI.
- 4) A lead merchant banker should have valid certificate.

Since the merchant banker act as a fiduciary agent of the company, SEBI has delineated some code of conduct for the merchant banker .

4.3 Guidelines Related to Fees

1. A sum of Rupees five lacs as registration fees is required at the time of the grant of certificate by the Board.
2. From 4th year, renewal fee of Rs 2. 5 lacs every three years is required to pay.

5. Merchant Banking Activities

A merchant banker is capable of delivering various services which include:

1. Issue Management
2. Bankers to the Issue
3. Debenture Trustee
4. Underwriting
5. Monitoring Agency

A merchant banker can take any one of a combination of services to a client on fee basis.

1. Issue Management

For managing the issue, Merchant bankers are required to plan the total issue process in terms of timings, issue size, types of securities, issue price, terms and conditions of issue etc. Drafting of prospectus and its vetting with SEBI is another activity performed by merchant banker.

2. Bankers to the Issue

Merchant banker can act as banker to the issue or help a company to appoint banker to the issue. It can act itself as banker to the issue provided it is a scheduled bank registered with SEBI. 'Bankers to the Issue' business as a part of Merchant Banking business is one of the good source of low cost deposit from point of view of bank.

If a merchant banker is a scheduled bank registered with SEBI it can act as paying banker too. Assignment of payment of dividend warrants is a way for the bank to get short-term deposits at nominal cost.

3. Underwriting:

Most of the merchant bankers act as underwriters to the issue. Underwriting is a contingent liability. They should be very careful in accepting / recommending such business proposals

4. Debenture Trustee

As per SEBI guidelines, company issuing debentures with the maturity period more than 18 months are required to have "Debenture Trustee" and its name must be mentioned in the prospectus.

The creation of debenture trust is necessary in order to bring the large number of debenture holders under one roof rather than individual debenture holders. Merchant Bankers having valid Registration as debenture trustee can act as Trustees for the debenture holders to accept security created by the company and to safeguard the interest of investors. This helps in creating an interface between the company and the debenture holders.

5. Monitoring Agency

To have check and control on the end use of the proceeds of the public issue. SEBI has made it mandatory for the supervision by a monitoring agency. In case of issues exceeding 500 crores, the Company shall assign financial institution which can monitor the proceeds of the issue. The monitoring agency has certain responsibilities to take care of Firstly it has to ensure that the proceeds are properly utilized for the purpose for which it has been raised.

Secondly, keeping the track on the expenditure incurred in parking the proceeds and other expenditure incurred on any revision in the offer document. Thirdly, ensuring that the project is not delayed and all required approvals are disclosed in the offer document.

Apart from activities mentioned above, Merchant banker helps company to get the security listed on stock exchange, stock broking, arranging for credit rating, syndication of loans etc.

Qualities of the Merchant Banker

Merchant banker must be an entity well conversant with the financial services industry. Various duties assigned to the merchant banker expect him to be in possession of the possess the required knowledge and information about capital markets, Behavior of investors, International economic changes and new updates in stock exchange.

Merchant banker should have ability of analysis and evaluation of different projects. Merchant banker should have high level of integrity and must maintain professional standards in safeguarding interests of investors.

Merchant banker should be involved in creating financial instruments to meet to the changing needs of the investors.

CODE OF CONDUCT OF A MERCHANT BANKER

1. A Merchant Banker must act to protect the interests of investors.
2. A Merchant Banker must maintain high standards of integrity, dignity and fairness in the conduct of its business.
3. A Merchant Banker shall fulfill its obligations in a prompt, ethical, and professional manner.
4. A Merchant Banker should exercise due diligence and ensure proper care.
5. It must exercise independent professional judgment.
6. A Merchant Banker shall endeavor to ensure that all inquiries and grievances of investors are dealt with.
7. So as to enable to make balanced and informed decision, a merchant banker must furnish adequate information.
8. The copies of the prospectus, offer document, letter of offer or any other related literature is made available to the investors at the time of issue or the offer.
9. A Merchant Banker shall not discriminate amongst its clients, save and except on ethical and commercial considerations.

10. A Merchant Banker shall not make any statement, either oral or written, which would misrepresent the services that the Merchant Banker is capable of performing for any client or has rendered to any client.
11. A Merchant Banker shall avoid conflict of interest and if there is any interest he must make adequate disclosure of its interest.
12. Any potential areas of conflict of duties and interest while acting as Merchant Banker which would impair its ability to render fair, objective and unbiased services must be clearly explained.
13. A Merchant Banker shall not divulge to anybody any confidential information about its clients which has come to its knowledge, without taking prior permission of its clients, except where such disclosures are required to be made in compliance with any law for the time being in force.
14. A Merchant Banker shall not indulge in any unfair competition, such as weaning away the clients on assurance of higher premium or advantageous offer price or which is likely to harm the interests of other Merchant Bankers or investors or is likely to place such other Merchant Bankers in a disadvantageous position while competing for or executing any assignment.
15. A Merchant Banker shall maintain arm's length relationship between its merchant banking activity and any other activity.
16. A Merchant Banker shall have internal control procedures and financial and operational capabilities which can be reasonably expected to protect its operations, its clients, investors and other registered entities from financial loss arising from theft, fraud, and other dishonest acts, professional misconduct or omissions.
17. A Merchant Banker shall not make untrue statement or suppress any material fact in any documents, reports or information furnished to the Board.
18. A Merchant Banker shall maintain an appropriate level of knowledge and competence and abide by the provisions of the Act, regulations made thereunder, circulars and guidelines, which may be applicable and relevant to the activities carried on by it. The merchant banker shall also comply with the award of the Ombudsman passed under Securities and Exchange Board of India (Ombudsman) Regulations, 2003.
19. A Merchant Banker shall ensure that the Board is promptly informed about any action, legal proceedings etc., initiated against it in respect of material breach or non-compliance by it, of any law, rules, regulations, directions of the Board or of any other regulatory body.
20. A Merchant Banker shall outline the responsibilities of the various intermediaries appointed by it clearly so as to avoid any conflict or confusion in their job description.
21. A Merchant Banker shall provide adequate freedom to its compliance officer for the effective discharge of the compliance officer's duties.
22. A Merchant Banker shall ensure that good corporate policies and corporate governance are in place.

Source: SEBI website

Challenges faced by Merchant bankers

The Growth of the merchant banking as a service during the last few years is highly encouraging in India. However, merchant bankers have come across certain challenges. Majority of these challenges are:

- SEBI guidelines has authorised merchant bankers to undertake mostly issue related services with the only exception of portfolio management. This has made merchant bankers either restrict their activities or float subsidiaries to enlarge their scope of activities
- SEBI guidelines stipulate a minimum net worth of Rs 1 crores for the merchant bankers. Consequently , Small but professional and specialized entities, not having a minimum net worth of Rs 1 crores, are excluded from pursuing merchant banking business

6. Summary

- Merchant bank is defined as a financial institution engaged in providing a wide variety of services ranging from the conception of ideas to the post issue review.
- Various services provided by merchant bankers include – Issue management, Underwriting, acting as managers, consultants and advisors to the issue, Project counseling, portfolio management, act as debenture trustee etc.
- The services provided by merchant bankers are quite specialized in nature requiring knowledge, ability to analyze and evaluate, high level of integrity and zeal to innovate.
- The regulation of merchant bankers have been increasingly emphasized in terms of the activities that they can undertake, the capital adequacy requirements, the various procedural formalities to be complied with etc.
- SEBI as regulator have specific guidelines pertaining to Merchant banks like Registration requirement, fee related guidelines, responsibility, code of conduct etc.