Merchant Banking: Origin, Meaning and Evolution:

Origin of Merchant Banking:

The origin of merchant banking can be traced back to 13th century when a few family owned and managed firms engaged in sale and purchase of commodities were also found to be engaged in banking activity. These firms not only acted as bankers to the kings of European States, financed coastal trade but also borne exchange risk.

In order to earn profits, they invested their funds where they expected higher returns despite high degree of risk involved. They charged very high rates of interest for financing highly risky projects. In turn, they suffered heavy losses and had to close down. Some of them restarted the same activity after gaining financial strength. Thus merchant Banking survived and continued during the 13th century.

Later, merchant Bankers were known as “commission agents” who handled the coastal trade on commission basis and provided finance to the owners or supplier of goods. They made investments in goods manufactured by sellers and made huge profits. They also financed continental wars. The sole objective of these merchant bankers was profit maximisation by making investments in risky projects.

Importance of merchant bankers:

Fundamentally, merchant banks are financial institutions. They engage in business loans as well as underwriting[1]. They mostly cater to large enterprises and individuals of high net worth. They perform a combination of consultancy and banking services. They provide consultancy on matters pertaining the finances, marketing, management, and law. Such consultancy services assist starting of businesses, raise finance, modernise, expand or restructure a business, revival of sick units[2] as well as provide assistance to companies in registering, buying and selling shares. They do not perform the functions of depositories or retail lender institutions. They are, instead, intermediaries. They also often assist international transactions that involve multinational corporations.

For example, if ABC, a multinational corporation intends to take over a smaller company, MNO, it will approach a merchant bank for advice on the acquisition and might also make use of the merchant bank in the financing aspect of the acquisition, in the form of underwriting or loans.

It was in 1967 that National Grindlays Bank introduced the concept of merchant banks in India. In 1972, the State Bank of India became the first Indian Commercial Bank to set up a separate Merchant Banking Division. Till date, however, merchant banks in India have been operating mostly as issue houses and not full- fledged merchant banks like in other countries.

Regulations governing merchant bankers:

The Securities Board of India, under the SEBI Regulations[3], exercising its powers under Section 30, SEBI Act, 1992[4], has made regulations for various components of the capital market. The merchant bankers are regulated by SEBI (Merchant Bankers) Regulations, 1992. H.R.Machiraju[5] has described the objectives of these regulations in the following terms:

"The merchant bankers regulations which seek to regulate the raising of funds in the primary market would assure for the issuer a market for raising resources at low cost, effectively and easily, ensure a high degree of protection of the interest of the investors and provide for the merchant bankers a dynamic and competitive market with high standard of professional competence, honesty, integrity and solvency. The nine regulations would promote a primary market which is fair, efficient, flexible and inspire confidence." [6]

SEBI (Merchant Bankers) Regulations, 1992

This regulation has five chapters pertaining to definitions, compulsory registration with SEBI, renewal of certificate and fee payable to SEBI, capital adequacy requirements, obligations and responsibilities, code of conduct, procedure for inspection by SEBI, of documents, records and books of accounts, procedure in case of default, i.e. the action to be taken against concerned merchant banker (cancellation or suspension of registration by SEBI).

Authorisation by SEBI

- The criteria established for obtaining the SEBI authorisation are:
- Professional qualifications in law, finance or business management
- Available infrastructure including office space, power, equipment, etc.
- Compliance with capital adequacy norms
- A record including experience, reputation, etc.

Classification of merchant bankers

The Securities Exchange Board of India segregated merchant bankers into the following four categories:[7]

Category-I[8] advisor, issue manager, consultant, portfolio manager and underwriter.

Category-II[9] Consultant, advisor, portfolio manager, and underwriter.

Category-III[10] Advisor, underwriter, and consultant only.

Category-IV[11]Advisor or consultant to issue of capital.

Given the above provisions, the role of lead managers of an issue could be fulfilled only by merchant bankers registered under Category-I alone. From 9 December 1997, however, all other categories were abolished, and merchant bankers can now only be registered under Category-I by SEBI.

Capital Adequacy Norms

The Securities Exchange Board of India (SEBI) has prescribed capital adequacy norms for merchant bankers to register under the various categories.[12] The minimum 'net worth' set by SEBI for Category-I of merchant bankers was initiallyfixed at the value of Rs. 1 crore and later raised to the value of Rs. 5 crores through an amendment of the regulations in the year 1995.[13]

Other guidelines in the SEBI (Merchant Bankers) Regulations, 1992

SEBI has laid down several other guidelines in that are a must to be complied with. These are as follows:

- Submission of the half-yearly unaudited result of financial documents to SEBI.[14]
- Compulsory Appointment of Compliance Officer.[15]
- SEBI may send in an officer for inspection of records, books, etc.[16]
- SEBI may collect an authorization fee followed by annual or renewal fees.[17]
- There exists a minimum underwriting obligation upon lead managers to the extent of 5% of the size of the issue or of Rs. 25 lakh, whichever is lesser.[18]

Code of conduct for merchant bankers[19]

Since merchant banking is a profession, like all other professionals, merchant bankers must abide by a specific and strict code of conduct. The code of conduct for merchant bankers states that a merchant banker must:

- Protect the interest of the investors to the best of his capabilities
- Conduct business with a high level of dignity, integrity, and fairness
- Professionally and ethically fulfill all obligations
- Refrain from discriminating against clients
- Make sure that all necessary documents like letter of offer, prospectus, etc. are available at the time of issue to all investors
- Advise clients in the most efficient way possible
- Inform clients about any penal action taken against them by the Securities Exchange Board of India.
- Inform SEBI regarding any legal proceedings that have been initiated against him or her.
- Develop an internal code of conduct to govern internal operations
- Make sure that all the employees are working under them are capacitated to be merchant bankers.
- Be responsible for all the acts of its agents and employees

- Not create false markets
- Abide strictly by the rules and guideline laid down in Securities Exchange Board of India (Merchant Bankers) Regulations, 1992.

Role of merchant bankers

Raising finance

Merchant Bankers help their clients in raising finance by way of issue of a debenture, shares, bank loans, etc. They tap both the domestic as well as the international markets. Finance raised by this method may be used for commencing a new project or business or it may even be used for expansion and modernization of an existing business.

Promotional activities

In India, merchant bankers play the role of promoter of industrial enterprises. They help entrepreneurs in conceiving ideas, identifying projects, preparation of feasibility reports, getting Government approvals as well as incentives, etc. Merchant bankers may, at times, also provide assistance in financial and technical collaborations and i joint ventures.

Brokers in stock exchanges

Merchant bankers buy and sell shares in the stock exchange on behalf of the clients. They additionally conduct researches on equity shares, advise the clients on the share to be purchased, the time of purchase, quantity of such purchase and the time for selling these shares. Mutual funds offer merchant banking services, large brokers, investment banks, and venture capitals.

Project management

Merchant bankers offer help to clients in several ways in the process of project management. They offer advice regarding the location of the project, preparation of project report, in carrying out feasibility studies, planning out the financing of the project, tapping sources of such finance, information regarding incentives and concessions from the government.

Advise on modernisation and expansion

Merchant bankers advise on amalgamations, mergers, acquisitions, takeovers, foreign collaborations, diversification of business, technology up-gradation, joint-ventures, etc.

Managing public issue

They provide the following services in the above-mentioned process:

- the timing of the public issue
- the size of the issue
- the price of the issue

- acting in the capacity of manager to the issue
- assisting in receiving applications as well as allotment of securities
- appointment of brokers as well as underwriters of the issue
- listing of the shares on the relevant stock exchange.

Initially, merchant bankers mostly performed the function of managing new public issues of corporate securities of either newly formed companies or existing companies and foreign companies in the process of dilution of equity provided under the FERA[20]. Here, they acted as sponsors of issues. They get the permission of the Controller of Capital Issues (which is now the SEBI). They also provide several other services to guarantee success in the process of marketing of securities. These services include, preparation of the prospectus, making underwriting arrangements, appointing registrars, bankers, brokers to the issue, arranging for advertising and publicity as well as compliance with the listing requirements of the relevant stock exchanges, etc. A merchant banker acts as experts on the terms, type and timing of the issues of the corporate securities and makes them suitable for investors and provides freedom and flexibility to issuing companies.

Credit syndication

A merchant banker provides specialized services in the stages of preparation of a project, the loan applications required for the raising of short-term and long- term credit from various banks and financials institutions, etc. They help in managing Euro-issues and raising funds abroad.

Handling government consent for industrial projects

A merchant banker completes all formalities for his or her client, about government permission to expand and modernize business (necessary for companies) and commencing new businesses (necessary for business people).

Special assistance to entrepreneurs and small companies

Merchant banker advises entrepreneurs and small companies on availability and existence of business opportunities, concessions, incentives and government policies and helps them to take advantage of this option available to them, to the best of their capabilities.

Services to PSU's

Merchant banker offers numerous services to public sector undertakings and units and their public utilities. They assist in raising capital (long-term), in the marketing of securities, in foreign collaborations as well as in arranging for long-term finances from lending institutions.

Revival of sick units

A merchant bank helps in reviving sick industrial units. They negotiate with various agencies such as banks, long-term lending institutions, and the Board for Industrial and Financial Reconstruction (BIFR). They also plan and execute full revival packages.

Portfolio management of sick units

Merchant bankers offer revival services to companies that issue the securities as well as investors. These bankers advise clients, which are usually institutional investors, on investment decisions. They undertake purchase and sale of securities to provide them with portfolio management services. Some of these bankers are operating mutual funds as well as offshore funds.

Corporate restructuring

These services of merchant bankers include mergers, acquisitions (about existing units), the sale of units and disinvestment. These procedures demand proper negotiations, thorough preparation of numerous documents and completion of lengthy legal formalities. Merchant bankers fulfill all these formalities on behalf of the clients.

Money market operations

A merchant bank deals with as well as underwrites short-term instruments like:

- government bonds
- certificate of deposit issued by banks and financial institutions
- commercial paper issued by large corporate firms
- treasury bills issued by the government (in India by the Reserve Bank of India)

Leasing and finance services

Merchant banks also assist leasing and financing services. A lease refers to a contract that exists between a lessor and a lessee, by which the lessor permits the use of a specific asset that belongs to him or her(like equipment, land) by the lessee for a specified period. There is a fee charged by the lessor charges which is referred to asthe rentals. Several merchant bankers offer leasing and financing facilities to the customers. Some banks also keep venture capital funds to assist entrepreneurs. These banks also help the companies to raise finance through public deposits.

Servicing issues

Merchant bankers now also act as the paying agents for service of the debt- securities and act as the registrars as well as the transfer agents. In this way, they maintain the registers of the shareholders and the debenture holders and also arrange the payment of dividend and or the interest that is due to them.

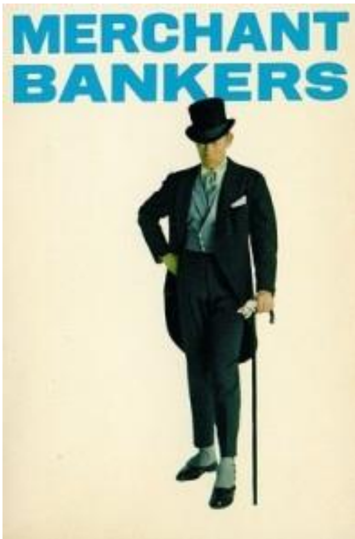
Management of dividend and interest

Merchant banks help the clients in the management of the interest on the debentures or loans, as well as the dividend on the shares. In addition to this, they advise the client with respect to the timings (whether interim or annual) of the dividend as well as the rate of the dividend.

Other services

Along with all the services mentioned above, the merchant bankers also offer certain other specialized services such as advisory services on matters such as mergers, amalgamations, tax related matters, on the matter of recruitment of executives, the cost of audit as well as its management among several others. The scope of functions, activities and the services provided by the merchant bankers are ever increasing and growing with the constant development in the money market.

Issues related to merchant banking



SEBI guideline authorizes merchant bankers to take up only issue related activities. This restricts the scope of activities of these merchant bankers and prevents them from working to their full potential.

The SEBI (Merchant Bankers) Regulations, 1992, has set high norms for capital adequacy necessary for authorisation. This deters independent, young professionals, though they may be highly specialized, from entering the playing field. This denies them the opportunity to participate in the market altogether.

May a time the issuing companies default, at the time of refund of scheduled allotment and application money. This creates a negative image of the merchant bankers in the eyes of the investors. There is no law in existence, to protect the merchant bankers if such a situation arises.

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Footnotes:

[1]Investopedia, “The process by which investment bankers raise investment capital from investors on behalf of corporations and governments that are issuing securities (both equity and debt).”Available at http://www.investopedia.com/terms/u/underwriting.asp

[2]Sick Industrial Companies (Special Provisions) Act, 1985, § 3(o), “an industrial company (being a company registered for not less than five years) which has at the end of any financial year accumulated losses equal to or exceeding its entire net worth.”

[3] Securities Exchange Board of India (Merchant Bankers) Regulations, 1992.

[4] Securities Exchange Board of India Act, 1992, § 30.

[5]H.R. Machiraju, *Merchant Banking- Principles and Practices,* 2003, p.19.

[6] See id

[7] Securities Exchange Board of India (Merchant Bankers) Regulations, 1992, Regulation 3(2)

[8]Securities Exchange Board of India (Merchant Bankers) Regulations, 1992, Regulation 3(2) (a)

[9] Securities Exchange Board of India (Merchant Bankers) Regulations, 1992, Regulation 3(2) (b)

[10] Securities Exchange Board of India (Merchant Bankers) Regulations, 1992, Regulation 3(2) (c)

[11] Securities Exchange Board of India (Merchant Bankers) Regulations, 1992, Regulation 3(2) (d)

[12] Securities Exchange Board of India (Merchant Bankers) Regulations, 1992, Regulation 7.

[13]A Grindlays Compendium, *Merchant Banking*, Grindlays Bank Brochure.

[14] Securities Exchange Board of India (Merchant Bankers) Regulations, 1992, Regulation 15

[15] Securities Exchange Board of India (Merchant Bankers) Regulations, 1992, Regulation 28A

[16]Securities Exchange Board of India (Merchant Bankers) Regulations, 1992, Regulation 29.

[17] Securities Exchange Board of India (Merchant Bankers) Regulations, 1992, Regulation 8A (4).

[18]Securities Exchange Board of India (Merchant Bankers) Regulations, 1992, Regulation 22.

[19]Association of Merchant Bankers of India, *Code of Conduct*.

[20]Foreign Exchange Regulation Act, 1973.