Our Views

Proposed Merchant Banking Regulations – will it make the big bigger!

At present, there are 224 merchant bankers (MBs) in the country operating under the Merchant Banking Regulations (MB Regulations). These regulations were prescribed in 1992 by SEBI after the capital markets went through a transition from the CCI regime to the SEBI regime. The objective of the MB Regulations, inter alia, was to lay down regulatory framework for Merchant Bankers, their eligibility, responsibility and their continuance in securities market.

Over the past three decades, the capital markets have undergone significant changes, and it is only appropriate that we comprehensively relook at this regulatory framework in line with the changing market dynamics. Accordingly, on August 28, 2024, SEBI issued a consultation paper of the proposed MB Regulations. This consultation paper makes several very good and valid suggestions. However, there are a couple of suggestions which according to me require a discussion.

First, the proposed regulations restrict the activities of a merchant banker to issue management, M&A only for listed companies, buyback, delisting, underwriting, private placement of listed/ proposed to be listed securities, and advisory services incidental to these activities in the securities market. At present, along with the securities market's activities, a regulated MB also deals with transactions such as private placements, M&A and restructuring for unlisted companies. The draft regulations make it clear that such activities cannot be termed as securities markets activities unless the company is listed or is proposed to be listed. Therefore, it proposes that such activities should be hived off into another entity.

I believe that such activities are quite intertwined with the securities market activities. While doing them, a MB builds sectoral expertise, product expertise and company-specific knowledge and at times facilitates transition of companies to public markets at an appropriate time. These expertise are common to both securities and non-securities market transactions. Often, there is a second leg of an unlisted company transaction which may culminate into a securities market situation. Hiving off one set of activities into another entity will not only increase the cost for MBs, but also the compliance burden.

As highlighted in the draft proposal, the suggestion to split the activities comes because SEBI's jurisdiction is restricted to securities market activities. At the same time, it is proposed that the entities which are regulated by other regulators can keep the structure as it is - for illustration a subsidiary of a bank or an NBFC need not hive off its activities and can continue to function as per the current structure. I believe that the assumption behind it is that a regulated entity will find it difficult to restructure and split businesses. However, it may be noted that non-securities market activities may not fall within the purview of any other regulator for them also. Therefore, it will be unfair to have a section of MBs continue those activities within the same entity and continue to enjoy the advantages of synergies while others will incur the burden of operating in two different entities with an arm's length relationship.

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In my view, the better way to handle this situation would be to find a way for SEBI to regulate an entity in its entirety rather than just a line of business. The requirements for Chinese wall and confidentiality practices can be further elaborated to ensure adequate controls.

Second, the draft regulations propose a significant increase in the networth and a minimum liquidity requirement of a MB. I totally understand the point that there has been considerable time since the networth requirement was fixed in 1992. However, we should put this in the right context. The networth requirement for a MB came in an era of hard underwriting when the norms on networth and liquid networth were critical. In general, a minimum networth requirement is prescribed for sectors where there is a direct/ indirect underwriting obligation such as insurance and banking. However, today when there are no hard underwriting requirements, the setting up of high networth and liquid networth norms are inconsequential. They only increase the cost of doing business. If there is a situation of hard underwriting, the same can be achieved by way of a funded escrow arrangement.

Our markets are growing, we should encourage more participants to come forward to bring in new thoughts, ideas and better service quality. The above two proposed changes, if implemented, may move the Merchant Banking business only in the hands of larger entities. Not only will it create high entry barriers for quality aspirants, but the smaller existing entities will also reel under the burden of increased costs of compliance and networth requirement. Concentration of Category 1 Merchant Banking licences in the hands of few entities will also have an impact on the demand-supply situation and increase the cost for corporates seeking MB services. Rather than restricting the participation and activities of merchant bankers, a focus on regular monitoring and inspection may allay some of SEBI's concerns about governance and stability. Am sure SEBI's intention is not to make the big bigger!

Sunil Sanghai
Founder & CEO
NovaaOne Capital Pvt. Ltd