GOPALA K R M.Com, NET, KSET
Assistant Professor of Commerce
Govt. Arts, Commerce & PG College Hassan

Underwriting of Shares

Meaning of Underwriting

Underwriting refers to an arrangement where a person or institution (called an **underwriter**) agrees to subscribe to the whole or a portion of a company's shares or debentures if the public does not subscribe to them fully.

It acts as a **guarantee** for the company that the entire issue will be subscribed, ensuring funds are raised as planned.

Advantages of Underwriting

For the Company

1. **Guaranteed Subscription**
   Ensures the entire issue is sold—removes the risk of under-subscription.
2. **Financial Certainty**
   The company can plan projects confidently knowing the required capital will be raised.
3. **Reputation & Credibility**
   Underwriters (often financial institutions) give the issue more public confidence, encouraging more investors to apply.
4. **Faster Capital Raising**
   The assurance provided by underwriters speeds up the fundraising process.
5. **Expert Assistance**
   Underwriters often provide advice on pricing, timing, and marketing of the issue.

For the Underwriter

1. **Commission Income**
   Earns commission (within statutory limits) for taking the subscription risk.
2. **Investment Opportunities**
   Can acquire shares at the issue price if public subscription is low.

For the Investors

1. **Increased Confidence**
   Knowing reputed underwriters are backing the issue reduces fear of investing.
2. **Better Information**
   Underwritten issues are generally more transparent and better presented.

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Types of Underwriting

1. Complete Underwriting

- The **entire issue** of shares or debentures is underwritten by one or more underwriters.
- If the public fails to subscribe to any part of the issue, the underwriter must take up all unsubscribed securities.
- **Example:** Company issues ₹10 crore shares, underwriter guarantees full subscription.

2. Partial Underwriting

- Only a **part of the issue** is underwritten, and the remaining is left for public subscription without any guarantee.
- Used when the company is confident about partial public response.
- **Example:** Out of ₹10 crore shares, ₹6 crore is underwritten, ₹4 crore left to public without guarantee.

3. Open (Pure) Underwriting

- The underwriter agrees to take up **only the portion of shares not subscribed by the public**.
- No obligation if the issue is fully subscribed.
- Common in situations where public demand is expected to be high.

4. Firm Underwriting

- Underwriter agrees to **subscribe to a fixed number of shares irrespective of public subscription**.
- Even if the issue is oversubscribed, the underwriter still gets the shares promised under firm underwriting.
- Often used when underwriters themselves want to invest.

Type of Underwriting	Main Feature	Liability
Complete	Entire issue covered	100% of unsubscribed shares
Partial	Part of the issue covered	Only that part
Open (Pure)	Covers only shortfall	Only unsubscribed shares
Firm	Fixed shares bought regardless of subscription	Always takes agreed number

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Types of Applications

1. Marked Applications

- These applications are **procured by underwriters** and bear their distinctive identification mark or code.
- Used to determine how many applications came through each underwriter for commission calculation.
- **Example:** If Underwriter A has an agreement for 40,000 shares, marked applications show how many were actually applied through A.

2. Unmarked Applications

- Applications **received directly** by the company without any underwriter's mark.
- These are later apportioned among underwriters in agreed ratios to determine liability.
- **Example:** General public applying directly through the company's issue form.

3. Firm Underwriting Applications

- Applications for shares/debentures that an **underwriter has agreed to take up regardless of public subscription**.
- These are separate from public applications and always allotted to the underwriter.
- **Example:** An underwriter agrees to take 5,000 shares firmly; these are allocated to them even if oversubscribed.

Guidelines Underwriting under Companies Act 2013

Legal Framework & Commission Limit

- Underwriting refers to an agreement where underwriters agree to take up unsubscribed shares or debentures—the obligation is triggered if the public fails to fully subscribe
- The Companies Act places a specific limit on underwriting commission—**up to 5% of the issue price** for both shares and debentures
- Particularly for banking companies, the Banking Regulation Act caps underwriting commission at **2.5% of the paid-up share value**

Disclosure & Documentation

- Companies must disclose details of underwriting agreements—commission rates, subscriber numbers (conditional or absolute), and file related contracts with the Registrar or via prospectus

SEBI Guidelines on Underwriting

Regulatory Scope

- SEBI defines underwriting as an agreement—conditional or otherwise—to subscribe to securities if the public (or existing shareholders) do not subscribe
- SEBI mandates that entities acting as underwriters must be **registered**, unless they're already registered as merchant bankers or stock brokers

Registration Requirements

- Applicants must meet eligibility criteria, including:
    - **Net worth of at least ₹20 lakh**
    - Adequate **infrastructure and manpower**
    - **Fit and proper** promoters and key personnel
    - At least two experienced individuals in underwriting in the management team
- Application involves filing Form A and payment of ₹25,000; upon approval, registration certificate is granted after payment of ₹1,333,300. Renewal requires ₹5 lakh every three years from the sixth year onward

Compliance & Conduct

- Registered underwriters must abide by the **SEBI Code of Conduct** (Schedule III) and enter into formal underwriting agreements detailing obligations, commission, timelines, etc.
- Must maintain detailed books of accounts and file annual financial statements, including capital adequacy and underwriting transactions with SEBI

- Underwriting is not compulsory. If minimum subscription (90%) isn't met—whether underwritten or not—the company must **refund all subscription amounts within 120 days**

Calculation of underwriter liability

Step-by-Step Procedure

When calculating underwriter liability for shares/debentures, you generally follow this order:

Step 1 – Determine Gross Liability

- Gross Liability = **Total Issue × Underwriter's Agreed Share (%)**
- This is the maximum number of shares the underwriter is responsible for.

Step 2 – Deduct Marked Applications

- Subtract the number of applications received through that underwriter (marked applications).

Step 3 – Apportion Unmarked Applications

- Divide the total unmarked applications among all underwriters **in their agreed ratio** and deduct from each underwriter's balance.

Step 4 – Add Firm Underwriting

- Add the shares that the underwriter has agreed to take under firm underwriting (these are always allotted).

Step 5 – Final Liability

- Final Liability = Gross Liability – Marked Applications – Share of Unmarked Applications + Firm Underwriting Commitment

Meaning of Underwriting Commission

- **Underwriting commission** is the amount paid by a company to its underwriters for guaranteeing to take up the shares or debentures that are not subscribed by the public.
- It is a **remuneration for risk-bearing** and marketing effort.
- Paid **whether or not** the underwriters are ultimately required to purchase any securities.

Legal Provisions under the Companies Act, 2013 (Section 40 & Rule 13 of Companies (Prospectus and Allotment of Securities) Rules, 2014)

1. **Maximum Commission Allowed**
    - **For shares** – Though the Companies Act allows up to 5%, in practice, SEBI restricts commission to 2.5%.
    - **For debentures** – Up to **2.5%** of the issue price of the debentures.
    - For **banking companies** – Further restricted to **2.5%** of paid-up value by Banking Regulation Act.
2. **Conditions to Pay Commission**
    - Must be **authorised by Articles of Association (AOA)** of the company.
    - Payment must be in respect of **shares or debentures actually offered to the public for subscription**.
    - The **rate of commission** must be disclosed in the prospectus or statement in lieu of prospectus.
    - Underwriting agreement must be filed with the **Registrar of Companies**.
3. **Payment Mode**
    - May be paid in **cash**, or in the form of **shares/debentures** of the company, or partly in both.