Quadrant II - Notes

Course Code : COC 110

Module Name: Meaning, Types of Underwriting of shares, Underwriting Commission and calculation of Liability of Underwriter

Introduction to underwriting

With growing size and magnitude of business, perspective companies requires huge capital to finance their activities. More and more companies go for public issues for their capital requirements. According to Companies Act 1956 collect 90% of issue within 15 days or pay 15%. During last few years there is instability in market. To avoid such situation companies go for underwriting.

Meaning of Underwriting of shares

It is an agreement between companies and certain parties known as underwriter who agrees to take up whole or part of securities which are not subscribe by public for the consideration.

Types of underwriting

1. Full Underwriting:

It is an agreement under which the underwriter undertakes the guarantee of buying the whole of shares or debentures placed before the public in the event of non-subscription. The liability of the underwriter is to buy and pay for the entire unsubscribed portion of the issue.

2. Partial Underwriting:

Under this type of agreement, the underwriter undertakes the guarantee for only part of the issue offered to the public and his liability is limited to the extent of unsubscribed portion of the issue underwritten by him.

3. Joint Underwriting:

In case of a large issue which is unmanageable by a single underwriter and where the risk involved is too high, the issuing company may enter into underwriting agreement with more than one underwriter. Each underwriter undertakes the guarantee for the issue of a certain portion of the whole issue offered to the public.

Thus, underwriters share the risk involved in the ratio of the number of shares or debentures underwritten by them. Sometimes the promoters of issuing company prefer joint underwriting from underwriters operating in different regions of the country so as to diffuse the issue over a number of investors scattered all over the country and retain control over management of the company.

5. Firm Underwriting:
When an underwriter undertakes to buy or subscribe a certain number of shares or debentures irrespective of the subscription from the public, it is called firm underwriting.

6. Sub-Underwriting:

Sometimes, the underwriter enters into agreement with some other underwriters to undertake guarantee for the issue of whole or part of the issue underwritten by him. Such an agreement between the underwriter and the other underwriters (called sub-underwriters) is known as sub-underwriting.

Needs and significant of Underwriting of shares

1. Assurance of Adequate Finance:
Underwriting is an act of undertaking guarantee by an underwriter to buy and pay for the shares or debentures placed before the public in the event of their non-subscription. Thus, through underwriting, an issuing company is assured of procuring the required funds from the issue of shares or debentures. In the event of non-subscription by the public, underwriters purchase the unsubscribed part of the issue and provide finance to the company.

2. Supplying Valuable Information to Companies:
In addition to the protection of risk of the issuing companies with regard to the success of the issue, the underwriters supply valuable information in regard to capital market conditions, general response of the investors, etc. to the issuing companies. These companies are, usually, benefited from the expert-advice of the underwriters.

3. Distribution of Securities:
After purchasing securities, underwriters distribute the same to the real investors. The underwriters, through agents and others diffuse the issue over a large number of investors scattered in different part of the country. Thus, underwriting helps promoters to retain control over the management of the company.

4. Increase in Goodwill of the Issuing Company:
The underwriting of capital issues by prestigious institutions generates confidence among investors and improves their response to the issues. Investors in advanced countries are influenced more by the prestige of the underwriting agencies than by the prestige of the issuing company. Underwriting, thus, ultimately increases the goodwill of the issuing company.

5. Service to Prospective Investors:
Underwriters provide essential information about the issuing companies to the prospective investors and also advise them about various issues. They encourage people to save more and direct their savings in corporate securities. Thus, investors are also benefited through underwriting.

6. Service to the Society:
The pace of industrialization of a country depends to a great extent upon the successful flotation of capital issues. By mobilizing resources and providing adequate finance, underwriters play a very important role in setting up of new projects, increasing employment, production and per capita income. Thus, it is not only the corporate enterprises but also the society at large which is benefited by underwriting.