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Role of Underwriters in A Company

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Abstract--- *One of the most familiar and visible element of the IPO process is the underwriter. The underwriter can be referred as the organization that is actually responsible for selling, organizing and pricing the issue. They are one of the most vital player in the financial market and hence there is need to regulate them and keep a watch on their functioning. In this paper we are going to understand the concept of what underwriters are and the SEBI guidelines to regulate the functioning of them. Along with its limitations and benefits of underwriters to the company and their role in IPO's and financial market.*

Index Terms--- *Underwriters, SEBI, Company, Financial Market*

I. INTRODUCTION

The word 'underwriting' is word used by those who are some or the other way connected with the company. Let us understand this word. It is a lane through which the companies reach to the public. Now the question arises for the need to be in the public. Every company needs the financial benefit for the pay off the existing debts, for capital expenditure, for research and development of the companies etc. The company had adopted this method for raising the capital. Underwriting services are provided by some large specialist financial institutions, such as banks, insurance or investment houses, whereby they guarantee payment in case of damage or financial loss and accept the financial risk for liability arising from such guarantee. This definition states about this subject. 1

Underwriting is the concept of the mediation of the buyer and issuer of bond. This is based on the newly issued bonds which are purchased by the investor bankers and sell the minimum amount of the issues of shares and debentures to the public. This process of purchasing and the selling is the risk-taking procedure where capital is raised by the investors banks for the investors on behalf of the government and cooperation that are issuing either equity and debt securities. It refers to those sell of issues which are issued by Public Limited Company. The one assuring is titled as 'Underwriter'. These underwriters earn the profit by the difference in the amount of purchasing the issues and the selling of those issues. Basically, as per the Companies Act, this concept arises when the people are failed to subscribe the issued share and then these underwriters take the responsibility for this as specified in the underwriting agreement and earn the commission for this. He must subscribe till the limit he agrees to do so. These undertaking contracts have many classifications on different bases. But the wide one is of three types, one is complete underwriting, next is partial underwriting and lastly firm underwriting based on the issues of shares and the debentures.2

There are certain objectives behind the concept of issuing the shares. According to the Companies act, every public

[1] https://economictimes.indiatimes.com/definition/underwriting,, Visited 30th December 2019
[2] https://shodhganga.inflibnet.ac.in/bitstream/10603/28023/1/chapter1.pdf, Visited 30th December 2019

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company has to raise fund, if they are failed to do so then the money has to be returned to the public but if there is delay of more than 78 days then the interest is also payable on it. These funds can be raised through the selling of the shares to the public which is possible through underwriting procedure. It guarantees the sale of the security and facilitates the money during the financial crisis of the company. Because of this, a new company can be recognized. This method is boon for the public companies. The companies receive the payment on the closing date. This is considering as a method of marketing securities. It is kind of assurance for the new security of the public and hence increases the market value for the company. It releases the company from the worries of the marketing of the issues and any uncertainty of the market and uncertainty in the market. 3

II. SECURITY AND EXCHANGE BOARD OF INDIA GUIDELINES

According to SEBI, the number of underwriters should be decided well in advance by the issuer and he must obtain prior permission from SEBI. Permission will be granted by SEBI only after finding out the net worth of the underwriters and their outstanding commitments and, secondly, 25% of each class of securities must be offered to the public and in the remaining 75%, the following method of firm allotment could be adopted. Besides this, the responsibilities of the underwriter that his obligation should not increase 20 times of the net worth and, cannot derive other benefits other than the underwriting commission which is 5% of shares and 2.5% of debentures. Besides this, if the investors are failed to sell the securities in any circumstances then the unsold securities are divided between the underwriters in the proportion on which they are agreed upon. This is the gratification as it provides the company with the required minimum subscription. Besides this, this system has many benefits as underwriters are the supporter and the confidence of the company which ensures the minimum shares to be sold out for the company.

To act as an underwriter, a certificate of registration must be obtained from Securities and Exchange Board of India (SEBI). The certificate is granted by SEBI under the Securities and Exchanges Board of India (Underwriters) Regulations, 1993. These regulations deal primarily with issues such as registration, capital adequacy, obligation and responsibilities of the underwriters. Under it, an underwriter is required to enter a valid agreement with the issuer entity and the said agreement among other things should define the allocation of duties and responsibilities between him and the issuer entity. 4These regulations have been further amended by the Securities and Exchange Board of India (Underwriters) (Amendment) Regulations, 2006.

III. LIMITATIONS

Practically speaking, every person tries to dig the profits as much as they can. But in this profession, the underwriter cannot dig except the commission which they receive from the underwriting commission which is according to the section 76 of the Companies Act, 1956.

Another disadvantage lies with the cost which is high in using this method. Using this method means sharing the information with the underwriters as they do important work for them. But sharing secret information leads to the fear

[3] Li, Mingsheng, Zheng, Steven and Melancon, Melissa, Underpricing, share retention, and the IPO aftermarket liquidity, International Journal of Managerial Finance, Vol. 1(2) (2005)
[4] Deb, S. S., and Marisetty, V. B. Information content of IPO grading, Journal of Banking and Finance, Vol. 34, (2010)

of misusing it. One of the fear runs behind this method is that it may be possible that these can purchase large number of shares to secure the control over the company. Besides this, dealers can incur liability on the underwriters in case of not selling these securities.

Conclusively, the underwriting is the process of selling the securities through the underwriters. It is very reliable method as the investors take the responsibility of only that amount of securities which they can sell at their own risk. This becomes security for the company in their composition. At the termination of the underwriting, the manager must make the final accounting for each underwriter. He should also remit the commissions and accounts for the expenditure incurred.5

Underwriting has become very important in recent years with the growth of the corporate sector.

IV. BENEFITS TO A COMPANY

- It relieves the company of the risk and uncertainty of marketing the securities.
- Underwriters have an intimate and specialized knowledge of the capital market. They offer valuable advice to the issuing company in the preparation of the prospectus, time of floatation and the price of securities, etc. They also provide publicity service to the companies which have entered underwriting agreements with them.
- It helps in financing of new enterprises and in the expansion of the existing projects.
- It builds up investors' confidence in the issue of securities.
- The issuing company is assured of the availability of funds. Important projects are not delayed for want of funds.
- It facilitates the geographical dispersal of securities because generally, the underwriters maintain contacts with investors throughout the country.

V. ROLE OF UNDERWRITERS

The underwriter is the organization that is responsible for pricing, selling, and organizing the issue, and it may or may not provide additional services. With direct public offerings, there is no need for an underwriter. Selection of a good underwriter is of the utmost importance, but it's important to understand that many underwriters are equally selective of their clients. Because an underwriter's reputation depends on successful issues, few firms will be willing to stake their reputation on questionable companies. When selecting an underwriter, it's important to seek out an established company with a good reputation and quality research coverage in your field. The decision may also depend on the kind of agreement the underwriter is willing to make regarding the sale of shares. For profitable and established private companies, it shouldn't be difficult to locate an underwriter willing to make a firm commitment arrangement. Under such an agreement, the underwriter agrees to buy all issues shares, regardless of ability to sell them at a price.

Under this arrangement, the underwriter accepts no responsibility for unsold shares. Aside from fees and sales arrangements, most underwriters are similar in their roles. An underwriter will assist in the preparation and submission of all appropriate SEC filings, helping potential investors make informed decisions about your offering. All underwriters are required to exercise due diligence in verifying the information they submit, so a certain amount of

[5] Brooks, R. M., Mathew, P. G., and Yang, J. J. When-Issued Trading in the Indian IPO Market, Journal of Financial Markets, Vol. 19, (2014)

investigation should be expected from any responsible underwriter. 6

In addition to SEC registration filings, the underwriter will create a preliminary prospectus that will become a major part of the issue's marketing campaign. This document is also referred to as the red herring, after a small red passage in the document that states that the company is not attempting to sell shares prior to SEC approval. Once SEC approval is obtained, the underwriter and the corporation will embark on a road show to gauge and attract interest from investors. While the road show does not involve getting binding commitments from investors, it helps the underwriter determine the best strategies for pricing and issuance.

After the initial public offering, the underwriter continues to provide services for the newly public corporation. For months or even years after the offering, the underwriter may continue to make a market for the stock, ensuring liquidity for investors and making the shares more desirable. Twenty-five days after the issue, the underwriter is also permitted to make statements or projections regarding the company and its prospects. Prior to that time, there is an SEC-mandated quiet period, since investors are forced to rely only on the documents filed by the underwriter. Most underwriters opt to provide favourable coverage at the end of the quiet period

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VI. SERVICES PROVIDED BY UNDERWRITERS

Underwriting services are provided by some large specialist financial institutions, such as banks, insurance or investment houses, whereby they guarantee payment in case of damage or financial loss and accept the financial risk for liability arising from such guarantee. An underwriting arrangement may be created in several situations including insurance, issue of securities in primary markets, and in bank lending, besides others.

The name derives from the Lloyd's of London insurance market. Financial bankers, who would accept some of the risk on a given venture (historically a sea voyage with associated risks of shipwreck) in exchange for a premium, would literally write their names under the risk information that was written on a Lloyd's slip created for this purpose.

In the insurance industry, the practice of underwriting refers to the process of accepting or rejecting risks. It is the very heart of insurance and is the first step taken by an insurance company to generate premiums. Originally, insurance and underwriting were synonymous. That is, underwriting referred to the operation of the insurance business. As the insurance industry developed, underwriting took on a more specialized meaning.

In the early day’s insurance was more personal than it is today. A contract was drawn up between a property owner and a second party, who was willing to insure the specified property, or between the insured and the insurer. The contract specified the terms under which the property would be insured. The property owner placed his name at the top of the contract, stating that he was the owner of the property and beneficiary of the contract if the property was subsequently damaged. The other party, who guaranteed the contract and was the insurer, signed his name below, at the bottom of the contract. Literally, he "underwrote" the contract.7

An underwriter is the person who decides whether to insure risks for which applications have been submitted. The underwriter's task is to evaluate a risk, estimate the potential exposure, determine the likelihood of loss, then decide

[6] Marisetty, V. B., and Subrahmanyam, M. G. Group affiliation and the performance of IPOs in the Indian stock market, Journal of Financial Markets, Vol. 13, (2010)
[7] Hanley, K. W., A. A. Kumar; and P. J. Seguin. Price Stabilization in the Market for New Issues, Journal of Financial Economics, Vol.34, (1993)

whether to accept the application for insurance.

VII. CONCLUSION

The term "underwriter" developed in the early days of marine insurance. It was common practice for individuals seeking insurance for a ship and its cargo to meet with those desiring to write such insurance in coffeehouses. A person seeking insurance for his ship and its cargo would bring a paper describing the ship, its contents, crew, and destination to the coffeehouse. The paper would circulate, with everyone who wished to assume some of the obligation signing his name at the bottom and indicating how much exposure he was willing to assume. An agreed-upon rate and terms were also included in the paper. Since these people signed their named under the description of the risk, they became known as underwriters.

As insurers changed from individual to companies, signatures on insurance contracts became those of company officers. The term underwriter continued to be used in a more restrictive sense; it applied only to the person who performed the process of selecting risks and determining the terms of insurance. Risk selection and determination of policy terms continue to be the basic duties of underwriters today.

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