REPORT OF THE REVIEW COMMITTEE ON SEBI (UNDERWRITERS) RULES AND REGULATIONS, 1993

UNDER THE CHAIRMANSHIP OF

SHRI VALLABH BHANSALI

October 2002

PREFACE

The SEBI (Underwriters) Rules and Regulations, 1993 deals primarily with issues such as registration, capital adequacy, obligation and responsibilities of the underwriters. The provisions of SEBI (Underwriters) Rules and Regulations, 1993 ("Regulations") were notified on October 8, 1993.

Scope of Underwriting

Underwriting services have been traditionally provided by financial institutions, banks, brokers who are members of stock exchanges, merchant bankers, mutual funds and persons with adequate financial capacity, appropriate standing and experience. As per rule 3(1) of the Securities and Exchange Board of India (Underwriters) Rules, 1993 no person can act as underwriter unless he holds a certificate granted by SEBI under the Securities and Exchanges Board of India (Underwriters) Regulations, 1993. Rule 3(2) exempts every stock broker or merchant banker holding a valid certificate of registration under section 12 of Securities and Exchange Board of India Act, 1992 to obtain separate certificate for underwriting. As per rule 4(b) of the Securities and Exchange Board of India (Underwriters) Rules, 1993, an underwriter is required to enter into 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.

Background

The provisions of the Regulation have by and large served well in fulfilling its object and purpose. However the rapid evolution in the domestic capital market over the past few years and its integration with world markets has given rise to new challenges. It was realised that in order to make the Regulations more efficient and effective, it was necessary to take a fresh look at the Regulations and undertake a dispassionate, well-informed review of the provisions of the Regulations.

Securities and Exchange Board of India (SEBI), with a view to addressing these concerns, constituted a Committee. The terms of reference of the Committee are:-

- To review the working of the Regulations
- To consider suitable suggestions in the Regulations, in the light of experience gained so far and in view of the changes in capital market and practices.

The Committee comprised of the following members: -

Mr Vallabh Bhansali, Director, Enam Financial Consultants Pvt Ltd – Chairman
Mr Vimal Bhutani, Vice President, SBI Capital Markets Ltd
Mr B. Madhuprasad, MD, Keynote Corporate Services Ltd
Ms Dipti Neelakantan, Executive Director, J M Morgan Stanley Pvt. Ltd.
Mr Vishwavir Ahuja, CEO, Bank of America
Mr T. R. Ramaswami, CEO, AMBI

SEBI was represented by:
Mr Amit Kapoor

The Committee discussed and considered several issues, which were raised before it. The Committee debated on the market conditions and the environment prevailing during the days of Controller of Capital Issue (CCI) as also during the time when the Regulations were drafted and the dynamic changes that have since taken place. The Committee reviewed the role of underwriters and the underwriting practices adopted during evolution of the capital markets. The Committee also dwelled upon the likely changes in capital market in the near future, its consequent pressures on underwriting and aligning underwriting practices with market developments. An underwritten issue today does not denote weakness requiring an underwriting support. On the contrary it adds to the issue's strength. It shows that there are intermediaries who after assessing the risks have decided to back the issue. The Committee believes that its suggestions would contribute greatly to the capital market. It is with this objective in mind that the Committee has made the following recommendations.

The recommendations are categorised under different headings as under:

1. Definition of "Underwriting"

1.1 Underwriting, as per rule 2(g) of the Regulations, is defined to mean "an agreement with or without conditions to subscribe to the securities of a body corporate when the existing shareholders of such body corporate or the public do not subscribe to the securities offered to them".

1.2 It was felt that the entire definition needed an overhaul since it fell short of practical need. The existing definition restricts underwriting to "subscription to securities". It also restricts the underwriting to issues by a body corporate and excludes "offer for sale" from its definition.

1.3 In practice, an underwriter need not always subscribe himself. He may also procure subscription from a third party. Such arrangement with third party is not captured in the current definition.

1.4 Section 76 of the Companies Act too recognizes that commission may be paid in consideration of subscribing / procuring subscription. The model underwriting agreement prescribed by SEBI also records underwriter's agreement to underwrite/procure subscription.

<u>The Committee recommends that</u>

S.1. The existing definition of "underwriting" may be extended to include "subscribe / procure subscription". The suggestion will bring the existing definition in line with Companies Act and model underwriting agreement. The definition may read as follows:

"an agreement to subscribe to or procure subscription for securities, issued or offered for sale, remaining unsubscribed. Underwriting includes sub-underwriting"

S.2. The same definition may also be adopted in SEBI's Disclosure and Investor Protection (DIP) Guidelines, 2000.

S.3 The words "subscribe / procure subscription" may be replaced for the word "subscribe" in regulation 14(iii) of the Regulations.

2. Capital Adequacy requirement

2.1 The existing capital adequacy prescribed by regulation 7(1) of the Regulations requires minimum net worth of Rs 20 lacs.

2.2 The capital adequacy for the underwriter was prescribed on October 8, 1993. Since then the capital markets have evolved and matured to a great extent. The minimum net worth requirements of almost all financial intermediaries including merchant bankers and brokers has increased substantially in last few years.

2.3 Minimum net worth for a merchant banker has gone up from Rs 100 lacs to Rs 500 lacs, while for a broker on The Stock Exchange Mumbai (BSE) it is Rs 50 lacs and on National Stock Exchange (NSE) it is Rs 200 lacs. The method of computation of net worth for each category is distinct from each other as shown in Annexure "A".

2.4 It is the ability of the underwriter to satisfy his commitment, which shall make the capital market a safer place and increase in minimum net worth is a step in that direction. A higher floor shall ensure committed and quality underwriters.

2.5 Underwriting being a financial risk, it is imperative for an underwriter to have adequate net worth to finance the risk.

The Committee recommends that

S.4. The minimum net worth requirement for underwriters may be increased to Rs 100 lacs. The underwriting capability of merchant bankers, brokers and entities registered with other regulators will be subject to satisfaction of norms prescribed herein.

S.5. Underwriters shall submit to the lead manager a certificate from a chartered accountant certifying its net worth and fructified outstanding obligations every time it seeks underwriting.

3. Computation of net worth

3.1 The current definition of net worth as per explanation to regulation 7 includes paid up capital and free reserves.

3.2 It is felt that the current definition is not explicit and specific.

3.3 For the purposes of underwriting, the liquidity of the underwriter at any point of time is more critical than net worth as on a particular date. The current definition does not give adequate weightage to tangible and liquid assets of the underwriters.

3.4 Options such as computing net tangible asset or obtaining certificate of liquidity from auditors are available.

3.5 SEBI has prescribed a method of computing net worth for brokers on BSE as reproduced in Annexure A. NSE also prescribes a method of computing net worth. Since this method is already tested in and adopted by the market, it may be extended for underwriters subject to suitable changes.

The Committee recommends that

S.6. The definition of net worth may be tightened and computed more explicitly as follows:

Net worth = Capital + Free Reserves

Less: Non-allowable assets viz.,

(a) Fixed assets
(b) Unlisted securities
(c) Bad deliveries
(d) Doubtful debts and advances
(e) Prepaid expenses, losses
(f) Intangible assets
(g) 30% of value of marketable securities and 30% of value of pledged securities net of outstanding liability

4. Limit on underwriting obligations

4.1 The current limit of maximum 20 times net worth as per regulation 15(2) of Regulations was believed to be high in view of the fact that net worth was not explicitly defined.

4.2 It was recognised that capital adequacy requirements of financial intermediaries has been consistently revised upwards in last few years.

4.3 It was also appreciated that underwriters with higher networth would be able to arrange financing in a more efficient manner than those with a low networth. On the other hand, underwriters with low net worth and higher multiple stand a greater risk of default.

4.4 Therefore, proposal to introduce slabs for limits on underwriting obligations based on net worth of the underwriter was found appropriate.

The Committee recommends that

S.7. The leverage should be linked to net worth. The following slabs may be adopted for determining the leverage for underwriters.

Net worth	***Multiple of net worth***
Between Rs 1 cr to Rs 5 crs	***10***
Greater than Rs 5 crs	***20***

5. Subscription in case of devolvement

5.1 The existing limit of 30 days for subscription/procuring subscription by underwriter as per model agreement is at a variance with limit of 45 days as per regulation 15(3) of the Regulations.

5.2 Besides, both the limits are antiquated in the current environment when allotment in fixed price issue gets done within 30 days from issue closure and in book building within 15 days from bid closure. There is a need to review the existing time frame.

5.3 However, the revised time frame has to also take into the account the time required for the registrar to the issue to co-ordinate with the bankers to the issue in order to determine the extent of under-subscription and the underwriters' obligation. The figures are then to be authenticated by an auditor before notices can be sent out to the underwriters. After receiving the notices, the underwriters should be allowed a fair period of time to fund subscription or procure subscription.

5.4 In the current environment, an investor is free to withdraw his subscription to the issue before allotment. There could be instances when the investor decides to withdraw from the issue due to devolvement on the underwriters. In such cases the underwriter is exposed to a larger financial risk for no fault of his. The investors should be allowed to withdraw only in case of material developments which put their investment at risk. In all other cases investors having subscribed to the issue should not be permitted to withdraw after a particular milestone.

5.5 Similar principle has been adopted in the latest amendments to Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 1997 wherein the shareholder may withdraw acceptance tendered by him upto three working days prior to the date of closure of the offer and not thereafter.

5.6 In a book building issue, underwriting is done once the price is discovered and bids allocated. It is essentially done to insure against defaults from bidders. Syndicate

members are responsible for ensuring that the amount allocated to each is subscribed in full. However this amount may differ from what is underwritten by them individually. As a result, there could arise possibilities where although the syndicate member is responsible for default in payment by his investor, the underwriting commission is paid to another member of the syndicate.

5.7 The merchant banker's role in collecting devolvement proceeds was reviewed. It was felt that although underwriting is a contract between the Issuer Company and underwriters, the issuer company relies on the lead manager for appointment and performance of underwriters. In such a situation, the lead manager should to the best of its capability facilitate collection of devolvement proceeds. It was also discussed whether lead manager should co-ordinate the dispatch of devolvement notices to underwriters and the subsequent follow up for collection of devolvement proceeds.

The Committee recommends that

S.8. For fixed price issue, the issuer company shall communicate devolvement details to the underwriter by giving a preliminary notice within 7 days of issue closure followed by final notice with the auditors certificate within 18 days of issue closure. Thereafter the underwriter shall subscribe / procure subscription within 7 days of the final notice from the issuer company.

S.9. Application once made in a fixed price issue may not be withdrawn after issue closure. Bids once made in a book building issue may not be withdrawn after bid closure.

S.10. The earliest closing date may be done away with. The issue may remain open for minimum 3 days and maximum 10 days except where otherwise specifically prescribed by SEBI.

S.11. In a book building issue the syndicate member shall underwrite all shares allocated to bidders who have bid through him, receive underwriting

commission on such bids and get devolved shares, if any. Alternately if the syndicate member is given underwriting which is different from the bids allocated to bidders who have bid through him, that syndicate member's obligation shall be restricted to the amount underwritten by him. The syndicate member who has procured the bid shall retain the brokerage.

S.12. Lead managers (as mentioned in inter-se allocation of responsibilities) shall be given the responsibility of determining devolvement obligations, sending devolvement notices to the underwriters, facilitating collection of devolvement proceeds.

6. Fees to Underwriter

6.1 Currently underwriting commission is paid to the underwriters much after the issue closure and listing permissions are obtained.

6.2 There is no obligation on the issuer company to expedite the release of commission to underwriters. The earliest obligation is while making an application to the regional stock exchange for release of its 1% deposit after four months from the date of listing permission.

6.3 The commission/brokerage cannot be paid before listing permission, where one of the objects to the issue is to meet issue expenses since the funds in the issue account cannot be utilized unless the securities are listed on all stock exchanges where listing is sought.

6.4 Neither can the underwriting commission be netted off against devolvement proceeds due to restriction mentioned above. Thus there is a need to put onus on the issuer company to expedite the commission / brokerage payment.

<u>The Committee recommends that</u>

S.13. Brokerage may be paid to the underwriter on the amount subscribed / procured by him against his devolvement obligation.

S.14. The commission and brokerage may be paid after obtaining listing approvals from stock exchanges but before obtaining trading permission.

S.15. Stock exchanges may insist on certificate from lead manager or auditor for payment of commission / brokerage before granting trading permission approval.

7. Registration criteria and registration fees

7.1 According to rule 3(1) of the Regulations, no person shall act as an underwriter unless he holds a certificate granted by SEBI under the Regulations.

7.2 One of the criteria for considering application for registration as underwriter, as per regulation 6 and Form A of the Regulations, is necessary infrastructure and past experience in underwriting. However, adequate infrastructure and experience are not clearly defined. Neither do these criteria ensure commitment towards underwriting. It is believed that underwriting involves a financial risk where adequate net worth is critical rather than adequate infrastructure and experience.

7.3 Most of the underwriters today are already registered with SEBI for some activity or the other. They may be merchant bankers, stock brokers, mutual funds etc. They are already regulated by SEBI for their actions under different regulations. Seeking one more registration for the same entity, as an underwriter, adds to the administrative burden of SEBI. Such separate registration may be avoided.

7.4 There could be few underwriters such as banks, financial institutions etc who may not be registered and regulated by SEBI. However they are registered and regulated by some other regulators for e.g. RBI in case of banks and institutions. In such cases

the respective regulator could monitor the underwriting activities as part of its regular monitoring of various other activities and if required report its findings to SEBI for necessary action. Thus registration with any regulator would be an eligibility criteria but the underwriter will be governed by the Regulations. In case of any default by the underwriter, the lead managers will report the same to SEBI through the issue monitoring reports. Thus the ability for action against underwriters continues with SEBI.

The Committee recommends that

S.16. Net worth may remain as the only criterion for underwriting.

S.17. No separate registration may be prescribed for underwriters. Instead intermediaries already regulated by SEBI, Stock Exchanges, RBI or other regulators may be automatically allowed to undertake underwriting.

S.18. There may be no separate registration and renewal fee for an underwriter

8. Code of Conduct

8.1 The existing code of conduct as per regulation 13 and schedule III of the Regulation is generic.

8.2 As proposed in point 7, there may be different regulators monitoring the performance of underwriters. Under the circumstances a separate code of conduct for underwriters may not be required since such regulators will have their own code of conduct which will apply to the underwriters.

<u>The Committee recommends that</u>

S.19. There should be no separate code of conduct for underwriters. Instead a common code of conduct for all financial intermediaries may be suitably drafted and adopted.

9. Model underwriting agreement

9.1 The existing model underwriting agreement as per SEBI Circular RUW Circular No 1 (93-94) dt 19/11/93 is applicable only for fixed priced issues.

9.2 Certain provisions of the aforesaid model underwriting agreement too have outlived its utility.

9.3 There is a need to review and strengthen the model underwriting agreement for fixed priced issues.

9.4 There is a need to adopt a model underwriting agreement for book built issues. The warranties and covenants adopted for underwriting agreement for book built issue may also be introduced for fixed price issue.

<u>The Committee recommends that</u>

S.20. The existing model underwriting agreement for fixed priced issues may be revised as follows:

i. In Para 3, the words "acknowledgement card" may be replaced by the words "observation letter"

ii. In Para 3, the following sentence may be added;

"The Company shall convey to the underwriter, electronically or otherwise, the changes including those arising out of observations of SEBI and provide for a reasonable period of time for the underwriter to convey his acknowledgement"

iii. ***In Para 6, "21" may be replaced by "10"***

iv. ***In Para 8, following may be added;***

"Provided the sub-underwriting arrangement is communicated to the issuer / lead manager before issue closure"

v. ***Clause ii.a of para 10 may be deleted***

vi. ***In Para 11(a), "30" may be replaced by "18"***
In Para 11(c), "30" may be replaced by "7"

vii. ***Para 12 may read as follows;***

"Right to receive underwriting commission – Subject to the Underwriter fulfilling his underwriting commitment, he shall be entitled to receive commission in respect of the full underwriting obligation undertaken by him at the rates set out in clause 13 hereunder."

viii. ***Brokerage shall be paid on amount subscribed / procured by the underwriter against the devolvement.***

ix. ***Para 13(2) may read as follows;***

"The underwriting commission / brokerage shall be payable by the Company after obtaining listing permission of the securities from the stock exchanges but before obtaining trading permission. The Company shall bear the applicable service tax, if any, leviable on the underwriting commission. The obligation to pay underwriting

commission shall arise only upon the underwriter fulfilling his underwriting commitment"

x. ***In Para 16(ii), the names of the following cities may be added viz., Bangalore, Hyderabad, Ahmedabad and Pune.***

xi. ***Suitable representations, warranties and covenants may be incorporated to protect the interest of the parties to the Agreement.***

A model underwriting agreement for book-building issues may be drafted to incorporate the following points:

a. ***Agreement shall be between the issuer company on one part and Book Running Lead Manager, Co-Book Running Lead Manager and syndicate members on the other part***

b. ***Details of book-building i.e. whether 100% of the net offer to the public through book building process or 75% of the net offer to the public through book building process and 25% of the net offer to the public at the price determined through book building***

c. ***Definitions of key terms such as Lead Underwriter, Underwriter, Bid, Bid Amount, Bid opening/closing date, Bidder, Bidding period, Confirmation Allocation Note, Escrow account of company/syndicate, Escrow agreement, Pay-in period, Qualified Institutional Buyers, Red Herring Prospectus, Syndicate agreement may be included***

d. ***The syndicate member shall underwrite all shares allocated to bidders who have bid through him, receive underwriting commission on such bids and get devolved shares, if any. Alternately if the syndicate member is given underwriting which is different from the bids allocated to bidders who have bid through him, that syndicate member's obligation***

shall be restricted to the amount underwritten by him. The syndicate member who has procured the bid shall retain the brokerage.

e. ***Obligation of and recourse available to the lead underwriter in case of default by underwriter or syndicate member***

f. ***Covenants***

The company and the underwriters will not make any verbal or written representations in connection with the offering other than those representations made pursuant to terms and conditions in the underwriting agreement

g. ***Procedure for effecting discharge of underwriting obligations. The milestones for discharging obligations may be clearly specified in terms of number of days.***

h. ***Recourse available to the company if the lead underwriter fails to discharge its obligation.***

i. ***Fees and commissions including brokerage payable on amount subscribed / procured by the underwriter on devolvement.***

j. ***Conditions to underwriter's obligations***

   i. ***No material / adverse development including regulatory changes after executing the agreement which affects the marketability of the issue unless conveyed to the underwriter and accepted by him.*** (This provision will protect the interests of the underwriters. In case of dispute of whether the information is material/adverse, SEBI may have the last word on the same and its views will be binding on the company and the underwriter)

ii. ***Certificate from the company of no material/adverse development since the date of the underwriting agreement***

k. ***Details of determination of issue price, allocation of bids and pay-n period***

l. ***Representations and warranties by company, lead underwriter and underwriter***

m. ***Indemnity***

n. ***Termination***

o. ***Jurisdiction***

p. ***Arbitration***

10. Mandatory underwriting

There has been some debate about 'safety net'/ 'hard underwriting' being made mandatory as one of the most practical methods to boost the primary capital market. The following is noteworthy in this regard:

1) During the CCI regime hard underwriting was compulsory. Even after free pricing was introduced under SEBI regulations, hard underwriting was mandatory for the first few years.

2) Traditionally, hard underwriting was mandatory for two important reasons:

- it made entry in the capital market safe for the issuer.

- the prospective investors, retail as well as wholesale, felt safe that the underwriters had evaluated the issue and were backing the issue with financial commitment.

3) 'Book Built' issues also have underwriting. However under the Book Building route underwriting covers only the 'payment risk' rather than 'subscription risk'.

Qualified Institutional Buyers (QIB) make the investment decision based on 'confidence' rather than underwriting provided by the so called underwriter.

Retail investors, under the current guidelines of SEBI get the price and volume guidance from the QIB participation.

There is no fall back option for the issuer to get the funds as there is no "last resort". The issuer has to withdraw the issue in case of inadequate demand.

4) If an underwritten issue fails and the underwriters are unable to meet the obligations, it disturbs the market. Similarly if a non-underwritten issue fails and the application money returned, it too disturbs the market. Issuers are driven by commercial exigencies and considerations to determine whether the issue should be underwritten or not.

Neither 'hard' underwriting nor 'soft' underwriting have proved reliable guide of the post listing market price and therefore both of them fail to be a 'safety net'.

Equity prices are influenced by complex and large number of factors and therefore 'safety net' insurance is very difficult to provide, particularly for the short-term.

5) What is the aggregate capability of the participants to underwrite large and small issues, including many issues at the same time, on an ongoing basis is a moot point.

   In the past, the term lending financial institutions and banks acted as the biggest underwriters because underwriting support was generally a part of the project finance provided by them. In the post 'liberalisation' era, not all such entities have either the financial ability or capital market expertise to do large underwriting. Banks also have some restrictions due to limits imposed by the Reserve Bank of India.

   What is relevant is the capability of the equity-oriented institutions such as Life Insurance Corporation, General Insurance Corporation and subsidiaries, New Insurance Companies, Mutual Funds etc. These institutions are active participants in the book-built issues and by earning underwriting commission can bring down their cost of acquisition. This should make them enthusiastic about underwriting.

6) Hard underwriting, as practiced traditionally, makes it difficult to adjust the price to the prevailing market conditions. Improvement is needed on this front, which with modern day technology should not be difficult.

7) It was seen in the past that not all issuers were able to collect the devolvement proceeds. In many cases, only 'application / allotment money' was paid and the issuer was left shortchanged. With better enforcement environment that is emerging, escaping underwriting liability should become difficult thus making underwriting more meaningful.

8) Typically only a few underwriters manage the bulk of the 'Book Built' issues. Since underwriting can be a steady business for the prudent (like Insurance companies), it can attract more participants.

The Committee would like to thank the individuals and institutions that responded to the Committee's request for their views and comments. The Committee also wishes to express its grateful thanks to Shri G.N. Bajpai, Chairman of SEBI for constituting the Committee and giving the members full freedom in fixing its terms of reference and deliberations.

ANNEXURE "A": METHOD FOR COMPUTATION OF NET WORTH

For Merchant Bankers [as per SEBI(Merchant Bankers) Regulations, 1992]

Net worth means paid up capital plus free reserves

For stock brokers on BSE [as per SEBI's letter No. SMD/SED/9012/93 dated May 14, 1993]

Paid-up Capital
Add: Free Reserves
Less: Non-allowable assets viz.,

A. Fixed assets including land and building
B. Receivables which are due and outstanding for more than three months
C. Value of the Exchange card
D. Doubtful debts / advances
E. Pledged securities
F. Preliminary exp. To the extent not written off

For stock brokers on NSE

Method I

Items	**Treatment for Net Worth computation**
Goodwill, Intangible assets, Patents, Trademarks and designs, Value of other stock exchange card, Deposit with other stock exchange, Debit Balance in P&L A/c	Not to be considered for Net Worth computation

Items	Treatment for Net Worth computation
Land, Buildings, Leasehold, Plant and Machinery, Furniture and Fittings, Development of Property, Vehicles, Computers (Hardware and Software), Government/Trust Securities, Debentures or Bonds, Shares (Fully paid-up and partly paid-up), Shares/Debentures and Bonds of Subsidiary companies, Immovable properties, Investments in capital of partnership firms, NSE Security Deposit, NSE VSAT & UPS Deposit, Stock-in-trade, Sundry Debtors, Provision for bad debts, Cash on hand, Fixed deposit with bank, Bank balances, Deposit with MTNL	To be considered at book value per statement of Assets & Liabilities/Balance Sheet

OR

Method II

By valuation of their assets on the following basis:

A. Listed (Quoted) investments in the name of the applicant (at market values)
B. Margin of 30% on market value of listed (quoted) Investments
C. Net value of listed Investments (A) – (B)
D. Investments in unlisted (unquoted) companies
E. Margin of 50% on (D)
F. Net value of unlisted Investments (D) – (E)
G. Other Investments (at cost) like PPF, NSC at current Value, Statutory deposits with the Exchange, Deposits with registered NBFCs, Bank FDs
H. Total Net Investments (C) + (F) + (G)
I. Market Value of Land & Building component of the Fixed Assets
J. Margin on I at 50%
K. Net value of such fixed assets (I – J)
L. Debtors not exceeding 3 months + Cash & Bank balance
M. Current Liabilities
N. Long term liabilities
O. Net worth (H + K + L) – (M + N)