During the past two years concern has been expressed within the industry about trends which have emerged in equity underwriting. As most major sub-underwriting institutions are involved in the Superannuation industry one way or another, the Association through the N.S.W. Investment Study Group has undertaken a survey to crystallise the industry viewpoint.

The major aspects of equity sub-underwriting which are causing concern, are:

1) The underwriting of issues by broking houses is becoming significantly more competitive and the emergence of underwriting agreements on terms which are finely pitched to the market, at very small commissions, is becoming increasingly evident.

2) Because of this situation, institutions are being asked to sub-underwrite issues (in effect accepting the bulk of the underwriting risk) for exceptionally small commissions.

3) The emergence of the shortfall disposal clause in underwriting agreements gives the underwriter the right to put the shortfall up for tender and sell to the highest bidder (and charge brokerage on the transaction) leaving the shareholder who preferred not to subscribe to the issue receiving the profit proceeds. Alternatively the underwriting broker sells the shortfall at a discount to the market and receives full brokerage on it. Thus the sub-underwriter, if he wants to participate in the shortfall for which he has taken the risk must pay a premium for that risk as well as brokerage.

The basic principle of underwriting is that the underwriter (and sub-underwriter) who accepts the risks for a fee is responsible for taking up any shortfall. This clause negates that basic principle and presents an intolerable situation in as much as —

a) the underwriter, who has covered the greater part of his risk with sub-underwriters, is virtually in a no loss situation and

b) the shareholder has the option to make his decision to take up or reject his entitlement right up to the last day of the issue. If the market falls and the issue is unattractive the shareholder can reject his entitlement. Thus he has the option not to make a loss.

However, should the market recover between the application close date and the time of finalising the issue, the shareholder who decided not to take the risk, which was mainly borne by the sub-underwriter, receives the profit. Now that most issues are providing poor sub-underwriting commission there appears to be very little incentive in sub-underwriting the risks being offered.

Whilst each institution or fund has the right to accept or reject a sub-underwriting on its merits, we have been concerned that the risks the institutions and funds are being asked to take are increasing, because of the finely pitched issues being offered, whilst the rewards in terms of sub-underwriting commission and profits from shortfalls on successful issues are diminishing.

During the two-year period 1970/71 there were 32 industrial equity issues offered for sub-underwriting providing an average sub-underwriting commission of 1.08%. All of these issues specified that the shortfall would be taken up by the underwriters and sub-underwriters.

Since the beginning of 1976 there have been 34 sub-underwritings with an average sub-underwriting commission of .85% — some 20% lower than the 1970/71 average. Of these 34 issues, 14 were large issues in respect of “leader” stocks and of these 50% had clauses in their underwriting agreements providing for sale of the shortfall and remittance of profit proceeds to the shareholder who declined to participate in the issue.
A questionnaire was sent to most major superannuation institutions, a wide cross-section of medium-sized institutions and fund managers, as well as most major self-managed Funds.

The responses reflect the views of superannuation oriented institutions and Funds, representing the management of $2.5 B in equity, with an annual equity turnover of approximately $450 M.

The questions posed, and the responses, are summarised as follows:—

**Question 1**
Does your institution/Fund share the general views expressed in relation to equity sub-underwriting?

86% of respondents replied in the affirmative. Of the 14% negative responses the following specific comments were expressed to qualify their positions:

a) The view was expressed that the question of sub-underwriting should not be addressed by A.S.F.A., as each sub-underwriting offer made can be either accepted or rejected. If the terms are adequate it should be accepted — if inadequate they should be rejected. Thus there is no case to answer.

b) The benefits of sub-underwriting should be considered in the long term. Some results will be more beneficial to the underwriters and/or the sub-underwriter than others, but over a long period of time the Fund has benefited. It was felt that the sub-underwriter with whom they are associated would keep in mind their obligations to the issuing company, and the arrangements which would be necessary to retain the support of sub-underwriters. In other words there is an obligation to protect the interests of all parties, and in recent years the Fund has not had cause to object to their treatment.

c) It is felt that rights issues should be fixed at a sufficient discount on market price, to ensure that there is no risk of a substantial shortfall. If this is done it is not necessary to have the issue sub-underwritten, and to do so is virtually giving away the shareholders’ Fund which is regarded as immoral.

**Question 2**
Do you feel that Broker’s sub-underwriting commissions during the past 12 months were:—

a) Too high?
b) Too low?
c) Adequate?

4% felt sub-underwriting commissions were too high. 75% regarded sub-underwriting commissions as too low. 17% felt sub-underwriting commissions were adequate. 4% could not assess.

**Question 3**
With regard to underwriting shortfalls where a potential profit is available, do you believe that:

a) The parcel should be placed for tender and sold to the highest bidder with the profit proceeds being spread amongst the shareholders who rejected their entitlement?

b) The shortfall should be apportioned to the underwriter and sub-underwriter in proportion to their underwriting or sub-underwriting commitments?

96% of respondents believed that the shortfall should be apportioned to the underwriter and sub-underwriter in proportion to their commitment.

The 4% advocating sale to the highest bidder also commented that in their opinion there should be no shortfall if the issue was pitched at an adequate discount to the market. Thus there would be no need to underwrite. Consequently it could be stated that the response was virtually unanimous against the placing of equity underwriting shortfalls for tender.

There were, however, a few important qualifications which we feel should be mentioned. Two respondents, whilst supporting the question of the underwriter and sub-underwriter receiving the shortfall, raised the question of the need to protect the interests of absent shareholders or overseas investors, and deceased estates where legal limitations are imposed on their right to take up new issues. The need to protect the interests of these parties is acknowledged. However, in respect of deceased estates and overseas investors where restrictions apply,
the period of rights trading should enable them to protect their own interests by selling rights if they are unable to take up the issue.

The question of absent shareholders interest is fairly fragile in as much as if the shareholders have not taken the necessary precautions by way of executing power of attorney in their absence, the company should not bear the responsibility to protect their interests.

**Question 4**

During the past 12 months has your institution or fund rejected such underwriting offers?

If so were the reasons for rejection related to:

a) The issue too finely pitched?
b) Commission too low?
c) Inclusion of the shortfall clause?
d) Other?

86% of respondents had rejected sub-underwriting offers during the past 12 months.

Of this 86% the inclusion of the shortfall clause was the greatest for rejection.

The results were as follows:

1) **Inclusion of the shortfall clause**: 73% of those who had rejected sub-underwriting offers listed this as a reason, and 37% (approx half) listed the shortfall clause as their main reason for rejection.

2) **Issue too finely pitched**: 78% listed this as a reason for rejection, but only 20% gave it as their main reason.

3) **Commission too low**: 68% listed this as a reason for rejection, but only 26% gave it as their main reason.

4) **Other**

30% listed other reasons for rejection, and 17% gave it as their main reason.

Thus the grading in order of main reasons for rejection is:

1) Shortfall clause 37%
2) Commission too low 26%
3) Issue too finely pitched 20%
4) Other 17%

100%

**Question 5**

Do you believe that an underwriter should carry part of the risk or cover his full risk with sub-underwriting?

82% stated that they believed the underwriter should carry part of the risk.

14% stated that it was irrelevant.

4% stated the underwriter should cover his full risk.

**SUMMARY AND CONCLUSION**

In summary, the overwhelming majority of respondents concurred with the study group's view that the trend is towards:

a) more finely pitched issues.
b) lower sub-underwriting commission.
c) the emergence and growing use of the shortfall tender clause.

The purpose of this survey was solely to provide a forum for institutions and superannuation funds to express their views, and the fact that the majority of respondents, both large and small, were so positive in their attitude, the major equity underwriters should take particular note of the general dissent.

It is clearly acknowledged that when a Broker accepts an underwriting risk he is at complete risk until such time as he can offset it with sub-underwriting. Consequently, it is not for us to question whether or not he wishes to accept that risk. What is of prime concern, however, is that it is traditionally expected that the sub-underwriter will support the issue offered, and we are now seeing the growth of more and more sub-underwriters rejecting issues mainly for the reasons outlined in the survey. Should these trends continue we can foresee the prospect of an underwriter getting caught with an unfavourable underwriting, and finding he is unable to sub-underwrite the risk. This would be an unfortunate situation. The institutional and Fund manager role of providing sub-underwriting facilities is an important part of the equity capital-raising function, and an underwriter needs these facilities to offset a significant part of his risk.

If the underwriter/sub-underwriter relationship is to continue to maintain a viable basis for raising equity capital, there will need to be a greater understanding and acceptance by the underwriter that the sub-underwriter is effectively a mutual partner in the capital-
raising exercise. The impression that is gained in recent years is that the underwriter is becoming more prone to treat the sub-underwriter as a poor cousin to whom he is offering a favour in the form of sub-underwriting. Institutions are becoming acutely aware of, and discontented with, the increased risks they are being asked to accept on behalf of the underwriter with diminishing rewards.

The competitive tendency for underwriting is resulting in underwriters accepting risks at less than acceptable commissions, and more finely pitched to the market. To offset the lower commission, more and more Brokers are including shortfall clauses in their underwriting agreement, which gives them the right to sell the shortfall by tender, and to obtain brokerage from the sale. The brokerage from the sale is not apportioned to the sub-underwriters who have been asked to carry the risk for what appears to be a diminishing commission.

In conclusion, we believe that traditional equity sub-underwriters are becoming more acutely aware of the recent unsatisfactory trends in equity sub-underwriting, and are becoming more prone to reject sub-underwriting offers where these trends are evident. We would hope that prospective underwriters acknowledge the dissent being voiced, and work towards reversing the trends before the failure of a major issue, (and its underwriter, through lack of being able to obtain sub-underwriting) places the important role of equity underwriting in jeopardy.

Respondents to the survey were asked if they objected to being named as participants, whilst they were assured complete confidentiality on the answers submitted. The following institutions/Funds granted approval to be named as participants in the survey, and are representative of the spread of 38 participants approached.


**BOOK REVIEW**

**SUPERB NEW BOOK ON INVESTMENT**


William F. Sharpe, Professor of Finance at the Graduate School of Business, Stanford University, U.S.A., is well-known to many of us as a distinguished writer of high-quality articles on investment in the Journal of Finance and Management Science. Those have enhanced his stature as an authority in that field. Accordingly, a fine new book of his simply entitled Investments is particularly welcome. It ranks with many of the best in the field.

Professor Sharpe's text covers investment value and market price, the valuation of riskless securities, the valuation of risky securities, portfolio analysis, risk and return, taxes; inflation, fixed-income securities, bond prices, yields and returns, common stocks, the valuation of common stocks, earnings, warrants, options, convertible securities, futures contracts, investment companies, financial analysis, investment management, securities markets and international diversification.

The book has taken note of the progress made in finance over the past two decades, Professor Sharpe says it "is intended to be encyclopedic without excessive or insignificant detail, vigorous without the use of needless analytic apparatus (only high-school algebra is utilised), internally consistent, and as integrated as possible".

Most chapters are supplemented with questions and problems, and the text is indexed. The volume is abundantly illustrated with useful graphs and it is excellently produced.

This book is strongly recommended to all seriously interested in the literature on investment.

E. F. GILLIN