Restricted / Escrowed Securities

By Michael Kemp

Initial Public Offerings (IPOs), where companies are broken up into many tradable units (shares) and sold to hordes of eager investors, have been around for a long, long time. The first was back in 1602 when the Dutch East Company "went public".

The Dutch East Company was a legitimate company, which delivered great profits to its shareholders, but in the 400 years since that first float, there have been plenty of others that haven't exactly been on the straight and narrow.

One of my favourite "float stories" is that of the Electrolytic Marine Salts Company.

In the late 1890s a Baptist minister, Prescott Jernegan, claimed he'd received a 'heavenly vision' which enabled him to extract gold from seawater. Jernegan saw the opportunity to convert his God-given skill into a profit-making scam. But first he needed to give it some credibility, so he enlisted the aid of lifelong friend and confidence trickster Charles Fisher, who was a professional sea-diver.

Jernegan had constructed a box which he called the 'Accumulator'. He claimed his invention could collect gold when dropped into the sea. To legitimise his 'gold from seawater' claim Jernegan invited an unwitting jeweller, Arthur Ryan, to come and take a look.

Ryan dropped the Accumulator off the end of a pier at Narragansett Bay, Rhode Island. While Ryan was waiting for the gold to 'accumulate', Jernegan's accomplice, Fisher, donned a diving suit, swam under the pier and slipped a few gold nuggets into the submerged box. Ryan retrieved the box and confirmed the gold was genuine.

Off the back of his now legitimised business model, Jernegan set about establishing a listed company. Stock in the Electrolytic Marine Salts Company was offered at $1 per share. The first tranche of 350,000 shares sold out in three days, and investors demanded more. Within weeks $2.4 million worth of stock had been subscribed.

So how did the story end? Jernegan and Fisher shot through with the $2.4 million without so much as a goodbye.

This fraudulent duo would be hard placed to play these games today. Stock exchanges now have much tighter controls to protect shareholders. And whilst this article won't discuss all of the current protections it will discuss one of them – restricted or escrowed securities.

What are Restricted Securities?

Restricted securities, as the name implies, are shares that have restrictions placed on them. In this case the restriction is that their owners can't sell them until a specified period of time has elapsed. This is referred to as the period of "escrow". For example even if Jernegan and Fisher, in the story above, were able to float their gold accumulator technology on a stock exchange today (which they wouldn't be able to), they would be restricted from selling certain of their own shares until the escrow period was over.

This restriction helps to align the economic outcome sought by the founders and originators of the newly floated company with those of its general shareholders.

The concept of placing the holdings of certain shareholders in escrow is an important factor in maintaining the integrity of listings and the market overall. Watching directors selling stock in the early days of a listing is not a good look, something which could potentially damage the market's perception of the company, even if its business model is a legitimate one.

Who's Shares are Likely to be Restricted?

It's important to say first up that whether shares are classed as restricted or not is determined on a case-by-case basis. Typically the escrow provisions apply to businesses that are substantially speculative, or don't yet have an established track record. But, like other stock exchanges around the world, the ASX has established some pretty clear guidelines on the matter. A summary can be found in Appendix 9B of the ASX listing rules but the following lists those people who are likely to have their shares placed into escrow:

- Early investors, that is investors who were issued securities, or the right to subscribe for securities, prior to the Issuer being approved to list.

- Vendors who have been issued securities in exchange for assets or services they've provided. For example this could include sellers of assets to an Issuer, professional advisers who accept securities for their services or promoters of the Issuer's capital raising.

- Current directors of the company.

The period of escrow varies but is typically 12 or 24 months.

The ASX is unlikely to place escrow limitations on a soon to be listed company if it meets certain requirements, for example if the company already has a profitable track record or has an acceptable revenue stream. Escrow limitations are also unlikely if the company holds substantial assets which are either tangible or of a readily determinable value.

One way a company will almost certainly bypass the escrow requirement is if it meets the ASX's profits test (that is, unless the ASX decides otherwise). The profits test is a series of profit-based requirements which are outlined in the ASX listing rules. To meet this test the company must be a going concern, must present at least 3 years of audited accounts and must clear minimum profit hurdles.

Interestingly, even if the ASX requirements are met, some founding shareholders or existing directors choose to voluntarily escrow their shares. A common reason for doing this is the belief it will improve the marketability of the offer. For example this year's Spotless float saw both the chief executive officer and the chief operating officer place shares into voluntary escrow despite Spotless clearly meeting the profits test.

Should You Consider Restricted Securities in Your IPO Assessment?

There are a couple of things you should consider when looking at an IPO which involves restricted securities.

Firstly you need to ask why the ASX deemed an escrow arrangement to be necessary. Remember that the requirement itself is often a reflection of the lesser quality of the float. So study the company's business model closely.

A second question is whether an escrow arrangement will affect the value of the non-escrowed shares. After all a hangover of shares is created that potentially might one day be dumped onto the market (when the escrow period expires).

My simple answer to this question is: no, it shouldn't affect the value you place on the shares you are thinking of buying in the IPO. And that's because (despite the difficulty in determining it) shares are worth the present value of the future cash flows they will deliver. So in that respect the whole issue of whether other shares are restricted is a bit of a sideshow.

But what about the short-term price effect, when the escrow period is over? Won't the share price be impacted then? The answer to that question is that it depends on a number of factors, for example:

1. Maybe the holder of the previously restricted shares won't sell the shares.

2. If they do sell then stock market sentiment at the time is important. For example when sentiment is high it's more likely there will be lots of willing buyers to support the price.

3. Also, how many shares might the seller be trying to sell? And how will this number compare to a typical day's trading volume for that stock?

Even after considering these issues remember that there is one inescapable economic reality when considering the worth of any share. Over the long-term value is driven by the profits the business delivers, not by short-term trading aberrations.

And if you are a trader, who hopes to make a quick buck from short-term price moves following the release of escrowed shares, don't get too excited. It's difficult to know exactly when any of those potentially large shareholdings are going to be dumped onto the market. That is if they come onto the market at all!

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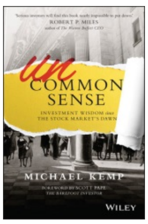

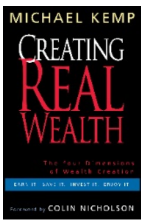

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Michael Kemp is the chief analyst for the Barefoot Blueprint and author of "Uncommon Sense". Published under the Wiley label "Uncommon Sense" delivers a deeply considered and logical approach to the otherwise complex world of investing.