

May 19, 2021

Memorandum

To: Members, Committee on Financial Services
From: FSC Majority Staff
Subject: May 24, 2021, IPECM Subcommittee Hearing entitled, “Going Public: SPACs, Direct Listings, Public Offerings, and the Need for Investor Protections.”

The full Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets will hold a hearing entitled, “Going Public: SPACs, Direct Listings, Public Offerings, and the Need for Investor Protections” on Monday, May 24 at 12:00 p.m. on the virtual meeting platform Cisco WebEx. There will be one panel with the following witnesses:

- **Stephen Deane**, Senior Director of Legislative and Regulatory Outreach, CFA Institute
- **Andrew Park**, Senior Policy Analyst, Americans for Financial Reform
- **Usha Rodrigues**, Professor & M.E. Kilpatrick Chair of Corporate Finance and Securities Law, University of Georgia School of Law
- **Scott Kupor**, Investing Partner, Andreessen Horowitz

Overview

The phrase “going public” historically refers to the process by which a privately held company sells shares of its stock to the general public for the first time through an initial public offering (IPO).¹ The Securities Act of 1933 (“Securities Act”) requires the disclosure of all material facts about securities that are publicly offered for sale so that investors can make fully informed investment and voting decisions.² Section 5 of the Securities Act requires every offer and sale of securities to be registered with the Securities and Exchange Commission (SEC) unless there is an exemption available.³ For registered securities, issuers are required to file a registration statement with the SEC, typically using Form S-1, which includes a prospectus containing audited financial statements, as well as detailed disclosures about the issuer’s business operations, financial condition, risk factors, and its management.⁴ The Securities Act provides several exemptions from the registration requirements⁵ and authorizes the SEC to exempt additional classes of securities.⁶ A security offered or sold in reliance on an exemption is known as an “exempt offering,” and the markets for these exempt offerings are known as “private markets.” Because exempt offerings are not required to be registered, investors receive significantly less information about the security than investors in registered offerings.

¹ Securities and Exchange Commission, [Going Public](#) (accessed May 10, 2021).

² See H.R. REP. NO. 73-85, at 1 (1933) (stating that the purpose of the Act was “to provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails”).

³ 15 U.S.C. § 77e.

⁴ Securities and Exchange Commission, [Form S-1](#) (accessed May 10, 2021).

⁵ See Section 3 of the Securities Act of 1933 [15 U.S.C. § 77c].

⁶ See Section 28 of the Securities Act of 1933 [15 U.S.C. § 77z-3] (authorizing the SEC to exempt “any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this subchapter or of any rule or regulation issued under this subchapter, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.”).

Initial Public Offerings

The IPO process officially begins with the filing of a registration statement, typically Form S-1, with the SEC, which includes important disclosures such as the prospectus that will be used to advertise the securities to investors, information on the financial health of the company, and details of company operations and strategy.⁷ Under Section 5(c) of the Securities Act, a company is generally prohibited from holding meetings to solicit investors regarding its IPO, also known as a “Road Show,” prior to filing a registration statement.⁸ Upon filing, the registration statement will undergo a review by SEC staff for compliance with requirements on the disclosure of information material to investors and applicable accounting standards.⁹ During the review process, SEC staff will provide comments to the company on any revisions to the registration statement that need to be made before the transaction will be allowed to go forward.¹⁰ Under Sections 11 and 12 of the Securities Act, issuing companies, their directors, and underwriters are legally liable for “misstatements and omissions in disclosures made in connection with a public offering.”¹¹ In contrast, when issuers are found to have made inaccurate or misleading forward-looking statements in other types of SEC filings, such as annual reports and proxy statements, they are granted a measure of protection from lawsuits by the Private Securities Litigation Reform Act (PSLRA) of 1995.¹²

When companies go through the IPO process they generally must rely on underwriters, typically investment banks, to assist with the marketing and sale of their securities. Fees charged by underwriters are frequently cited as one of the most significant costs associated with a company completing an IPO.¹³ According to an analysis by PwC, between 2015 and 2020, underwriter fees have on average ranged from 3.5 percent of gross proceeds of the IPO for offerings over \$1 billion to 7 percent of gross proceeds for offerings \$25 to \$99 million.¹⁴ IPOs also often involve what is known as a “lockup agreement” between the issuing company and its underwriters.¹⁵ Lockup agreements are generally designed to prevent company directors, employees, and early investors from selling their shares in the company too soon, usually within 180 days, after the IPO is completed.¹⁶

Special Purpose Acquisition Companies

A special purpose acquisition company (SPAC) is a company which is established by a management team, also known as a “SPAC sponsor,” with the intention of raising capital by completing an IPO and then using the funds generated by that public offering to acquire one or more operating companies.¹⁷ Upon completing an IPO, a SPAC will typically maintain 90 percent of the capital it raised in escrow until the acquisition of a target private operating company, often called a “de-SPAC” transaction, is complete.¹⁸ SPACs are also generally required to complete a de-SPAC transaction within a certain timeframe, usually two to three years, or be required to return the funds to investors.¹⁹ Once a SPAC has reached an agreement to acquire or merge with a target company, a vote by shareholders in the

⁷ See Securities and Exchange Commission, *Investor Bulletin: Investing in an IPO* (accessed May 10, 2021).

⁸ See Craig F. Arcella, Cravath, Swaine & Moore LLP, *The Nuts and Bolts of Roadshows* (2010).

⁹ *id.*

¹⁰ Securities and Exchange Commission, *Filing Review Process* (Sept. 27, 2019).

¹¹ See Klausner, Michael D, et al, Yale Journal on Regulation, *A Sober Look at SPACs*, at 42 (Oct. 28, 2020).

¹² *id.*

¹³ KPMG, *A Guide to Going Public*, at 10 (2015).

¹⁴ PwC, *Considering an IPO? First, understand the costs* (accessed May 10, 2021).

¹⁵ See Securities and Exchange Commission, *Fast Answers: Initial Public Offerings: Lockup Agreements* (Sept. 6, 2011).

¹⁶ Perkins Coie, *The IPO Handbook* (accessed May 10, 2021).

¹⁷ Harvard Law School Forum on Corporate Governance, *Special Purpose Acquisition Companies: An Introduction* (Jul. 6, 2018).

¹⁸ Securities and Exchange Commission, *Release No. 34-82478; File No. SR-NASDAQ-2017-087*, (January 9, 2018).

¹⁹ *id.*

SPAC may be required to approve the transaction.²⁰ Prior to the completion of the de-SPAC transaction, investors in the SPAC maintain the option to redeem their shares for the original purchase price plus any accrued interest.²¹

In the past two years, there has been a rapid increase in new SPAC IPO activity. In 2020, the number of new individual SPAC offerings rose 420 percent over the prior year²² and surpassed the \$67 billion raised by traditional IPOs, with new SPAC IPOs earning \$83 billion in investments.²³ 2021 has been an even more active year for SPAC activity, with 315 new SPAC IPOs, a 27 percent increase over 2020, in just the first five months of the year.²⁴

Although SPACs are required to file a registration statement with the SEC prior to an IPO, because they are effectively shell companies and have no operations, their S-1 filings²⁵ generally provide investors with very little detailed information. SPACs are, however, required to make additional disclosures prior to a shareholder vote on the acquisition of a target company and after a de-SPAC transaction has been completed. If shareholder approval is required for the SPAC to complete a merger with the target company, under Section 14(a) of the Securities Exchange Act the SPAC sponsor is required to provide shareholders with a proxy statement prior to the vote.²⁶ The proxy statement is required to include important information regarding the “business of the company that the SPAC wants to acquire, the financial statements of the company, interests of the parties to the transaction, including the sponsor of the SPAC, and the terms of the initial business combination transaction, including the capital structure of the combined entity.”²⁷ Within four days of completing a de-SPAC transaction, SPAC sponsors must also file Form 8-K with the SEC, a public disclosure providing detailed information on the terms of the transaction and the company being acquired.²⁸ As a result of the substantial amount of information required to be provided in this disclosure, these filings by SPACs are often called a “super 8-K.” With regard to both proxy statements and 8-K filings, SPAC Sponsors are currently granted a measure of protection from liability for overly optimistic projections as a result of the safe harbor for “forward looking statements” provided under PSLRA.

When a SPAC undergoes its IPO, it will generally do so by issuing “units” in the SPAC rather than simple equity shares. Units are typically offered at an initial price of \$10 per unit and are comprised of a share of common stock of the SPAC and a warrant to purchase additional shares of the stock at a set price.²⁹ After the IPO is complete, units, shares, and warrants generally begin trading separately on securities exchanges.³⁰ SPAC sponsors are typically compensated through a “promote,” which generally consists of 20 percent of post-IPO equity in the SPAC.³¹ During the period between the IPO and de-SPAC transaction, SPAC sponsors must also manage the assets of the SPAC as cash is withdrawn when investors redeem their shares.³² Both the compensation structure of the promote and the impact of redemptions over time appear to have the effect of diluting the value of SPAC shares for those who hold their shares through the de-SPAC transaction.³³ According to a recent academic analysis of 47 SPAC transactions in 2019 and

²⁰ Securities and Exchange Commission, *Investor Bulletin - What You Need to Know About SPACs* (Dec. 10, 2020).

²¹ *id.*

²² SPACInsider, SPAC Statistics, *SPAC IPO Transactions: Summary by Year* (May 10, 2021).

²³ <https://www.nasdaq.com/articles/2020-has-been-the-year-of-spac-ipos%3A-here-are-the-prominent-4-2020-12-28>

²⁴ SPACInsider, SPAC Statistics, *SPAC IPO Transactions: Summary by Year* (May 10, 2021).

²⁵ In September 2020, the SEC issued guidance limiting SPACs’ ability to use an abbreviated registration form. See Securities and Exchange Commission, Securities Act Forms, [Question 115.18](#)

²⁶ See Securities and Exchange Commission, *Investor Bulletin - What You Need to Know About SPACs* (Dec. 10, 2020).

²⁷ *id.*

²⁸ Securities and Exchange Commission, *How to Read an 8-K* (Jan. 26, 2021).

²⁹ Harvard Law School Forum on Corporate Governance, *Special Purpose Acquisition Companies: An Introduction* (Jul. 6, 2018).

³⁰ *id.*

³¹ Harvard Law School Forum on Corporate Governance, *A Sober Look at SPACs* (Nov. 19, 2020).

³² *id.*

³³ *id.*

2020 found that, despite being valued at \$10 a share, “as of the time of a merger, the median SPAC holds cash of only \$6.67 per share,” and that “SPAC shares tend to drop by one third of their value or more within a year following a merger.”³⁴

The Jumpstart our Business Startups (JOBS) Act established a new class of issuers in which issuers with “total annual gross revenues of less than \$1.07 billion during its most recently completed fiscal year, and, as of December 8, 2011, had not sold common equity securities under a registration statement” would be subject to weaker disclosure and accounting standards and would, among other benefits, be permitted to “use test-the-waters communications with qualified institutional buyers and institutional accredited investors.”³⁵ While this classification was intended to “coax small-cap companies into going public by reducing the burdens of public disclosure and ongoing federal regulation,” some have noted that EGCs may be using the SPAC process to reduce securities regulation compliance costs by using SPACs as a vehicle to go public, while also enjoying the “greatly reduced ongoing reporting requirements” that EGCs as a class enjoy.³⁶ Indeed, “[f]our months after the JOBS Act’s passage, one out of every nine EGCs was a SPAC.”³⁷ This translates to a legal avenue for companies to go public without the regulatory safeguards of a traditional IPO, while also allowing companies to obviate many of the investor protections associated with being a publicly-traded company.

Some practitioners have claimed that SPACs are a better alternative over traditional IPOs because the targets, and the public company, have reduced exposure to liability under securities laws.³⁸ In a recent statement, SEC staff questioned claims of reduced liability, but explained that, in some cases, the law is “uncertain at best.”³⁹ For instance, the PLSRA contains a safe harbor that protects established reporting companies from private litigation stemming from forward looking statements, so long as the company complies certain conditions.⁴⁰ IPOs are excluded from that safe harbor.⁴¹ However, IPO is not defined causing some uncertainty as to whether SPACs are similarly excluded, leading SEC staff to opine that “there may be advantages to providing greater clarity on the scope of the safe harbor in the PSLRA.”⁴²

Direct Listings

Historically, a direct listing is the process by which a company goes public by selling existing shares to the general public instead of offering new ones.⁴³ Like IPOs, to complete a direct listing, companies are required to file a registration statement with the SEC.⁴⁴ Unlike an IPO, because companies do not traditionally issue new shares during a direct listing, they are not generally pursued for the purpose of raising new capital.⁴⁵ One of the primary benefits of a direct listing is that it provides existing shareholders with greater liquidity. Direct listings also differ from IPOs in that they typically do not involve a lockup agreement and do not rely on underwriters to help market the securities or determine an initial offering price.⁴⁶

³⁴ See Klausner, Michael D, et al, Yale Journal on Regulation, [A Sober Look at SPACs](#) (October 28, 2020).

³⁵ *Id.*

³⁶ Harvard Business Law Review, [SPACs and the JOBS Act](#), Usha Rodrigues.

³⁷ *Id.*

³⁸ See [SEC, Public Statement, SPACs, IPOs and Liability Risk under the Securities Laws](#) (April 8, 2021).

³⁹ *Id.*

⁴⁰ [15 U.S. Code § 78u-5](#).

⁴¹ *Id.*

⁴² See [SEC, Public Statement, SPACs, IPOs and Liability Risk under the Securities Laws](#) (April 8, 2021).

⁴³ Gibson Dunn & Crutcher, [A Current Guide to Direct Listings](#) (Jan. 8, 2021).

⁴⁴ *Id.*

⁴⁵ Corporate Finance Institute, [Direct Listing: The Process by Which a Company Can go Public](#) (accessed May 10, 2021).

⁴⁶ Gibson Dunn & Crutcher, [A Current Guide to Direct Listings](#) (Jan. 8, 2021).

On December 22, 2020, the SEC approved a change to the listing requirements of the New York Stock (NYSE), significantly expanding the scope of direct listings on that exchange by allowing companies to issue new securities and raise capital when going public through a direct listing.⁴⁷ The SEC’s initial August 26, 2020 order approving the rule change was subject to a temporary stay following a petition for review filed with the Commission by the Council of Institutional Investors (CII) on the basis that it would reduce investor protections.⁴⁸ Specifically, CII highlighted in its petition that the omission of the underwriting process with direct listings would result in heightened risks for investors.

The petition noted that the rule change would likely hurt the ability of shareholders to pursue lawsuits under Section 11 of the Securities Act, which imposes liability on an issuer when a registration statement includes material misstatements or omissions. This is because the U.S. Court of Appeals for the Second Circuit has held that settlements involving claims arising from registration statements can limit recovery only to claimants who can trace their purchase of securities to the registration statement in question.⁴⁹ Therefore, by approving direct listings which allow the concurrent public sale of shares held by the company and covered by a registration statement, as well as shares held by employees and not covered by a registration statement, CII expressed concern that the rule change would exacerbate the issue of “traceability.” Both of these concerns were later echoed in a joint statement by SEC Commissioners Alison Lee and Caroline Crenshaw regarding the final rule change.⁵⁰ In particular, the Commissioners highlighted that “underwriters provide an important independent check on the quality of the registration statement” by being “incented to do their job well because if they do not, they are subject to strict liability under Section 11 and Section 12(a)(2) of the Securities Act.”⁵¹

Legislation

- **H.R. _____**, to amend the Private Securities Litigation Reform Act by redefining the phrase “blank check company” in a manner that would include special purpose acquisition companies.

⁴⁷ Securities and Exchange Commission, [Release No. 34-90768; File No. SR-NYSE-2019-67](#) (Dec. 22, 2020).

⁴⁸ See Council of Institutional Investors, [Petition for Review of an Order, Issued by Delegated Authority, and Brief in Opposition to Motion to Lift the Automatic Stay](#) (Sept. 8, 2020).

⁴⁹ *id.*

⁵⁰ See Securities and Exchange Commission, [Statement on Primary Direct Listings by Commissioners Allison Herren Lee and Carline A. Crenshaw](#) (Dec. 23, 2020).

⁵¹ *id.*