



Testimony before the
Investor Protection, Entrepreneurship, and Capital Markets Subcommittee
U.S. House Committee on Financial Services

“Going Public: SPACs, Direct Listings, Public Offerings, and the Need for
Investor Protections”

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May 24, 2021

Chairman Sherman, Ranking Member Huizenga and Members of the Subcommittee:

On behalf of CFA Institute, let me thank you for the invitation to testify at this hearing. I am Senior Director of Legislative and Regulatory Outreach for the Americas at CFA Institute. My work focuses on capital market policies. I also serve as a volunteer member of the Markets Advisory Council of the Council of Institutional Investors. Previously, I served for more than nine years at the U.S. Securities and Exchange Commission, including in the Office of the Investor Advocate (since its inception) and as the Commission’s staff liaison to the Investor Advisory Committee. It is an honor to appear before you today.

CFA Institute is a not-for-profit, nonpartisan global association of investment professionals that sets the standard for professional excellence and credentials. The organization is a champion of ethical behavior in investment markets and a respected source of knowledge in the global financial community. Our aim is to create an environment where investors’ interests come first, markets function at their best, and economies grow. Our Mission Statement is, “To lead the investment profession globally by promoting the highest standards of ethics, education, and professional excellence for the ultimate benefit of society.”

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SPACs: Two Starkly Different Worlds

SPACs present two starkly different worlds. Two different narratives. Two different transactions – the initial public offering (IPO) and the subsequent merger in lieu of an IPO. Two different sets of investors – big, sophisticated investors on one side, and individual investors on the other. And two starkly different sets of investment outcomes – excellent for the big investors who exit at the time of the merger, and poor returns or losses for the ordinary investors who stay on.

One narrative of SPACs—the optimistic one—mixes hype and hopes in touting perceived benefits of SPACs over traditional IPOs. This narrative portrays SPACs as the poor man’s private equity, allowing ordinary folks to get in on the ground floor of profitable companies. If they don’t like the merger, they can get their money back.¹ SPACs also bring private companies into the sunlight of public markets without the perceived drawbacks of the traditional IPO.

The second narrative points to troubling features of SPACs: conflicts of interest, dilution, lucrative profits for big investors, and a track record of dismal returns for ordinary investors. These features threaten to feed into a third, all-too-familiar narrative—that Wall Street is rigged.

Winners and Losers: A Pattern of Starkly Divergent Investment Returns

Investment returns offer an unforgiving reality test for any investment product, including SPACs. Unfortunately, SPACs have displayed a clear pattern of winners and losers. Big investors – the SPAC sponsor, the hedge funds and others who invest in the IPO, and investors in the PIPE – generally do very well. Retail investors—who often buy their shares at the time of the merger announcement and hold them into the post-merger period—generally do poorly.

Two recent studies document this pattern of divergent investment returns. The first study (“the Klausner et al study”) analyzed the 47 SPACs that completed mergers between from January 2019 to June 2020.² The second study (“the Ritter et al Study”) examined the 114 SPAC IPOs from January 2010 to May 2018.³

The Klausner et al study finds that sponsors have fared well, even in cases where the post-merger company has not. Specifically, sponsors enjoyed a mean return of 393% for both three and six

¹ This is close to a money-back guarantee, though there are some differences. Investors are only entitled to their pro rata share of the trust account, which may be less than the market price they paid for their shares on the market. See SEC, What You Need to Know About SPACs – Investor Bulletin (Dec. 10, 2020), “(SEC 2020)”, available at <https://www.sec.gov/oiea/investor-alerts-and-bulletins/what-you-need-know-about-spacs-investor-bulletin>.

² Klausner, Michael D. and Ohlrogge, Michael and Ruan, Emily, A Sober Look at SPACs, (“Klausner et al”), (October 28, 2020). Yale Journal on Regulation, Forthcoming, Stanford Law and Economics Olin Working Paper No. 559, NYU Law and Economics Research Paper No. 20-48, European Corporate Governance Institute – Finance Working Paper No. 746/2021, Available at

SSRN: <https://ssrn.com/abstract=3720919> or <http://dx.doi.org/10.2139/ssrn.3720919>

³ Gahng, Minmo and Ritter, Jay R. and Zhang, Donghang, SPACs, (“Ritter et al”), (January 29, 2021). Available at SSRN: <https://ssrn.com/abstract=3775847> or <http://dx.doi.org/10.2139/ssrn.3775847>.

months after the merger, and 187% after 12 months. (Median returns after 12 months were a more modest, but still lucrative, 32%.⁴) The Ritter et al study noted, however, that sponsors' actual profits may be less than they appear. That is because sponsors give away some of their compensation, in the form of shares and warrants, to certain other investors as inducements either to invest new capital or refrain from redeeming their shares.⁵

Klausner et al also found that IPO investors—who invest when the SPAC first launches its IPO and, in most cases, redeem their shares at the time of the merger announcement—earned mean annualized returns of 11.6%.⁶ The Ritter study—using a different time period and different weightings—found an average annualized return of 9.3%. These are excellent returns for an investment which, as explained below, involves minimal risk.

These returns stand in stark contrast, however, to those of the post-merger public company. This is important, because the post-merger returns represent what retail investors will earn by investing around the time of the merger and holding on to the stock.

The Klausner study found that the sample's 12-month mean return after the merger was -34.9%.⁷ (The median return in that time period was an even worse -65.3%). The SPAC cohort also underperformed benchmarks involving an IPO index and the Russell 2000. The study also analyzed returns going back to 2010. For every year since 2010, SPAC post-merger one-year returns underperformed the Russell 2000 by 10% or worse. Tellingly, the study also found the poor returns were highly correlated with the level of dilution.

The returns were also negative, but not quite that poor, according to the Ritter et al study. Specifically, it found returns of either -15.6% or -4.0%, depending on how they were measured.⁸ In sum, these findings present a consistent track record of profits for certain types of investors and losses for others.

Questionable Design Features of SPACs

Are there systematic design features of SPACs that explain this strikingly divergent record of returns, which draw a sharp line between SPAC winners and losers? The two studies point to three particular features of SPACs: dilution, misaligned incentives, and an uneven regulatory playing field that permits forward-looking statements at the time of the merger.

⁴ See Klausner et al, *supra* note 2, at 39.

⁵ Sponsors forfeit an average of 34% of their common share promotes and 42% of their private placement warrants, according to the study. See Ritter et al, *supra* note 3, at 6.

⁶ See Klausner et al, *supra* note 2, at 18.

⁷ *Id.* 34.

⁸ The difference in returns is based on how the researchers weight the shares. The less negative number (-4%) only counts the money that public SPAC investors leave in after redemptions. In other words, this number reflects the fact that investors redeem most of their shares in deals that produce the lowest returns. See Ritter et al, *supra* note 3, at 5.

Before elaborating on these features, it may be helpful to review the basics of how a SPAC works. A SPAC – short for Special Purpose Acquisition Company – is a publicly listed company set up for a single purpose: to find a private operating company, merge with that company, and thereby take it public, thus bypassing the traditional IPO process. SPACs typically have 18-24 months to complete that merger or else dissolve and give shareholders their money back.

Dilution

The SPAC sponsor arranges its IPO, manages the search for a merger target, and negotiates with the target on merger terms. As compensation, the SPAC receives 20% of the post-merger shares for a nominal price. This is called the sponsor’s “promote,” and it represents dilution of the future returns of the post-merger public company.

The very first investors in the IPO often include hedge fund regulars known as the “SPAC Mafia.” These initial investors purchase units, which are almost always priced at \$10 each. These units consist of shares, warrants and, in some cases, rights.⁹

Warrants give the holder the right, but not the obligation, to buy shares (or a fraction of a share) at a certain price (for SPACs, \$11.50 per share) from the post-merger company. After about two months (usually 52 days after the IPO), the warrants and rights detach from the shares and can be traded separately.¹⁰ After this time, an investor buying shares on the public market will receive no warrants or rights. The initial bundling and subsequent unbundling of warrants and shares is a critical feature to which we will return.

The SPAC places the proceeds of the IPO in a trust. There the money remains for months, while the sponsor searches for a merger target. The SPAC will use this money to complete the merger. In this pre-merger period, the SPAC has no operating business. It has no products or services to sell.

At the time of the merger announcement, investors—big and little—can ask for their money back. The greater the redemptions, however, the more the trust is depleted. The SPAC will need this money to complete the merger and provide the merger target with capital—just as the merger target would receive capital from IPO proceeds if it had chosen that avenue to become a public company.

To replenish the trust (at least partially), SPAC sponsors often make private deals with certain investors—who could be institutional investors, private equity, or other professional investment firms—in transactions known as PIPEs (Private Investments in Public Equity). To induce these

⁹ The rights can be exchanged for a fraction of a share (such as one-tenth of a share) at no cost, provided that the SPAC merger is completed. See Klausner et al, *supra* note 2, at 7.

investors to invest in the PIPE, the SPAC sponsor often sweetens the terms with side deals, such as a discounted price. These side deals represent a second source of dilution to the SPAC.

The merger process is called the “de-SPAC.” It results in a newly merged company. In this manner, the previously private company becomes a public reporting company without having gone through the traditional IPO. This newly public company is an operating company, with products or services to sell.

In practice, nearly all of the initial IPO investors choose to dispose of their shares at the time of the merger announcement.¹¹ They can do so in either of two ways. If the current share price exceeds their initial purchase price (typically \$10), they will sell their shares on the open market. If the market price is less than the initial purchase price, they will instead redeem their shares to the SPAC, which will take money from the trust to pay them (plus modest interest that the money has earned while in the trust).

Critically, however, when initial IPO investors redeem or sell their shares, they get to keep their warrants. This is about as close to a free lunch as one can get in the investing world. Because their money has been placed in a trust, the investment has been close to risk-free. It’s true that, by tying their money up for months in the trust, the investment may entail opportunity costs. Nonetheless, Ritter et al liken this arrangement to a “*default-free* underpriced convertible bond with extra warrants.”¹²

It should also be noted that the initial IPO investors are allowed to vote for or against the merger, regardless of whether they retain or dispose of their shares. They will have an economic incentive to vote in favor of the deal – because they retain their warrants – even if they believe it is a bad deal.

In sum, SPACs entail several significant sources of dilution, including 1) the sponsor’s 20 percent promote; 2) the warrants that the initial IPO investors retain (even if they dispose of their shares) and 3) discounts or side payments given to the PIPE investors. All of these sources of dilution represent future claims on the returns of the post-merger company. They represent a handicap that the company must overcome before it can return profits to ordinary shareholders.

Both of the studies cited above find that the dilution is highly correlated with subsequent poor returns of post-merger companies to date.¹³ It is possible that a strong company can overcome these handicaps and reward its investors. In practice, however, the post-merger track record of

¹¹ Among large institutions known as 13f filers, the study puts the mean and median SPAC divestment rates at 90% and 98%, respectively. As for the SPAC Mafia, more than half of these hedge funds totally divest before the merger. (Institutions with at least \$100 million in specified equity securities are required to file 13f disclosures with the SEC.) See Klausner et al, *supra* note 2, at 17.

¹² See Ritter et al, *supra* note 3, at 34. (Emphasis in the original.)

¹³ Correlation, however, is not causation. As Ritter et al note, it is unclear whether dilution causes poor returns, or instead whether inferior SPACs require more dilution to induce investments. See Ritter et al, *supra* note 3, at 4 and Klausner et al, *supra* note 2, at 37.

SPACs – dating back to 2010 – shows how hard that is to accomplish. Most SPACs have been unable to overcome these hurdles.

Could this time be different? No one can predict the future, and it is always possible that future returns will break the old pattern. It is also possible that SPACs could evolve new features to reduce dilution.¹⁴ The evidence to date, however, points to the need for legislators and regulators to be vigilant in protecting investors and for investors themselves to exercise informed judgment in their investment decisions.

Misaligned Incentives

SPACs also present some misaligned incentives. For example, the sponsor has a strong financial interest to complete the merger – even if it is a bad deal for ordinary shareholders. If the sponsor makes no deal at all, the SPAC must return all the shareholders’ money and dissolve the SPAC. In that case, the sponsor will lose its entire investment in the SPAC, which can total millions of dollars. It will receive no compensation whatsoever for its work of the past year or two. Its 20 percent promote will be worthless, along with any warrants or rights it had purchased.

As the deadline to produce a merger approaches, the sponsor will face increasing pressure 1) to find a merger target and 2) to negotiate the terms of the merger deal. A bad deal may nonetheless yield lucrative returns for the sponsor—even as it leads to poor returns for the regular shareholders in the post-merger company. And the pressures on SPAC sponsors can only be expected to grow more intense in the months ahead. Hundreds of SPACs are now competing to find and negotiate deals with private companies—even while competing with private equity firms, which are also awash in cash.¹⁵ The competition may far exceed the limited pool of viable merger targets that will make suitable public companies; i.e., companies that 1) have systems, controls and resources in place to meet their obligations as public reporting companies and 2) can maintain or grow their business, and hence their stock price, as a post-merger publicly listed company.

The initial IPO investors also have incentives that are misaligned with those of public investors who buy their shares later on the public market. The IPO investors have an economic incentive to vote in favor of a merger, even if it is a bad deal. If there is no merger, the IPO investors’ warrants and rights will become worthless. And, as noted above, these investors are free to dispose of their shares even while voting in favor of the merger and retaining their warrants and rights.

¹⁴ Indeed, warrants have fallen more recently. See Ritter et al, *supra* note 3, at 36. Also, some SPACs have adopted features that are significantly more investor-friendly. So far, however, these improvements are the exception that prove the rule.

¹⁵ See SEC 2020, *supra* note 1, (“*With an increasing number of SPACs seeking to acquire operating businesses, it is important to consider whether attractive initial business combinations will become scarcer.*”). (Emphasis in original.)

What about the incentives of the private investors in the PIPE at the time of the merger announcement? They have a mix of incentives, some aligned and some potentially misaligned with those of ordinary shareholders. These are typically sophisticated investors, and they gain access to confidential information about the merger that is not available to the public. (They typically agree not disclose or trade on the information, so as not to run afoul of Regulation FD.) Thus, if a prestigious private investor chooses to invest in the PIPE, the investment can signal to public investors that the deal has merit. In essence, retail investors may believe that they are riding the coattails of the due diligence conducted by the private investors. And since the private investors retain their shares after the merger, their incentives are aligned with the post-merger retail shareholders.

On the other hand, any side deals offered to the private investors in the PIPE can cause their incentives to diverge from those of public shareholders. These inducements represent a source of dilution that comes at the eventual expense of public shareholders. In addition, if the PIPE investors receive discounts as inducements, they will have a different yardstick than public investors to measure the success of the investment. For example, a private investment at, say, \$8 per share can turn a profit sooner than a public investment made at the prevailing market price of \$10 or more per share. In sum, the incentives of PIPE investors overlap but may also partially diverge with those of public investors.

Safe Harbor for Forward-Looking Statements

In a singular regulatory advantage over IPOs, SPACs have enjoyed a safe harbor from private liability to make forward-looking statements about the proposed merger (provided the statement is accompanied by meaningful cautionary statements).¹⁶

Yet the two parties making the forward-looking projections—the SPAC sponsor and the target company—both have incentives to promote the merger. The sponsor has a strong financial incentive to complete the merger, as we have seen, and the merger target has a similar incentive: the transaction will enable the private company to become a public company and receive the capital that the SPAC has raised.

In an IPO, in contrast, the issuer and the underwriter enjoy no safe harbor from private litigation for making any forward-looking statements. As a result, IPOs generally avoid forward-looking statements. This is an important protection for investors and market integrity, because it eliminates the risk of rosy and unrealistic forward-looking statements.

The disparate regulatory treatment of forward-looking statements makes for an unlevel playing. And yet the SPAC merger and IPO are functionally equivalent. Whether via a SPAC merger or IPO, the private company becomes a public one; i.e., it becomes subject to public reporting

¹⁶ In a recent statement, however, John Coates, Acting Director of the SEC Division of Corporation Finance, raised questions as to the extent that SPACs should rely on this safe harbor. See SEC, John Coates, Public Statement, “SPACs, IPOs and Liability Risk under the Securities Laws,” (April 8, 2021), available at <https://www.sec.gov/news/public-statement/spacs-ipos-liability-risk-under-securities-laws>.

requirements and is listed on a stock exchange. Moreover, this is the first time that the investing public learns about the hitherto private company in filings to the SEC.

It should also be noted that our federal securities laws subject the IPO issuer and underwriter to strong legal liabilities for material misstatements and omissions in the registration statement and the prospectus. The issuer faces strict liability; the underwriter is subject to similar liability – unless it can make an affirmative defense that it performed due diligence. This gives the underwriter a strong incentive to conduct its own independent review of the accuracy and veracity of the IPO registration statement and prospectus. There do not appear to be the same third-party due diligence incentives in the case of SPAC mergers (or direct listings).

At one level, this may sound like a rather arcane discussion of federal securities laws. But the frenzy surrounding SPACs over the past year or so shows how important these investor protections are in the real world.

The Path Going Forward

Though SPACs have been around for years, they took off in popularity beginning in March 2020. They are still evolving, and they may ameliorate concerning features such as high levels of dilution.¹⁷

SPACs now face scrutiny by Congress – including this hearing – as well as by the SEC and the media. That is a good thing. The SEC, for example, has published two investor bulletins explaining how SPACs work and considerations that the public should keep in mind. One bulletin explains how the incentives of sponsors and certain other investors may “diverge from your interests.” The other bulletin specifically cautions against relying on celebrity endorsements of SPACs.¹⁸

CFA Institute also has raised questions about the investor protection issues involving SPACs.¹⁹ In addition, we have announced that we are forming a working group to examine and possibly make recommendations regarding the surge in SPACs and the implications for investor protection, corporate governance, and market integrity.²⁰

¹⁷ See *supra* note 14.

¹⁸ SEC, *Celebrity Involvement with SPACs – Investor Alert*, (March 10, 2021), at <https://www.sec.gov/oiea/investor-alerts-and-bulletins/celebrity-involvement-spacs-investor-alert>, (“*It is never a good idea to invest in a SPAC just because someone famous sponsors or invests in it or says it is a good investment.*”). (Emphasis in original.)

¹⁹ See, e.g., Margaret Franklin, CFA, President and CEO of CFA Institute, “5 things to watch out for before you invest in SPACs,” (April 14, 2021), available at <https://www.marketwatch.com/story/5-things-to-watch-out-for-before-you-invest-in-spacs-11618349032>; Stephen Deane, CFA, *Barron’s*, “SPACs May Feed the Public’s Worst Fears About Wall Street,” (April 22, 2021), available at <https://www.barrons.com/articles/WP-BAR-0000043424>.

²⁰ See CFA Institute Announces the Launch of SPAC Working Group, (May 5, 2021), available at <https://www.cfainstitute.org/about/press-releases/2021/cfa-institute-announces-launch-of-spac-working-group>.

Investor education is a necessary tool in addressing a wide range of novel investment products and financial innovations, including SPACs. Public education alone, however, is not enough. Congress and securities regulators must remain vigilant to protect investors and the integrity of securities markets.

As Congress deliberates on whether and, if so, how to take action on SPACs, we welcome the focus on measures to protect investors and enhance transparency. This submission has sought to articulate several investor protection concerns regarding SPACs. Specifically, these involve 1) dilution; 2) misaligned incentives that may work against the interests of certain SPAC investors, including retail investors; 3) the lack of disclosure of side deals with PIPE investors or others; and 4) the unlevel regulatory playing field and the risks of biased information that flow from a safe harbor for forward-looking statements related to SPAC mergers.

Thank you for holding this hearing and, more generally, in addressing these investor protection issues.