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

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Chairman Sherman, Ranking Member Huizenga and Members of the Subcommittee, it is an honor to participate in today’s hearing on Going Public. My name is Usha R. Rodrigues and I am a professor at the University of Georgia School of Law, where I teach and write in the areas of corporate law, corporate governance, and securities regulation. Prior to joining the faculty at UGA, I worked as a corporate lawyer in a Silicon Valley-based law firm.

I have written extensively about the public and private markets, and co-authored an early paper on special purpose acquisition companies (SPACs). In fact, my co-author Michael Stegemoller and I are currently conducting ongoing, active research into SPACs. My remarks today will be grounded in our research, but I want to emphasize that that research is incomplete and ongoing. In this testimony I will provide some context for the public offering process, and then turn to addressing some of the specific proposals for the potential reform of SPACs.

SPACs bill themselves as cheaper, faster, more certain alternatives to IPOs.¹ Let me be clear: I do not believe there is anything fundamentally wrong with the current IPO process. It does not need “fixing.” Admittedly, it is a slow and painful process. But given the vital importance of protecting the public capital markets, this deliberate process is entirely appropriate.

A public offering marks the debut of a company on the public markets. This debut represents a significant milestone in a corporation’s life. An operating corporation begins as a private entity, sheltered from public scrutiny. Any capital raises occur in the private markets. U.S. securities laws allow a much more laissez faire approach in the private markets—aside from anti-fraud protections, we mostly expect private investors to “fend for themselves”² relying on wealth as a proxy for sophistication.³ As I explain to my law students, this is why they cannot invest in hedge funds, venture capital funds, or a hot Silicon Valley startup.

The public markets, in contrast, allow ordinary citizens to invest. They represent a vast new source of capital for companies—and expose average investors to risks that only wealthy and institutional investors faced when the company was privately held. Entry into the public markets thus brings tremendous scrutiny to a newly public company. It must satisfy a host of periodic disclosure requirements; its financial reporting is scrutinized by analysts; its board must be independent. Its officers must certify as to the strength and reliability of its internal controls.⁴ The process of readying a company for the “big leagues” of the public markets is admittedly a slow and difficult one. It should be. After all, the end result is that the company is public—that average individuals, who lack the wealth and sophistication of private investors, can invest in them. Public companies need to be vetted. They need to be tested.

With this background context, I turn to the reform proposals of the Americans for Financial Reform and the Consumer Federation of America (Proposals) and the Discussion Draft. Two of the Proposals apply the IPO regulations and requirements to the de-SPAC transactions, and it is with these that I begin.

Excluding SPACs from the PSLRA’s Forward-Looking-Statements Safe Harbor

The Discussion Draft and one of the proposals of the Americans for Financial Reform and the Consumer Federation of America is to “Tamp Down Pre-Merger Hype” by amending Section 27A of the 1933 Act and Section 21E of the Securities Exchange Act to exclude SPAC disclosures from the safe harbor for forward-looking statements provided by the Private Securities Litigation Reform Act of 1995 (PSLRA). I support this proposal.

U.S. securities laws treat the going-public process as a period fraught with the possibility of investor hysteria. Ever since the passage of the 1933 Act, a key concern has been that the public will be whipped up into a frenzy and will overbid for new offerings untested in the public markets. Communication in the time before a private firm’s debut is thus highly regulated. U.S. securities laws divide the offering process into distinct time periods with specific rules regarding communication in each. Before the filing of the first public registration statement on Form S-1, the company is in the “quiet period.” So-called “gun-jumping” rules prohibit the issuer or underwriter from saying much about the firm’s prospects in general and about the offering in particular. The exact beginning of the quiet period can be difficult to identify, but once a company is in it, it must be careful not to “jump the gun,” because offers to buy or sell are strictly prohibited during this time.

Beyond explicit offers, the issuer may not say anything to advertise the offering or “condition the market.” The business is highly circumscribed in terms of what it can say about the business and its prospects, and the government will scrutinize the manner of communication, the content of the message (casting a negative eye on statements touting the firm’s future prospects), and the method of distribution. Violations trigger liability under Section 12, with a right of rescission or damages.

These laws exist for good reason—investor interest in a private company debuting on the public markets for the first time is intense. Despite all of the actions taken by the SEC to try to tamp down investor excitement, the prices of IPO shares typically jump (or “pop”) in the first day.

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7 Id. at 4.
8 Id. at 15.
9 Id.
10 Id.
11 Id. at 78.
12 Id.
of trading.\textsuperscript{13} For example, Airbnb’s IPO priced at $68 a share and soared in first-day trading to close at $144, an increase of 113%\textsuperscript{14} DoorDash’s IPO similarly surged 86% on opening day.\textsuperscript{15} While these are particularly noteworthy examples, a consistent pattern of underpricing remains.

Congress enacted the PSLRA’s safe harbor for forward-looking statements in 1995 to acknowledge that investors hunger for financial projections and other information about a company’s prospects.\textsuperscript{16} This information is extremely valuable—but it is also speculative. In 1995, Congress made the calculus that the benefits of forward-looking information outweighed the risks—for companies that had already been through the rigorous vetting of the IPO process.

These considerations are relevant because the de-SPAC transaction is effectively an IPO. Allowing forward-looking statements in a de-SPAC allows a transaction functionally equivalent to an IPO to skirt a key prohibition in a traditional IPO. Because the acquisition is effectively an IPO, it should be treated as such. There is no good policy reason for this disparate treatment.

I would anticipate that such a regulatory move would have a chilling effect on new SPACs, because it would take away one of their chief attractions over a traditional IPO. Indeed, John Coates, Acting Director of the SEC’s Division of Corporation Finance, released a statement titled “SPACs, IPOs and Liability Risk under the Securities Laws,” in which he questioned whether the PSLRA’s safe harbor even applied to de-SPAC transactions.\textsuperscript{17} The press attributed a slowdown in SPAC listings, at least in part, to this statement.\textsuperscript{18}

Ensure Section 11 Underwriter Liability

Because the de-SPAC is the functional equivalent of an IPO, I likewise support the proposal to extend Section 11 liability to SPAC sponsors and underwriters. Investment banks play an important role in a traditional IPO. They put their reputation on the line, as well as taking on


\textsuperscript{14} See Andrew Ross Sorkin et al., \textit{Airbnb’s Stunning I.P.O.}, N.Y. TIMES (Dec. 11, 2020), https://www.nytimes.com/2020/12/11/business/dealbook/airbnb-ipo-chesky.html (reporting how Airbnb’s shares were set to begin trading at $139 after its IPO had priced them at $68).

\textsuperscript{15} Id.

\textsuperscript{16} Susanna Kim Ripken, \textit{Predictions, Projections, and Precautions: Conveying Cautionary Warnings in Corporate Forward-Looking Statements}, 2005 U. ILL. L. REV. 929, 932 (2005) (“Historically, the SEC objected to the dissemination of forward-looking statements, fearing that unsophisticated investors would rely too heavily on this type of speculative information. In order to promote the disclosure of future-oriented information, however, Congress in 1995 enacted the Safe Harbor for Forward-Looking Statements (the “Safe Harbor”) as part of the Private Securities Litigation Reform Act (the "Reform Act"). The Safe Harbor was designed to give corporations the freedom to make projections and discuss the future potential of company operations without fear of liability should managers fail to predict the future accurately.”)


at least theoretical economic risks in a firm commitment offering.\textsuperscript{19} Furthermore, by putting the “deep pockets” of the investment bank on the hook in a traditional IPO, U.S. securities laws in essence deputize the investment bank to police the offering documents and ensure their accuracy.\textsuperscript{20} The banks do this through an extensive due diligence process as the registration statement is revised again and again. The banks thus serve as an important check, performing a gatekeeping role. They will not price an offering unless—and until—they are convinced it will sell and that none of the statements in the prospectus subject them to Section 11 liability.\textsuperscript{21}

Banks should be subject to the same kind of liability in the de-SPAC transaction—because it is the functional equivalent of an IPO. Instead, banks currently face no Section 11 liability in the de-SPAC transaction. Moreover, the banks often agree to delay a portion of their compensation unless and until the de-SPAC occurs.\textsuperscript{22} Thus, far from being a gatekeeper, the underwriter is incentivized to make sure that an acquisition—any acquisition—closes and that the target goes public. This subversion of the typical role of the underwriter is another example of regulatory arbitrage—there is no principled justification for it.

Again, the effect of this reform likely would be to decrease the number of de-SPAC transactions and the number of SPAC IPOs. Investment banks, facing strict liability for misstatements in the de-SPAC disclosures, would likely vet them much more thoroughly, therefore theoretically slowing down the process (although the de-SPAC can stretch over many months). Moreover, they might demand more compensation upfront, to account for the decreased likelihood of an eventual acquisition.

In terms of the Proposals, I am more skeptical of extending Section 11 liability to include SPACs’ financial advisors. The Securities Act defines “underwriter” as “any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such underwriting.”\textsuperscript{23} I believe this definition to be capacious enough to include financial advisors who functionally serve as underwriters, as the Act contemplates.

While I have supported two of the Proposals as described above, I have more hesitation about two of the other Proposals.

\textbf{Apply the Definition of a “Blank Check Company” to Include SPACs}

Rule 419 defines a “blank check” company as one that is both issuing penny stock and “is a development stage company that has no specific business plan or purpose or has indicated that its business plan is to engage in a merger or acquisition with an unidentified company or
companies, or other entity or person.”

SPACs avoid penny-stock status by having a market value of over $5 million and trading at over $4 per share.

Were the definition of a blank-check company expanded to include SPACs, thus subjecting them to Rule 419, the SPAC form would likely cease to exist. Rule 419 requires that both the proceeds and the securities offered in the IPO be held in escrow until an acquisition is completed. Thus, this requirement would eliminate any secondary market in SPACs. SPACs’ whole raison d’être is to allow for public trading of pre-acquisition shares. I believe the application of Rule 419 would make them economically unviable. It may be that Congress determines that there is no merit at all to SPACs as a route to the public markets. I am not willing to go so far. I believe other reforms might refine the form, as I describe below.

Enhanced Disclosures at the SPAC Offering and Merger Stages

Both the proposed Sponsor Promote & Compensation Act and the Proposals advocate more disclosure at the offering and merger stages. This section will address each in turn and describe why I believe disclosure to be insufficient.

Disclosures in Offering Documents

The Proposal requires clear disclosure of fees and payments to the sponsor, underwriter, and other parties, as well as the potential dilutive impact of warrants. These disclosures are important information and, as the Proposal points out, “should be made more explicit to investors, especially retail investors who often purchase SPAC shares in the secondary market.” The SPAC goes public largely as a shell. Much of the information that is of interest, especially to retail investors, will be contained not in the offering documents, but instead in the periodic filings—the annual and quarterly reports, and 8-Ks that the company must disclose under the 1934 Act—that update the market on how the SPAC is faring in its hunt for a target. As someone who has looked at hundreds of these forms, I cannot overemphasize the need for standardization in these disclosures. But such disclosure must of necessity not be simply in the offering documents—which are something of a dead letter once the offering is complete—but instead apply to the current and continuously updated periodic filings. Investors who purchase on the secondary market, sometimes over a year after the IPO, need to understand any related-party transactions, the dilutive effects of warrants, and other crucial matters, even more than do purchasers in the initial offering.

Disclosures Relating to the de-SPAC/Merger Transaction

The de-SPAC disclosures must be more standardized and transparent. My co-author and I are actively reviewing these disclosures as part of our ongoing research. They are byzantine in their complexity. We are left unsure as to the interests of the sponsor and its related entities, the identity and interests of the PIPE investors, and the principals of the target. Some subsequent

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25 See 17 C.F.R. § 240.3a51-1 (definition of a “penny stock”).
26 17 C.F.R. § 230.419(b)(1)(i).
28 See Klausner, Ohlrogge & Ruan, supra note 1, at 43–45.
investments came from trusts whose beneficial owners are the sponsors. Entities and affiliations are not always consistently identified. Disclosures are not cumulative, so it is difficult to keep track of the full financial picture. In short, these disclosures are a mess. And they are, crucially, a mess just when the SPAC enters its arguably most important period: the last period, when investors face a choice as to whether to exit and get their money back or instead risk ownership of an untested public company. These disclosures are in dire need of clarity and standardization if shareholders are to understand the economics of any proposed transaction. But improved disclosure, while necessary, is not sufficient to protect retail investors.

**Disclosure Is Not Enough: Voting Reform Is Needed**

The incentives of the major SPAC players tilt inexorably towards closing a deal—any deal. Sponsors devote their own money and time to a SPAC, and will receive compensation if and only if they complete an acquisition. Similarly, underwriters—the gatekeepers in the traditional IPO model—defer a portion of their compensation, which they will only receive if a deal closes. And they have only a limited period of time to claim that compensation after the fact—generally 18 to 24 months following the IPO—or they will have to return the money in the trust account to shareholders. If that happens, the sponsors lose everything, and the investment banks lose out on the deferred portion of their underwriting fee.

Thus, the merger is a time of great peril for shareholder, sponsor, and underwriter alike. My co-author and I documented in 2014 this powerful last-period pressure. Both our past and current research suggest that SPACs disproportionately complete acquisitions in the last few days before they expire. Press reports have detailed examples where even these bad deals can result in paydays for SPAC sponsors. The Wall Street Journal described a case where, although a post-acquisition SPAC’s shares were down about 30%, its sponsor’s initial $20 million investment was valued at about $140 million.

Early SPACs provided valuable counterweights to these last-period pressures. First, they required a majority vote on a proposed acquisition. Second, if more than 20% of shares were redeemed, the transaction would not close. The reasons for these two separate protective measures are clear. The first was a standard vote on the deal, a familiar measure because the shareholders of targets generally receive a vote on an acquisition.

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29 Id. at 6–11.
31 See Rodrigues & Stegmoller, supra note 21, at 886–90.
32 See Rodrigues & Stegmoller, supra note 29, at 119.
33 See id.
35 Id.
36 Rodrigues & Stegmoller, supra note 24, at 856.
38 See Rodrigues & Stegemoller, supra note 21, at 856.
The second vote, called the conversion threshold, was rooted instead in principles of basic economics. If the purpose of the trust account was to fund the ultimate acquisition, then the target and the SPAC needed the certainty of having enough money to close. The 20% conversion threshold, a deal term borne of economic necessity, became effectively a second supermajority requirement.39

Note that both of these mechanisms are safeguards that counterbalance managerial pressure to close a deal—even a bad deal for shareholders. Early SPAC sponsors had to convince at least a majority of the SPAC shareholders that the public target was worth at least what the SPAC was offering. During the financial crisis, these robust investor protections became a liability, as hedge funds piled into SPACs—either as a safe haven or as a target for “greenmailing,”40 withholding votes or threatening redemption as a way to extort side benefits.

In response, SPACs evolved—with the consent of the SEC—to largely eliminate the conversion threshold.41 SPACs now require only a majority vote—and in some cases, they use tender offers to avoid a vote entirely. The SEC justified the elimination of the conversion threshold and, sometimes, even of the vote itself by focusing on the protection offered through letting shareholders “vote with their feet” in a tender offer.42 That is, the SEC reasoned that shareholders do not need a vote for protection because they can always get their money back. That, in their reasoning, should be protection enough.

This reasoning had a fatal flaw: SPACs typically allow their shareholders to vote for the proposed transaction and still redeem their shares. In essence, then, the “vote” is merely pro forma, decoupled from any economic interest. A shareholder can vote for an acquisition in which she has no desire or intent to participate.

In approving the elimination of the vote, the SEC reasoned that any shareholders unhappy with the transaction could exit.43 But, as I will explain below, the conversion threshold protected not just the exiting shareholders, but also those shareholders who were left behind. The current system allows savvy shareholders to approve a transaction even as they head for the exit—leaving the most vulnerable investors holding the bag.

Professors Henry Hu and Bernard Black criticized the hypothetical possibility of decoupled voting and economic interest as “empty voting.”44 The ability of shareholders to vote yes and nevertheless jump ship in a de-SPAC is a species of empty voting. It is deeply troubling because, in mergers especially, voting interests typically accompany economic interests.

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39 See id. at 856.
41 Rodrigues & Stegemoller, supra note 21, at 856.
43 Id.
This point bears emphasis, and an example will make it more concrete. Target shareholders in a typical merger have what are called dissenters’ or appraisal rights, which protect them from a low-ball offer.\(^45\) If they vote against a proposed acquisition, then they can go to court and ask the court to determine the fair value of the deal. And if the court says the fair value of the deal is more than the merger consideration, they receive the difference.

In a famous case, T. Rowe Price owned shares in Dell and wanted to claim dissenters’ rights when Silver Lake Partners and Michael Dell took the company private. The offer was $13.75 per share.\(^46\) The Court agreed with T. Rowe Price; its appraisal price was $17.62 a share, or 28% above the Silver Lake buyout price. But it turned out that T. Rowe Price had neglected actually to vote against the merger before it went to court.\(^47\) The Court held that in order to exercise its economic rights to reject the deal, T. Rowe Price needed to have voted to reject the deal.\(^48\) Thus, T. Rowe Price lost out on $194 million in dissenters’ rights.\(^49\)

This story emphasizes the importance that the law traditionally places on aligning shareholders’ votes with their economic claims—on aligning a proxy vote with a shareholder’s wallet. I believe that, in asserting to the elimination of the vote via tender offers and in allowing SPACs to decouple voting and economic interest, the regulators at the SEC made a mistake. The original SPAC mechanism of a vote and redemption right protected not only the investors who opted out of the proposed business combination, but \emph{also those who remained}. As originally conceived, the SPAC’s managers had to convince the market of the proposed deal’s merits. If a certain percentage of the shareholders were unconvinced and wanted to cash out, then the deal failed. Bad deals could be frustrated. Thus, the sophisticated players who could comprehend those byzantine de-SPAC disclosures protected the retail investors who could not.

With these voting protections gone, skeptics can cash out, leaving only the convinced or the unwary—thus eliminating the market test of the transaction that SPAC originators touted as a key safeguard. In one study of recent SPACs, at the median 73% of the IPO proceeds are redeemed.\(^50\) I believe that if more than 50% of the shareholders ask for their money back, the deal should not go forward.

The safeguard of a market check is all the more important because the evidence shows that SPACs, at least in the early years of our sample, can be quite thinly traded. A considerable percentage of SPACs in our initial stage of review have been threatened with delisting for having fewer than 300 shareholders. In such a context, where the concern is with the retail shareholders left behind after hedge funds and other institutional players have redeemed their shares, simple disclosure cannot be sufficient protection. The retail investors need the protection of the

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\(^{47}\) In re Appraisal of Dell Inc., 2016 WL 3030909, at *31 (Del.Ch., 2016).

\(^{48}\) \emph{Id.}

\(^{49}\) \emph{Id.}

\(^{50}\) Klausner, Ohlrogge & Ruan, \emph{supra} note 1, at 14.
sophisticated investors—and they are more likely to have that protection if economic and voting interests are aligned.

Conclusion

To sum up, although it can be improved, I do not believe the IPO process needs fundamental “fixing.” Graduating a private company to the public markets is a major step in a corporation’s life. The federal securities laws acknowledge that with a host of regulations and restrictions. Among them are a ban of forward-looking statements and the assignment of Section 11 liability, which deputizes the investment bank to police the offering documents for material misstatements. Treating the de-SPAC, which is the functional equivalent of an IPO, differently from an IPO weakens investor protections without a good policy reason. And while more robust and standardized disclosure is necessary, it is not sufficient. I believe that if less than a majority of the public stockholders are willing to put their money on the table for a de-SPAC, then the transaction should fail.

Thank you, Chairman Sherman and Ranking Member Huizenga, for inviting me to participate in today’s hearing. I look forward to your questions.