

February 16, 2021

Chairwoman Maxine Waters
House Financial Services Committee
Washington, DC 20515

Ranking Member Patrick McHenry
House Financial Services Committee
Washington, DC 20515

Dear Members of the House Financial Services Committee:

We write to bring to the Committee’s attention the significant increase in public offerings by “blank check companies,” often referred to as special purpose acquisition companies (SPACs). The growth in SPACs represents attempts by sponsors and their targets to end-run longstanding rules designed to promote fair and efficient markets, and exposes investors and our markets to significant risks. The incentives of the SPAC sponsors, underwriters and early investors are poorly aligned with those of ordinary investors. As a result of these distorted incentives, SPACs have performed very poorly for most investors. At the same time, the boom in SPACs has provided spectacular windfalls for insiders and favored investors.¹ In this letter, we outline our concerns with SPACs, and offer recommendations for steps Congress and financial regulators should take to better protect retail investors.

Record issuance of SPACs in 2020, more expected in 2021

In 2020, SPAC offerings reached an all-time high of \$83 billion,² over six times greater than the prior record of \$14 billion in 2019. All signs point to even higher overall volumes in 2021, with over 144 SPACs completed so far, raising over \$44 billion, just two months into the year.³

¹ Michael D. Klausner, Michael Ohlrogge and Emily Ruan, A Sober Look at SPACs, at 3 (October 28, 2020). Stanford Law and Economics Olin Working Paper No. 559, NYU Law and Economics Research Paper No. 20-48, available at SSRN: <https://ssrn.com/abstract=3720919> or <http://dx.doi.org/10.2139/ssrn.3720919> (“We find that [SPACs] create substantial costs, misaligned incentives, and on the whole, losses for investors who own shares at the time of SPAC mergers. By contrast, there is an essentially separate group of investors that buy shares in IPOs and sell or redeem their shares prior to the merger, and these investors do very well”).

² SPACInsider. <https://spacinsider.com/stats/>.

³ Margot Patrick and Amrith Ramkumar, “Led by ‘Mr. SPAC,’ Credit Suisse Cashes In on Blank-Check Spree,” Wall St. J., Feb. 5, 2021, https://www.wsj.com/articles/led-by-mr-spac-credit-suisse-cashes-in-on-blank-check-spree-11612527389?mod=article_inline.

Today's SPAC sponsors represent a mix of financiers, venture capitalists, former politicians, and celebrities seeking to leverage their investment prowess, notoriety and professional networks to identify promising private companies to bring to the public market, ostensibly at a lower cost than a traditional public offering.

Background

For many years SPACs were associated with scams and relegated to the backwaters of the market.⁴ Now SPACs have grown in popularity, as they promise to provide private companies a faster route to a public listing when compared to traditional initial public offerings (IPOs), or even direct listings.

At the time the SPAC launches its initial public offering, it holds no significant assets. When investors initially purchase their shares they are betting on the sponsor's ability to identify an attractive target and negotiate a merger within two years. In the typical SPAC structure, the initial investors buy into units of a SPAC.⁵ Each unit consists of one share priced at \$10 and a warrant, a derivative similar to a call option that entitles the holder to buy additional shares (or fractions thereof) at \$11.50. Minimal substantive disclosures are required at the IPO stage other than a vague description of the types of industries in which the proceeds may be used to acquire a company. The S-1 prospectus from former baseball player Alex Rodriguez's SPAC, Slam Corp., merely states for example that the sponsor is targeting companies within "sports, media, real estate, enterprise software, and e-commerce".⁶

SPAC investors place their faith in the SPAC sponsor, which is usually given two years from the initial offering to find a company with which to merge (de-SPAC). A common arrangement is for 90% of the funds raised to be placed in escrow and invested in liquid securities (i.e., treasuries) until the de-SPAC process is completed.

When the sponsor identifies a merger target, its shareholders will be asked to vote to approve the merger. Shareholders that choose not to participate in the post-merger entity can sell their shares in the open market, or redeem their shares at the original purchase price.⁷

The targeted private company will not file public financial documents until after a SPAC merger is announced. At this point disclosure will be provided via a joint proxy statement and S-4 Registration Statement required when seeking shareholder approval for the merger and issuing additional shares.⁸ If

⁴ Tse, Crystal and Baker, Liana, "Once associated with fraud, 'SPAC' deals now are rehabbed and swapped for failed IPOs," Bloomberg, Dec 29, 2016, <https://www.latimes.com/business/story/2019-12-29/special-purpose-acquisition-companies-failed-ipos>.

⁵ The initial investors in SPAC IPOs are mostly hedge funds who are repeat players in this market. Known as the "SPAC mafia," these investors rarely hold their shares through the merger. Instead they sell into the market before the merger or redeem their shares, but retain their warrants which they can sell separately or hold to convert post-merger. See Klausner et al., at 11.

⁶ Slam Corp. (2021, February 4). Form S-1. Retrieved from <https://www.alexandria.unisg.ch/259427/1/1-s2.0-S0929119916300852-main.pdf>

⁷ It is important to note even if SPAC investors vote in favor of the merger, they can still redeem their shares. This structure means initial SPAC investors can provide the votes needed to ensure that the merger is completed, despite lacking any economic interest in the post-merger company.

⁸ In some instances, shareholder approval may not be required. In that case the SPAC will file a tender offer statement, offering to redeem the shares of any SPAC holders who choose to opt out of the merger. In either case the SPAC must provide comprehensive information about the target company, including audited financial statements.

enough of the SPAC's shareholders approve, upon completion of the merger, the combined company assumes the target's name. As a listed company, it will disclose its financials on a regular basis, just like any other publicly listed company. Shareholders can also vote against the merger, forcing the sponsor to search for other companies to merge with within the remaining two-year deadline. If the sponsor fails to identify a company or the SPAC's shareholders opt to redeem their shares instead, shareholders receive their initial investment back in addition to the interest accrued in their share of the trust.

Notably, upon consummation of a merger (de-SPACing) the sponsor usually receives (or vests in) 20% of the SPAC's shares as compensation (the "promote"). As a result of the sponsor's "promote" and other dilutive transactions, by the time of the merger, a typical SPAC only has \$6.67 in cash left behind every share issued at \$10. This dilutive impact means the costs to investors who buy in the open market or stay invested through the merger are far more significant than most commentary suggests, and greatly exceed the costs of a "traditional" IPO.⁹ It is not lost on us that Pershing Square's Bill Ackman, who himself has been criticized for receiving excessive pay, has called SPACs more of a "compensation scheme."

Issuers and SPAC Sponsor Benefits

The SPAC IPO phenomenon accelerated just as the highly-publicized The We Company (WeWork's parent company) traditional IPO began to flounder and collapse. Essentially, a company that its founder had claimed was "profitable" and had a private market valuation of tens of billions of dollars had its IPO collapse amidst investor and public scrutiny shortly after the filing of its S-1. Many venture capital investors and corporate issuers eyeing IPOs looked for ways to avoid a similar fate. SPACs have provided it.

The SPAC surge appears to be driven in part by private companies' desire to exploit the perceived speed, greater negotiating power, streamlined disclosures, reduced liability, and reduced shareholder rights offered by the SPAC process. As one SPAC investor recently explained SPACs offer "[s]ubstantially quicker process, less distraction for management, higher likelihood of getting it done, ability to make forward projections and often substantially higher valuation than a company would get in private markets."¹⁰ Given these features, it is not surprising that highly speculative companies (e.g., those related to crypto currencies, like eToro and Bakkt) are looking to access the public markets via SPAC mergers.

At the same time, SPAC sponsors and the hedge funds that dominate the early investor pool have come to appreciate the benefits of near-guaranteed attractive investment returns for an essentially risk-free investment, while avoiding the disclosure obligations and liability risks associated with the typical IPO. A recent study found that early investors who sell or redeem their shares before the merger receive an average return of 11.6% on a risk-free investment. SPAC sponsors' investments perform even, better earning a mean return of 32% in the 12-month period post-merger.¹¹

⁹ See Klausner et al. at 26-31.

¹⁰ Sheep of Wall Street (@Biohazard373), Feb. 1, 2021, <https://twitter.com/Biohazard3737/status/1356464468704788481?s=20>.

¹¹ See Klausner et al. at 18, 39.

SPACs Have Traditionally Performed Very Poorly For Most Investors Over the Long Term

The performance of SPACs for the period between the initial SPAC offering and allocation and the actual merger transaction (while the SPAC is an empty shell), is often good. We have recently seen that at this stage, retail investors often get into the game, lured by the “opportunity” to invest in the next “hot” private company at an early stage. Often, investing message boards and other media reflect speculation about targets, as well as other “hype” about the “potential” of the company.¹²

Unfortunately, the stock price performance after the eventual merger is often far more disappointing than promised by the pre-merger hype. In fact, SPACs have historically offered poor long-term performance for their investors, driven heavily by the misaligned incentives between the issuers and investors. A study of 158 SPACs covering the period from 2003 to 2008 found that on average a SPAC issued in those years lost 33% after one-year and 54% after three years.¹³ A more recent a study of SPACs from 2015 to 2019 found that, on average, they lost 18.8%, and only 29% had a positive return.¹⁴ Similarly, a November 2020 study of 47 SPACs from 2019 and early 2020 found poor relative performance.¹⁵ Much of the underperformance can be explained by SPACs historically merging with weaker, more indebted companies compared to their better performing peers that instead opt for the more traditional IPO process.¹⁶

Despite the poor long-term performance of SPACs, retail investors remain eager to invest. This is likely due to the attention drawn by the relatively few SPAC mergers that have earned outsized returns. The widely touted performance of shares of SPAC-launched companies such as Virgin Galactic and Draft Kings helps feed the myth that SPAC investing provides a route for ordinary investors to profit from access to high-tech investments that are typically limited to venture capitalists hedge funds, and other institutional investors.

Additional Risks for Investors

¹² See, e.g., SPAC Insider, VectoIQ Acquisition Corp (VTIQ) to Combine with Nikola Corporation (“This is one very cool company. Admittedly I know less than nothing about hydrogen fuel cells, but the presentation makes a very compelling story”); Sheep of Wall Street (@Biohazard373), Feb. 1, 2021, <https://twitter.com/Biohazard373/status/1356452402539421698?s=20> (“One of the most promising start ups I’ve ever seen will go public via SPAC in a few weeks. They will re-define a whole industry.”). Notably, in the replies to the tweet, a large number of individuals ask for information to help identify the companies involved, and begin significant speculation.

¹³ Howe, John and O’Brien Scott. *Advances in Financial Economics*. “SPAC Performance, Ownership, and Corporate Governance,” Nov 6, 2012, https://www.researchgate.net/publication/243463742_SPAC_Performance_Ownership_and_Corporate_Governance.

¹⁴ Celarier, Michelle, “Egregious Founder Shares. Free Money for Hedge Funds. A Cluster**k of Competing Interests. Welcome to the Great 2020 SPAC Boom, Institutional Investor,” Sep 21, 2020, <https://www.institutionalinvestor.com/article/b1ngx7vttq33kh/Egregious-Founder-Shares-Free-Money-for-Hedge-Funds-A-Cluster-k-of-Competing-Interests-Welcome-to-the-Great-2020-SPAC-Boom>.

¹⁵ Klausner et al. at 34.

¹⁶ Johannes Kalb and Teresa Tykova. *Journal of Corporate Finance*. “Going public via special purpose acquisition companies: Frogs do not turn into princes,” July 2016, <https://www.alexandria.unisg.ch/259427/1/1-s2.0-S0929119916300852-main.pdf>

In addition to the crucial matter of poor long-term performance, SPACs pose other significant risks for investors,¹⁷ including that:

- Initial SPAC disclosures may not provide investors with an appropriate understanding of the ultimate target company’s risks, operations, or other factors;
- The SPAC sponsor typically has insufficient incentive to “drive a hard bargain,” when negotiating with a merger target, because the sponsor’s primary objective is simply a completed transaction, along with the compensation it will earn upon the merger’s consummation;
- The SPAC sponsor and other financial advisors typically have insufficient incentives to perform robust due diligence that might turn up information that jeopardizes the deal;
- Target company disclosures may be less reliable, as a result of significantly lighter scrutiny in the SPAC process, and the fact SPAC sponsors and underwriters do not face the same legal liability risks as underwriters in an IPO, thereby increasing the risk of fraud;
- SPAC sponsors and other late-stage investors (in PIPE transactions) often receive incentives and significant compensation that materially dilute investors’ interests;
- SPAC investors have little ability to address perceived problems with corporate governance of the target company, executive compensation, or other terms because they are typically not party to the merger negotiations (often leading to more favorable terms for the target company executives and venture capital investors);
- Investors and the public have insufficient time to review detailed disclosures of the target, which reduces their ability to conduct thorough due diligence before deciding whether to stay invested through the merger;
- Due to certain loopholes in the federal securities laws, investors have fewer legal protections against misstatements by the target company and underwriter than they would have in a traditional IPO; and
- Investors have already committed to parting ways with the capital prior to receiving detailed disclosures, which creates significant “inertia” to remain invested.

Compounding these concerns, there are now exchange traded funds (ETFs) focused on SPACs. For example, NextGen SPAC IPO ETF, has invested in recently listed SPACs over the past 18 months. Because ETFs are explicitly marketed as passive investment vehicles, the creation of a new, passive investor base only exacerbates the existing problem of investors in SPACs not demanding that the sponsor take greater diligence and precautions in order to acquire the best company at the appropriate price.

Recommendations

To address the conflicts of interest inherent in SPAC structures and protect retail investors from misleading and incomplete disclosure regarding SPACs, we urge the Committee to consider the following reforms to statutes, rules and regulations governing SPACs.

¹⁷ Securities and Exchange Commission. Corporation Finance Disclosure Guidance: Topic No. 11. “Special Purpose Acquisition Companies”. Dec 22, 2020. <https://www.sec.gov/corpfin/disclosure-special-purpose-acquisition-companies>

1. Modernize the Definition “Blank Check Company”.

Congress should revisit the legislation that authorized the SEC to regulate blank check companies.¹⁸ Specifically the definition of “blank check company” should be amended so that it is not limited to blank check companies that issue “penny stock.” At the time the statute was enacted fraud and inefficiencies related to blank check offerings centered around so-called “penny stock” offerings (shares offered for low prices with a low aggregate offering size). Now that promoters and sponsors are using significantly larger vehicles to finance blank check companies, they can evade the restrictions Congress adopted to protect investors from the misleading information, conflicts of interest, and fraud so often associated with blank check offerings. Making an investment vehicle larger and attracting larger investments does not cure the problems inherent in marketing, selling, and trading in blank check stock.

2. Tamp Down Pre-Merger Hype

SPAC Sponsors, target companies, and their advisors are currently protected from liability for overly optimistic projections included in merger related disclosure due to the safe harbor for “forward looking statements” provided under Private Securities Litigation Reform Act of 1995. In a traditional IPO, financial projections in offering documents are subject to Section 11, Section 12 and Rule 10b-5 liability if they turn out to be unfounded, because IPO documents are specifically excluded from the PSLRA safe harbor. Congress should amend 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. These amendments would put SPAC mergers on a level playing field with IPOs and reduce incentives for private companies to access the public markets via SPACs.¹⁹

Closing this loophole and requiring SPAC sponsors and their financial advisors to assume liability for misleading projections will help to ensure that blank check company sponsors and advisors will not inject overly optimistic or unrealistic projections in SPAC related documents. Tamping down on hype is especially important because many SPAC merger targets have no revenues at all, but often boldly claim to investors they will be able to generate billions in revenue in the near future.²⁰ CIIG Merger Corp’s merger documents with electric vehicle producer Arrival Corp for example shows the company expects no revenues through the end of 2022 but tells investors that it suddenly expects revenue to jump to \$14 billion by 2024.²¹

3. Ensure Appropriate Underwriter Liability.

¹⁸ See Securities Enforcement Remedies and Penny Stock Reform Act, Pub. L. No. 101-429 §§ 501-510, 104 Stat. 941, 951-58 (1990), The Act amends the Securities Act of 1933 to require the SEC to prescribe special rules for registration statements filed by any issuer that is a blank check company (one with no specific business plan or purpose, or whose intent is to merge with an unidentified company); Securities Act Rule 419, 17 CFR §§ 230.419.

¹⁹ See Klausner et al. at 42-43.

²⁰ See, e.g., SPAC Insider, <https://spacinsider.com/2020/03/03/vectoiq-to-combine-with-nikola-corporation/> (reporting with respect to Nikola, a company with no reported revenue, “The company expects to generate revenue by 2021 with the roll out of its BEV truck, followed by FCEV truck sales starting in 2023”).

²¹ CIIG Merger Corp. (2020, December 15). Form 425. Retrieved by <https://sec.report/Document/0001193125-20-317561/>

Ensure that Section 11 liability extends not only to SPAC sponsors, but also to their underwriters and financial advisors in connection with disclosures made during the merger phase. Requiring that underwriters and deal advisers assume underwriter liability will help to ensure that proper due diligence is conducted when preparing merger-related disclosures.²² Because the SPAC underwriter receives more than half of its underwriting fee at the completion of the merger, the underwriter should be deemed to be an underwriter for the entire SPAC offering that culminates at the time of the de-SPAC transaction. In addition, any financial advisor on the SPAC merger should also be deemed an underwriter. Ensuring underwriter liability for the merger transaction will help to ensure that SPAC merger disclosures are prepared with the same level of care as a typical IPO S-1.²³ To ensure equal footing with IPO offerings, tracing should be presumed for any SPAC shares purchased during the 90-day period following the de-SPAC transaction.²⁴

4. Enhanced Disclosures at SPAC Offering and Merger Stages.

SPAC merger disclosures should include the amount of cash per share expected to be held by the SPAC immediately prior to the merger (under various redemption scenarios); any side payments or agreements to pay sponsors, SPAC investors, or PIPE investors for their participation in the merger, including any rights or warrants to be issued post-merger and their dilutive impact.

SPACs must on their offering documents clearly disclose fees and other payments to the sponsor, underwriter, and other parties. The average sponsor takes 20% of the final SPAC while the underwriting investment bank charges around 5.5%. Such disclosures should also include the potential dilutive impact of warrants that remain outstanding even after SPAC investors redeem their shares pre-merger. Although this information can often be pieced together from various parts of the public offering documents, the dilutive impact of warrants, redemptions, and pre-merger PIPEs should be made more explicit to investors, especially retail investors who often purchase SPAC shares in the secondary market.

5. Study the Risks and Results of SPAC Mania

Direct the SEC to collect data on SPAC shareholders and warrant holders, and produce a report evaluating average performance across investor types. In particular, the SEC should study SPAC investors and the performance of SPAC shares, including by collecting the firms, addresses, and other information for each investor in the shares and warrants of SPACs. Current law²⁵ regarding blank check companies, allows the SEC to require issuers to provide information on the names and address of

²² Under Section 2(a)(11) of the Securities Act, the definition of underwriter includes any person who “offers or sells for an issuer in connection with a distribution,” the bringing SPAC underwriters and merger advisers squarely within the definition, due to their extensive role in arranging, marketing and promoting the merger transaction.

²³ See Klausner et al. at 55.

²⁴ See id. at p. 45 (noting the possibility of easing tracing requirements with respect to SPAC transactions).

²⁵ Securities Act of 1933. 17 CFR 230.419 (5) <https://www.law.cornell.edu/cfr/text/17/230.419>.

investors in them. If the definition of a blank check company is updated to include SPACs as our prior recommendation suggests, the SEC can use its existing authority to collect that additional information.

This key information should enable the Commission to accurately assess the categories of investors that typically bear the brunt of SPACs' post-merger losses. The SEC study should determine the extent of redemption of SPAC shares pre-merger and the characteristics of investors who retain their shares through the merger, or purchase shares in the open market post-merger. These investors, many of whom are retail investors, are often drawn to SPAC investments by the publicity and hype that surrounds the announcement of a SPAC merger. These investors are likely unaware of the complexity of fee arrangements or the expected dilution that will eventually erode the value of their investments. The rapid growth of trading platforms, such as Robinhood, who are designed to appeal to unsophisticated investors, adds to the urgency of these studies.

Conclusion

The SPAC boom is fueled by conflicts of interest and compensation to corporate insiders at the expense of retail investors. Congress and the SEC should close the legal loopholes that allow SPAC sponsors, target companies and their financial advisors to evade the securities law's disclosure obligations, scrutiny and other liability rules that were designed to protect investors from ill-informed investment decisions and fraud.

We thank you for your consideration of these issues. If you have any additional questions, please feel free to contact Andrew Park at andrew@ourfinancialsecurity.org or Professor Renee M. Jones, Boston College Law School at jonesrx@bc.edu.

Sincerely,

Americans for Financial Reform

Consumer Federation of America