Written Testimony before the House Financial Services Committee of
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"Going Public: SPACs, Direct Listings, Public Offerings, and the Need for Investor Protections"

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Chairwoman Waters, Ranking Member McHenry, and Members of the Committee:

Thank you for inviting me this afternoon to share my views on the different ways that private companies have been opting to go public outside of the traditional Initial Public Offering process.

My testimony will focus in particular on the rise of Special Purpose Acquisition Companies (SPACs). Over $100 billion have been issued this year, ten times the total in 2018.[1] This exponential growth is concerning because SPACs historically have performed very poorly for retail investors, while the issuers, advisers, and a select group of institutional investors profit.

Unlike other public market investments, a SPAC initially has no assets outside of the cash investors provide during the initial offering, betting solely on the sponsor's ability to identify a company to merge with ("de-SPAC") within two years. It's perhaps for this very reason that sponsors have resorted to hiring celebrities with little financial expertise to help market their SPAC to the public, developments that have led the Securities and Exchange Commission (SEC) to issue a warning.[2]

In the typical SPAC structure, the initial investors buy into units of a SPAC. 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. Initial investors who receive the warrants for free are typically large players like hedge funds. Retail investors typically come in after that and purchase regular shares or those warrants for a price in the secondary market.

[1] SPACInsider. https://spacinsider.com/stats/
[2] SEC's Office of Invest Education and Advocacy. Celebrity Involvement with SPACs – Investor Alert. Mar 10, 2021. https://www.sec.gov/oiea/investor-alerts-and-bulletins/celebrity-involvement-spacs-investor-alert

Shareholders have no ability to evaluate the companies they are potentially investing in until a merger is announced, when they receive a joint proxy statement and Form S-4 and are asked to quickly vote to approve or reject the merger. Shareholders who choose not to participate in the post-merger entity can either sell their shares in the open market or redeem their shares at the original purchase price of $10.

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") for free, which means that issuing SPACs exceeds the costs of a "traditional" IPO. It is not lost on us that hedge fund Pershing Square's Bill Ackman has called SPACs more of a "compensation scheme."[3]

The SPAC surge appears to be driven in part by private companies' desire to exploit the perceived speed, greater negotiating power to get a higher price for themselves than in the private markets, streamlined disclosures, reduced liability, and reduced shareholder rights offered by the SPAC process. 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.

Although many people have just started hearing about these SPACs recently, SPACs are far from new. In fact, they date back to the 1980s when they were called blank check companies and often associated with scams, bilking unsuspecting investors out of millions of dollars.[4]

Fraud was so pervasive in these blank check companies that Congress passed the Penny Stock Reform Act (PSRA) in 1990[5] to address some of the problems, which was followed by the SEC putting in place Rule 419 for blank check companies.

Blank check company issuers, however devised the modern-day SPAC structure to get around those rules, reminding us that properly regulating new assets requires continuing attention and action.

There are two main ways SPACs escape from coverage by PRSA and Rule 419. First, the $4/share "penny stock" threshold, and second the extremely low standard of $5 million in net

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[3] Celarier, Michelle. Institutional Investor. Egregious Founder Shares. Free Money for Hedge Funds. A Cluster***k of Competing Interests. Welcome to the Great 2020 SPAC Boom. 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

[4] Hinden, Stan. Washington Post. In For A Penny, Out Of A Pound. Dec 24, 1989. https://www.washingtonpost.com/archive/business/1989/12/24/in-for-a-penny-out-of-a-pound/29febe0c-8b94-4006-9722-4a4ae155ea35/

[5] Securities Enforcement Remedies and Penny Stock Reform Act of 1990. https://www.congress.gov/bill/101st-congress/senate-bill/647

tangible assets.[6] Every SPAC holds much more than $5 million in cash and they are deliberately issued at $10/share.[7]

Safe harbor from forward-looking statements

SPACs also rely on a safe harbor from being held accountable for forward looking statements under the Private Securities Litigation Reform Act of 1995.

Whereas in an IPO, issuers and underwriters are liable for making false and misleading forward looking statements, SPACs are not subject to that same standard. That has emboldened many pre-revenue companies in highly speculative industries such as electric vehicles, cryptocurrency, and space exploration to make what might generously be called very rosy projections.

If we look at nine electric vehicle companies that have come public through a SPAC in 2020, their combined annual revenue was $139 million. But between them they projected to investors that they will generate $26 billion in annual revenue by 2024.[8] Or look at Holicity's proposed merger with Astra Space. The company has not yet launched any rockets, but they are projecting that they will have daily rocket launches by 2025.[9] For context, SpaceX so far has topped all the private space exploration companies with 26 launches in 2020.[10]

The House Always Wins

What's most concerning is that retail investors are buying into this kind of hype, in some instances pouring their life's savings into certain SPACs[11] when data continues to show that they perform poorly over the medium and long run.

A large part of that underperformance comes from the sizeable upfront compensation to the sponsor, who receives the 20% promote regardless of the quality of the acquisition.

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[6] 17 U.S.C. §240.3a51-1 (1992). Definition of "penny stock". https://www.law.cornell.edu/cfr/text/17/240.3a51-1
[7] Heyman, Derek K. Entrepreneurial Business Law Journal. From Blank Check to SPAC. 2007. https://core.ac.uk/download/pdf/159610375.pdf
[8] Allaj, Ortenca and Indap, Sujeet and Kruppa, Miles. Financial Times. Automotive tech start-ups take wild ride with Spacs. Jan 12, 2021. https://www.ft.com/content/688d8472-c404-42d6-88b7-fbd475e50f7c
[9] Securities and Exchange Commission EDGAR. Holicity Inc. Form S-4. May 3, 2021. https://www.sec.gov/Archives/edgar/data/1814329/000121390021024003/ea138694-s4_holicity.htm
[10] Wall, Mike. Space.com. SpaceX's very big year. Jan 2021. https://www.space.com/spacex-astronaut-starship-launches-2020-milestones
[11] Lee, Isabelle. BusinessInsider. A 17-year-old Wall Street Bets enthusiast poured nearly all of his savings into Chamath Palihapitiya-backed Clover Health – and now stands to lose it all as the stock struggles. May 13, 2021. https://markets.businessinsider.com/news/stocks/chamath-palihapitiya-clover-health-investing-advice-spac-teenager-investment-2021-5-1030427409

In addition to the 20% dilution that SPACs will immediately experience from paying the sponsor upon completion of a merger, many SPACs will spend additional capital redeeming most of their initial investors.

As a result, the average SPAC issued at $10/share, after paying the sponsor and meeting those redemptions, ends up with only $6.67/share in cash after the merger[12], meaning that the value of the company would need to rise 50% just to get back to its initial $10, leaving many of the retail investors who are holding the post-merger SPAC at significant disadvantage.

But even more alarmingly, there is little quality control being done on the deals that retail investors end up investing in. The SPAC's initial investors are failing to serve as the first line of defense to insist that a deal is properly negotiated, since they are able to profit essentially risk-free without doing so.

The hedge fund initial sponsors will actively purchase various SPACs, and then sell all their shares before the merger is completed, while still holding onto what are effectively lottery tickets in the form of the warrants they received for free during the initial SPAC listing, and that they can exercise for a profit if the stock does end up rising above $11.50/share.[13] A 2020 study[14] documented the scale of this behavior, finding that an astounding 97% of the hedge funds who initially purchased certain SPACs either sold their shares in the open market or redeemed them to get their $10 back plus interest.

SPAC issuers meanwhile can sell the shares they received for free anytime. For example, Virgin Galactic's Chamath Palihapitiya sold his entire $213 million stake before the company had generated any significant revenue.[15]

We wouldn't want people's 401Ks to be used at the Blackjack table given how the game is mathematically stacked against them. But unfortunately investing in SPACs in their current form is not very different.

I'll end my remarks with these figures that show just how clearly the house always wins. The average SPAC issuer between 2019 to 2021 saw returns of 958%. The average initial

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[12] Klausner, Michael and Ohlrogge, Michael and Ruan, Emily. Yale Journal on Regulation. A Sobert Look at SPACs. Oct 28, 2020. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3720919

[13] Bryant, Chris. Bloomberg Opinion. Hedge Funds Love SPACs But You Should Watch Out. Dec 9, 2020. https://www.bloomberg.com/opinion/articles/2020-12-09/hedge-funds-love-spacs-but-retail-investors-should-watch-out?sref=f7rH2jWS

[14] Klausner et al.

[15] Sheetz, Michael. CNBC. Virgin Galactic drops 10% after chairman Chamath Palihapitiya dumps his $213 million personal stake. Mar 5, 2021. https://www.cnbc.com/2021/03/05/chamath-palihapitiya-sells-virgin-galactic-spce-stake.html

institutional investor who is conducting arbitrage (which I can later elaborate further on) averaged a 40% return.[16]

But, retail investors who chase these SPACs with high hopes are losing. A 2012 analysis of 158 SPACs issued between 2003 and 2008 found their average one-year return was -33% while that loss deepened to -54% after three years.[17] Between 2010 and 2018, the average one-year return following a merger was -15.6%.[18] Even more recently, a Goldman Sachs index of 200 SPACs in April saw average losses of -17% compared to a 10% return this year in the S&P 500.[19]

Given the dramatically misaligned incentives that characterize these deals and their extremely poor performance for retail investors, we urge the Committee to take action. We urge you to amend the Exchange Act to align the rules governing forward looking projections in SPACs with those of IPOs, and to broaden the definitions of blank check companies to better protect main street investors.[20]

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[16] Cemblast, Michael. JP Morgan Asset Management. Eye on the Market. Feb 8, 2021. https://privatebank.jpmorgan.com/content/dam/jpm-wm-aem/global/pb/en/insights/eye-on-the-market/hydraulic-spacking.pdf

[17] Howe, John and O'Brien, Scott. Advances in Financial Economics. SPAC Performance, Ownership, and Corporate Governance. November 2012. https://www.researchgate.net/publication/243463742_SPAC_Performance_Ownership_and_Corporate_Governance

[18] Gahng, Minmo and Rittter Jay R. and Zhang, Donghang. University of Florida Warrington College of Business. SPACs. Mar 2, 2021. https://site.warrington.ufl.edu/ritter/files/SPACs.pdf

[19] Sorkin, Andrew Ross et al. New York Times DealBook. Is the SPAC boom over? Apr 22, 2021. https://www.nytimes.com/2021/04/22/business/dealbook/tech-giants-dc.html

[20] Park, Andrew and Jones, Renee M. Letter from Americans for Financial Reform to the House Financial Services Committee on SPACs. Feb 16, 2021. https://ourfinancialsecurity.org/wp-content/uploads/2021/02/AFR-Letter-on-SPACs-to-HFSC-FINAL.pdf