# The IPO Alternative: Special Purpose Acquisition Companies Are Gaining Traction in Private Equity

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## I. INTRODUCING SPECIAL PURPOSE ACQUISITION COMPANIES

At its simplest, private equity is an investment in an entity that is currently not publicly listed on a major exchange such as the New York Stock Exchange ("NYSE") or NASDAQ.[1] As a result, private equity is often subjected to less scrutiny by the public and governing bodies compared to publicly traded securities.[2] Traditionally, private companies become publicly listed through an initial public offering ("IPO"), making them available for the common investor.[3] IPOs have been the go-to for private companies transitioning to public companies throughout history. However, the past decade has seen Special Purpose Acquisition Companies ("SPAC" or "SPACs") become increasingly

1. *See generally* HARRY CENDROWSKI ET AL., PRIVATE EQUITY: HISTORY, GOVERNANCE, AND OPERATIONS (2d ed. 2012) (providing an overview of private equity portfolio company operations).

2. *Id.* at 5–6 ("The privacy in which the industry operates is essential to its function.").

3. *See* Shobhit Seth, *IPO vs. Direct Listing: What's the Difference?*, INVESTOPEDIA (Apr. 10, 2021), https://www.investopedia.com/investing/difference-between-ipo-and-direct-listing/ [https://perma.cc/Z4FX-Q8G4].

popular alternatives year after year, with their own unique benefits and drawbacks.[4]

SPACs are blank check companies—having no day-to-day operations—that go public with the intention of pooling capital through their IPO to acquire or merge with one or more unspecified companies or assets.[5] These targets are typically private companies and as a result become publicly traded.[6] The specific acquisition is usually not disclosed until after the SPAC's IPO.[7] SPACs represent a low-risk opportunity for investors to enter what would typically be a private equity investment.[8] The average investor can purchase a share of a SPAC through their brokerage, close the position by selling the share back, or hold the share through the merger and own a share of the newly-public company.[9] The entry is often low-risk as "shareholders vote on whether to accept an acquisition, and individual investors have the right to reject the proposed business acquisition and can redeem their shares for full value."[10] In addition, "if the SPAC cannot find a target company in an agreed-upon and allotted time frame, generally 18 to 24 months, the SPAC vehicle is liquidated, and all funds are returned to shareholders."[11]

The downside is that once an operating entity is acquired and merged with the SPAC, the Securities and Exchange Commission ("SEC") normally does not allow "the typical grace period for many areas of regulatory compliance"—meaning that the merged entity must immediately satisfy various SEC rules and regulations.[12]

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4. *See SPAC Statistics*, SPACINSIDER, https://spacinsider.com/stats/ [https://perma.cc/7ZFK-NZKX] [hereinafter SPACINSIDER] (listing one IPO in 2009 and 447 in 2021). Another IPO alternative not examined in this Note is a direct listing, where shares already held by members of the company sell them to the public, rather than the company hiring an underwriter and issuing new shares (which would dilute ownership); *see also* Seth, *supra* note 3.

5. *See What You Need to Know About SPACS - Updated Investor Bulletin*, SEC (May 25, 2021), https://www.sec.gov/oiea/investor-alerts-and-bulletins/what-you-need-know-about-spacs-investor-bulletin [https://perma.cc/25NC-Z27V] ("SPACs have become a popular vehicle for various transactions, including transitioning a company from a private company to a publicly traded company.").

6. *Id.*

7. *Id.*

8. The average investor for the purposes of this note refers to a retail investor, a singular non-professional investor, trading securities on their own behalf through a brokerage or savings account, such as a 401(k). *See* Adam Hayes, *Retail Investor*, INVESTOPEDIA (Feb. 17, 2021), https://www.investopedia.com/terms/r/retailinvestor.asp [https://perma.cc/8SH8-TXXJ]. Conversely, institution-al investors are persons or organizations that trade securities professionally in large quantities, often investing a group of investor's funds (e.g., an investment bank or hedge fund). *See, e.g.*, James Chen, *Institutional Investor*, INVESTOPEDIA (Aug. 19, 2021), https://www.investopedia.com/terms/i/institutionalinvestor.asp [https://perma.cc/7SRJ-9FSL].

9. *See* SEC, *supra* note 5 (describing the manner in which investors can purchase SPAC shares).

10. Chris Wright & Charles Soranno, *Rise of the SPACs: Understanding the Risks and Rewards in This Vogue IPO Vehicle*, PROTIVITI (June 5, 2020), https://blog.protiviti.com/2020/06/05/rise-of-the-spacs-understanding-the-risks-and-rewards-in-this-vogue-ipo-vehicle/ [https://perma.cc/G6UT-N4FH].

11. *Id.*

12. *Id.* For example: "1) the SPAC is not afforded the one-year annual grace period for internal control compliance integration for the acquired entity, and 2) the acquired entity becomes the SEC reporting entity and must follow the rigid filing timelines as set forth by the SEC, with no delay in compliance afforded." *Id. See also* Matty Merritt, *Traditional IPO vs SPAC: Everything You Need to Know About Taking Your Company Public*, Morning Brew (Apr. 14, 2021), https://www.morningbrew.com/daily/stories/2021/04/14/traditional-ipo-vs-spac-everything-need-know-taking-company-public (explaining that "[t]hey have become increasingly popular because they help companies go public a lot quicker").

Many companies choose the SPAC route over traditional IPOs because of this simplicity. The traditional IPO process is long and difficult, taking between six months and a year.[13] But the SEC rarely asks extensive questions up front to SPACs, thanks to their simple purpose, their nonexistent financial history and assets, and their minimal business risk. This allows companies to go public in just a few short months.[14] Once the SPAC is in place, the process for a subsequent merger is much simpler than a full registration with the SEC.[15]

SPACs, which were once a last resort, have become an increasingly popular option for companies looking to go public. Recently, the volume of SPAC deals has grown year after year, breaking the record in 2019 with about $13.6 billion in gross proceeds, re-breaking the record in 2020 with $83.35 billion in gross proceeds, and again in 2021 with $129 billion gross proceeds through September 2021.[16] About half of all IPO volume in 2020 came from SPACs.[17] This Note provides a comprehensive background of SPACs and their growth and argues that the current regulatory framework for SPACs creates discordant incentives between management and investors and should be reworked.

## II. Background

### *A. History of Blank Check Companies and SPACs*

Blank check companies developed in the 1980s and garnered a poor reputation as a result of dishonest activity based on defrauding inexperienced investors utilizing penny stocks.[18] The 1990s saw a growing U.S. economy after the 1980s recession making IPOs

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13. *See* Wright & Soranno, *supra* note 10 (discussing a typical SPAC life cycle).

14. *See* Merritt, *supra* note 12 (describing the SPAC path as "[t]he indie route: once obscure, now wildly popular.").

15. *See* Dan Caplinger, *What Are SPACs, and Why Are They Back?*, MOTLEY FOOL (Apr. 12, 2019, 8:03 AM), https://www.fool.com/investing/2019/04/12/what-are-spacs-and-why-are-they-back.aspx [https://perma.cc/2FZ8-TD54] (stating that SPACs provide a more efficient vehicle for private companies to go public instead of an initial private offering).

16. *See* SPACINSIDER, *supra* note 4 (providing various statistical analyses on SPAC utilization). *See also* Crystal Tse & Liana Baker, *Once Associated With Fraud, 'SPAC' Deals Now Are Rehabbed and Swapped for Failed IPOs*, L.A. TIMES (Dec. 29, 2019, 6:00 AM), https://www.latimes.com/business/story/2019-12-29/special-purpose-acquisition-companies-failed-ipos [https://perma.cc/S98E-P7R7] (stating that SPAC deals are rapidly growing in popularity); *see also The SPAC Market is Deflating. Here's Why.*, PRIVATE EQUITY INSIGHTS (Aug. 17, 2020), https://pe-insights.com/news/2020/08/17/the-spac-market-is-deflating-heres-why/#:~:text=SPACs%20are%20having%20a%20big,IPO%20in%20the%20near%20future.&text=At%20the%20time%20of%20the,interest%20earned%20since%20the%20IPO [https://perma.cc/UT3B-5JL6] (explaining why the SPAC market may be on a downward trend despite a strong 2020 performance).

17. Sanghamitra Saha, *2020 Has Been the Year of SPAC IPOs: Here Are the Prominent 4*, NASDAQ (Dec. 28, 2020, 8:01 AM), https://www.nasdaq.com/articles/2020-has-been-the-year-of-spac-ipos%3A-here-are-the-prominent-4-2020-12-28.

18. *See* Alexander Osipovich, *Blank-Check Companies, A Hot IPO Fad, Contains Pitfalls for Investors*, WALL ST. J. (Feb. 26, 2019, 7:58 PM), https://www.wsj.com/articles/blank-check-companies-a-hot-ipo-fad-contain-pitfalls-for-investors-11551186000 [https://perma.cc/7HFV-484N] (explaining that the blank check companies associated with penny-stock frauds paved the way for the growth of SPAC listings). As defined by SEC Rule § 3a51-1 of the Securities Exchange Act of 1934, a "penny stock" is "any equity security other than a security" that is registered or traded on a national exchange. Securities Exchange Act of 1934, 15 U.S.C. 78a, 17 C.F.R. § 240.3a51-1 (2021).

an increasingly popular investment tool for sophisticated U.S. investors.[19] To protect investors from the blank check companies seen in the 1980s, Congress imposed strict regulations on blank check companies in the form of the Penny Stock Reform Act of 1990.[20] This act required brokers selling specific stock to obtain a written sales agreement from investors who did not usually purchase from that broker.[21]

In addition to the Penny Stock Reform Act, the SEC required increased disclosure and management requirements through Rule 419 of the Securities Act of 1933.[22] SPACs arose in 1992 as a way for blank check companies to provide "sufficient investor protection . . . to gain the approval of the SEC."[23] To avoid Rule 419, early SPACs maintained more than $5 million in assets, meaning the stock issued was not defined as penny stock under § 3a51-1 of the Securities Exchange Act of 1934, a vital aspect of modern SPACs.[24] These first-generation SPACs typically complied with Rule 419 regulations to instill confidence in investors cognizant of blank check companies' questionable history.[25] Today, most SPACs continue to follow Rule 419 of their own volition, although the SEC should take steps to ensure compliance.[26] The initial generation of SPACs included many of the features a modern SPAC carries. For example, excluding the small portion of money used to cover operating expenses, most money raised through the SPAC IPO is held in a trust account.[27] These SPACs also included the right for shareholders to liquidate their shares upon the announcement of an undesired acquisition.[28] Unfortunately, this is one of the few rights that SPAC shareholders have regarding their relationship with the SPAC, as such this Note later discusses and argues for increased SPAC shareholder rights.[29]

Despite the reasonable success of the early SPACs, increased regulation and a swell

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19. *See* Daniel S. Riemer, *Special Purpose Acquisition Companies: SPAC and SPAN, or Blank Check Redux?*, 85 WASH. U. L. REV. 931, 944–45 (2007) (describing the first generation of SPACs following the new regulatory environment created by Rule 419).

20. Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, 104 Stat. 931.

21. Randolph Beatty & Padma Kadiyala, *Impact of the Penny Stock Reform Act of 1990 on the Initial Public Offering Market*, 46 J.L. & ECON. 517, 517 (2003).

22. *See, e.g.*, Laura Anthony, *Rule 419 and Offerings by Shell or Blank Check Companies*, LAWCAST (Jan. 5, 2010), http://lawcast.com/2010/01/05/rule-419-and-offerings-by-shell-or-blank-check-companies/#:~:text=Rule%20419%20requires%20that%20the,for%20an%20acquisition%20or%20merger [https://perma.cc/9RMK-UE4E] (discussing the intended purposes of Rule 419, the notification of investors, and the definition of a shell company).

23. Derek K. Heyman, *From Blank Check to SPAC: The Regulator's Response to the Market, and the Market's Response to the Regulation*, 2 ENTREPRENEURIAL BUS. L.J. 531, 532 (2007).

24. *See* Securities Exchange Act of 1934, 17 C.F.R. § 240.3a51-1 (2011) (defining "penny stock"); *see also* Riemer, *supra* note 19, at 941–42 (narrating the promulgation of SEC Rule 419, which adopted the Securities Exchange Act of 1934's definition of "penny stock").

25. *See* Riemer, *supra* note 19, at 945–46 (enumerating the strategies employed by first-generation SPACs to "enhance their legitimacy."); *see also infra* Part IV (examining the necessity of the penny stock exemption).

26. *See infra* Part IV (discussing the reasons the SEC should formally require SPAC Rule 419 participation).

27. Riemer, *supra* note 19, at 944–45.

28. *Id.* at 946 n.97.

29. *See infra* Section III.C.3 & Part IV.

in traditional capital market activity by small capitalization ("small cap") companies[30] drove blank check companies to the brink of extinction in the 1990s.[31] In 2003, SPACs returned in a new regulatory era, one in which the Sarbanes-Oxley Act of 2002 required "sweeping auditing and financial requirements for public companies."[32] The 2000s saw a year-over-year increase in the total equity SPACs raised.[33] In 2005, the SEC adopted rules "that required SPACs completing a business combination to file with the SEC all of the information regarding the operating company that would be required had the operating company gone public by filing a traditional registration statement."[34] The SEC's stated goal was to "protect investors by deterring fraud and abuse in our securities markets through the use of reporting shell companies."[35] In addition, the American Stock Exchange ("NYSE Amex") in 2005 allowed SPACs to list without requiring operating histories.[36]

The 2000s saw SPACs and private equity reach new heights.[37] SPACs reached their peak in 2007, accounting for nearly 22% of all IPOs that year.[38] SPACs—and the world economy—were subsequently crushed by the housing bubble burst and credit crunch.[39] In 2010, SPACs returned with many of the specific terms we see today.[40] For example,

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30. Small cap refers to "companies with a relatively small market capitalization . . . [which] generally means a company with $300 million to $2 billion in market capitalization." *See* Adam Barone, *Small Cap*, INVESTOPEDIA, https://www.investopedia.com/terms/s/small-cap.asp [https://perma.cc/28A9-BS3H] (last updated Aug. 6, 2021).

31. *See* Heyman, *supra* note 23, at 532 (finding approximately 2,700 blank check offerings in 1987–1990, but in the early 1990s, "there were fewer than fifteen").

32. Wright & Soranno, *supra* note 10.

33. *See* Heyman, *supra* note 23, at 532–33 (stating that "[i]n 2004, there were twelve [SPAC] issues raising $0.44 billion; in 2005, there were twenty-nine issues raising $2.06 billion; and in 2006, there were thirty-seven, raising almost $2.7 billion"). This trend continued, as can be seen with 34 issues and $10.05 billion in 2017, 46 issues and $10.75 billion in 2018, 59 issues and $13.6 billion in 2019, and 248 issues and $83.35 billion in 2020, and 405 issues and $129 billion through September of 2021. *See* SPACINSIDER, *supra* note 4.

34. Carol Anne Huff, *SEC Should Revisit Its Special Purpose Acquisition Co. Regs*, LAW360 (Feb. 14, 2019, 2:08 PM), https://www.law360.com/articles/1129102/sec-should-revisit-its-special-purpose-acquisition-co-regs [https://perma.cc/9WLM-QNUG]; *see also* Use of Form S-8, Form 8-K, and Form 20-F by Shell Companies, SEC Release No. 33-8587; 34-52038, 70 Fed. Reg. 42, 234 (Jul. 15, 2005), https://www.sec.gov/rules/final/33-8587.pdf [https://perma.cc/6TRU-3LWV] [hereinafter *Use of Forms by Shell Companies*] (supplying rules instituted by SEC, 17 C.F.R. §§ 230, 239, 240, and 249).

35. *Use of Forms by Shell Companies*, *supra* note 34.

36. *SPACs 2.0: New SPAC Rules Changes Approved by NASDAQ and NYSE AMEX and New Market Features Make SPACs A More Attractive Investment Vehicle in 2011*, SHEPPARDMULLIN (Mar. 21, 2011), https://www.corporatesecuritieslawblog.com/2011/03/spacs-2-0-new-spac-rules-changes-approved-by-nasdaq-and-nyse-amex-and-new-market-features-make-spacs-a-more-attractive-investment-vehicle-in-2011/ [https://perma.cc/34U4-FTWM] [hereinafter Mullin].

37. Alexandros Seretakis, *A Comparative Examination of Private Equity in the United States and Europe: Accounting for the Past and Predicting the Future of European Private Equity*, 18 FORDHAM J. CORP & FIN. L. 613, 615 (2013) ("Fueled by an abundance of liquidity in the financial system, private equity activity reached its greatest heights between 2003 and 2007.").

38. Johannes Kolb & Tereza Tykvová, *Going Public Via Special Purpose Acquisition Companies: Frogs Do Not Turn into Princes*, 40 J. CORP. FIN. 80, 80 (2016) (finding of the 161 SPACs that went public in the U.S. between 2003 and 2008, 66 reached a public listing in 2007).

39. Seretakis, *supra* note 37. *See also* Mullin, *supra* note 36.

40. *Compare* Mullin, *supra* note 36 (detailing the 2010 NYSE Amex SPAC rules), *with* FINRA, REG. NOTICE 08-54, GUIDANCE ON SPECIAL PURPOSE ACQUISITION COMPANIES (2008), https://www.finra.org/rules-

the NYSE Amex required SPACs to have at least 90% of their gross capital raised held in trust and the completion of at least one merger or acquisition within three years of the IPO (valued at least 80% of the net value of the funds held in trust). The acquisition or merger must be approved by a majority of public shareholders, and shareholders disapproving of the business combination must be entitled to redeem their shares for a pro rata portion of the trust funds.[41] These requirements were very similar to the NYSE or NASDAQ SPAC listing requirements.[42] SPACs were further regulated in the 2010s. For example, in 2010 Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank" Act) in response to the 2008 financial crisis, increasing regulations on banks and implementing executive compensation requirements—the latter of which had negative implications on SPAC founder compensation structures.[43] This downside was somewhat alleviated in 2012 when Congress passed the Jumpstart Our Business Startups Act ("JOBS" Act) which created the emerging growth company ("EGC") provision, commonly known as the "IPO on-ramp."[44] The provision aimed to make it easier for companies to go public and has been a crucial aspect in allowing SPACs to IPO quickly.[45] The EGC provision was designed to encourage "small cap companies into going public by reducing the burdens of public disclosure and ongoing federal regulation," and is crucial for current SPACs to remain competitive.[46] EGCs were allowed more lenient financial reporting standards and regulatory communication restrictions, eased Dodd-Frank executive compensation requirements, and were exempted from the typical mandated post-IPO quiet period.[47] This easing of Dodd-Frank executive compensation requirements has created unique issues addressed later in this Note and ought to be reversed.[48] Consequently, the JOBS

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guidance/notices/08-54 [https://perma.cc/T7JN-64SJ] [hereinafter FINRA Reg. Notice 08-54] (describing current SPAC rules).

41. Mullin, *supra* note 36.

42. *Id.*; *see also* Cynthia M. Krus & Harry S. Pangas, *A Primer on Special Purpose Acquisition Companies*, SUTHERLAND ASBILL & BRENNAN LLP (Mar. 2016), https://www.publiclytradedprivateequity.com/portalresource/SPACsOverview.pdf [https://perma.cc/Z2HZ-2WT5] (outlining changes to SPAC regulations for its investors); FINRA, Reg. Notice 08-54, *supra* note 40 (providing guidance on SPAC structure, trends, and conflicts of interest).

43. *See* Gregory J. Hudson & Joseph E. Silvia, *Recent Legislation Encourages Bank M&A Activity*, AM. BAR ASS'N (Dec. 18, 2018), https://www.americanbar.org/groups/business_law/publications/blt/2018/12/ma/ (describing the effects of Dodd-Frank on banking merger and acquisition activity); *see also* SEC, *SEC Adopts Rule for Pay Ratio Disclosure*, (Aug. 5, 2015), https://www.sec.gov/news/pressrelease/2015-160.html#:~:text=As%20required%20by%20the%20Dodd,ratio%20of%20those%20two%20amounts [https://perma.cc/3B2Q-TRFG] (clarifying new SEC rule for pay ratio disclosure).

44. *See* Usha Rodrigues, *SPACs and the JOBs Act*, 3 HARV. BUS. L. REV. ONLINE 17, 17–19 (2012) (discussing the implications of the JOBS Act on private equity).

45. *Id.*

46. *Id.* at 19; *see also* SEC, *Emerging Growth Companies*, (Jul. 24, 2019), https://www.sec.gov/smallbusiness/goingpublic/EGC [https://perma.cc/6S78-Z3ZY] (defining emerging growth companies and their disclosure requirements); *infra* Part IV (discussing the necessity of SPACs remaining designated as EGCs going forward).

47. Sarah Pickering, *JOBS Act—Modifications to Pre- and Post-IPO Process for "Emerging Growth Companies"*, 32 REV. BANKING & FIN. L. 50, 55 (2012) (stating how the JOBS Act changes an EGC's responsibilities after an IPO).

48. *See infra* Part III.C.3 & Part IV (discussing the drawbacks and incentive distortions this easing creates and arguing the merits of a cap on executive compensation).

Act made it cheaper and easier for SPACs to go public via the IPO on-ramp by allowing them to file confidentially and avoid auditor verification of financial statements under Sarbanes-Oxley as well as executive compensation disclosure.[49]

The lack of executive compensation disclosure has persisted within modern SPACs and creates information asymmetry issues for SPAC shareholders discussed later in this Note.[50] It was already easy for SPACs to go public under the Securities Act of 1933, however, "successful SPACS—that is, SPACs that complete acquisitions—can save a lot of money in securities regulation compliance costs by making use of the IPO on-ramp."[51] Furthermore, the EGC provision made it easier for an average investor to engage in private equity through investment in SPACs as a byproduct of enabling more SPACs to come to market.

In 2015, President Barack Obama signed into law the Fixing America's Surface Transportation Act ("FAST" Act), which included further provisions designed to build upon the JOBS Act and spur IPOs of EGCs.[52] The FAST Act expanded the IPO on-ramp accommodations by reducing Securities Act registration requirements further and increasing the need to prepare financial statements that would be unnecessary at the time of the IPO.[53]

The recent growth in SPAC volume, combined with a SPAC's two-year combination window, presents issues due to the limited number of quality companies that can be brought public. This will likely result in poorer quality companies being brought public.[54] But this growth is not new. For example, from 2003 to 2008 SPAC IPOs raised around $22 billion in total.[55] Since 2012, the quantity of SPAC IPOs and the gross proceeds from those IPOs has generally grown year-over-year. In 2012, the aggregate gross proceeds from SPAC IPOs were approximately $490 million from nine total IPOs.[56] By 2017, the aggregate gross proceeds rose to around $10 billion from 34 total IPOs.[57] In 2019, the aggregate gross proceeds rose to $13.6 billion from 59 IPOs.[58] 2020

49. Dan Lonkevich, *SPACs Declaring Themselves as Emerging Growth Companies Under JOBS Act*, 1 DEALFLOW REP. 14, 14–15 (Aug. 13, 2012), https://www.littmankrooks.com/wp-content/uploads/2012/12/SPACs-declaring-themselves-as-emerging-growth-companies-under-JOBS-Act.pdf [https://perma.cc/Y4LL-XDJ4] (reporting on three special purpose acquisition companies).

50. *See infra* Part III.C.3 & Part IV (discussing unique disadvantages of average public investors in SPACs).

51. Rodrigues, *supra* note 44, at 20.

52. *See* Stacy Kanter, *FAST Act: Capital Formation Changes and Reduced Disclosure Burdens*, HARV. L. SCH. F. CORP. GOVERNANCE (Dec. 29, 2015), https://corpgov.law.harvard.edu/2015/12/29/fast-act-capital-formation-changes-and-reduced-disclosure-burdens/ [https://perma.cc/2BAD-RME9] (discussing the changes to the EGC offering process); *see also* SEC, *Recently Enacted Transportation Law Includes a Number of Changes to the Federal Securities Law*, (Dec. 10, 2015), https://www.sec.gov/corpfin/announcement/cf-announcement---fast-act.html [https://perma.cc/XU8E-6C7N] (highlighting amendments to federal securities laws). *See also* SEC, *Emerging Growth Companies*, (June 30, 2013), https://www.sec.gov/corpfin/cf-manual/topic-10 [https://perma.cc/TV4B-YYC3] (describing disclosure requirements for newly public companies).

53. Kanter, *supra* note 52.

54. *See* Wright & Soranno, *supra* note 10 (discussing how regulatory compliance grace periods are waived for newly acquired SPACs); *infra* Part IV (discussing how this slip in quality can be alleviated through expanding the two-year de-SPACing window).

55. Kolb & Tykvová, *supra* note 38, at 80.

56. SPACINSIDER, *supra* note 4.

57. *Id.*

saw the largest surge in SPAC activity, with over $83.35 billion in aggregate gross proceeds across 248 IPOs.[59] By July of 2021, that record was already rebroken with 388 IPOs and $117 billion raised since January 2021.[60]

### *B. The Traditional IPO Process*

An IPO is the process by which a private company offers securities, typically common stock, to public investors thereby providing access to the capital markets and increasing liquidity in its securities. The first step in the IPO process is to hire a team of IPO advisors including an underwriting syndicate composed of investment banks, lawyers, and accountants to provide guidance throughout the IPO process.[61] Next, the corporation designates its filing status. Since 2012, "the vast majority of IPOs" have been EGCs as designated by the JOBS and FAST Acts.[62] To qualify as an EGC, the company must have less than $1.07 billion in total annual gross revenue for the most recent fiscal year and not have sold common stock on or before December 8, 2011.[63] As mentioned, EGC status allows more lenient financial reporting standards and regulatory communications.

Next, a non-binding letter of intent is signed between the firm and the underwriter specifying a target price for the shares of the company going public, the fees to be charged by the underwriter, and other minutiae such as the size of the IPO and which major stock exchange to list on.[64] After these details are settled, the company prepares its Form S-1 registration document and files with the SEC. The SEC typically reviews these documents and disclosures and requests revisions or clarifications.[65] Once the documents are completed to the SEC's satisfaction, the filing is declared effective and the company may begin selling shares to the public.[66] Between the filing and declaration of the filing being effective, a quiet period occurs where the company and its underwriters may not speak with investors. After the offer is declared effective the management team often goes on a roadshow, which is the sales pitch to institutional and retail investors.[67] Finally, following public access, the underwriter attempts to ensure stock price stability.[68]

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58. *Id.*

59. *Id.*

60. *Id.*

61. *See* JOSHUA ROSENBAUM & JOSHUA PEARL, INVESTMENT BANKING: VALUATION, LBOS, M&A, AND IPOS 415–45 (3d ed. 2020) (explaining what steps are typically taken by companies exploring the option of undergoing an IPO).

62. PWC, *Roadmap for an IPO: A Guide to Going Public*, at 1 (Nov. 2017), https://www.pwc.com/us/en/deals/publications/assets/pwc-roadmap-for-an-ipo.pdf [https://perma.cc/78U6-PHAX].

63. *Id.* at 12. *See also*, Pickering, *supra* note 47, at 51–52 (discussing the various reporting requirements companies must follow to qualify as an ECG).

64. CENDROWSKI ET AL., *supra* note 1, at 72–75.

65. *Id.* at 75.

66. *Id.*

67. *Id.*

68. Underwriters do this by purchasing stock immediately following the IPO to support the price of the new security, effectively creating artificial demand. The SEC has recognized this as a form of price manipulation; however, price stabilization is specifically exempted from the 1934 Securities Exchange Act. *See, e.g.*, N. R. Prabhala & Manju Puri, *What Type of IPOs Do Underwriters Support and Why? The Role of Price Support in the IPO Process* 1 (Stan. Graduate Sch. Bus., Research Paper No. 1546R, 1999).

### *C. The SPAC IPO Process*

A SPAC goes through the typical IPO process with some differences. Some similarities include the SPAC filing a Form S-1 registration document with the SEC, clearing SEC comments and review, and going on a roadshow to find an underwriter.[69] The differences begin with the underwriter and the SPAC management team determining a specific price (almost always $10) for a "unit" of the SPAC, which consists of a share of common stock and a portion of a warrant allowing purchase of common stock at a higher price in the future.[70] Regarding SEC disclosures, SPACs "generally provide only vague search indicators . . . when filing. Anything more specific than such indicators could require additional disclosures."[71] The important differences are the lack of day-to-day operations of the SPAC and that 90% of the proceeds of the SPAC IPO are held in trust until a merger or acquisition is completed.[72] The remaining 10% of the SPAC IPO proceeds are available for the management team to pay for administrative costs such as shareholders who decide to liquidate their position.[73] The lack of operations means that SEC review of financials and disclosures is abbreviated and the Securities Act of 1933 and Securities Exchange Act of 1934 filings are minimal.[74]

In addition, the IPO of the SPAC receives funding from a sponsor—typically an investment bank—which contributes 10% of the total post-IPO capital to cover the IPO, SEC reporting requirements, and administrative costs.[75] Importantly, the SPAC, at the time of the IPO, likely will not have identified a target company to acquire or merge with, as this would require disclosure in the Form S-1 filing.[76] This is an issue, as the influx of SPACs in 2020 and 2021, combined with a finite number of quality mature companies ready to be brought public, means that SPAC management will inevitably begin bringing

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69. Zach Tayler, *SPACs: An Increasingly Popular Alternative to Traditional IPOs*, U. MIA. L. REV. (Sept. 21, 2020), https://lawreview.law.miami.edu/spacs-increasingly-popular-alternative-traditional-ipos/ [https://perma.cc/99MM-5UFP]. Underwriters in a SPAC IPO do the same thing as in a traditional IPO; however, their compensation structure is different. *See* Ramey Layne & Brenda Lenahan, *Special Purpose Acquisition Companies: An Introduction*, HARV. L. SCH. F. CORP. GOVERNANCE (July 6, 2018), https://corpgov.law.harvard.edu/2018/07/06/special-purpose-acquisition-companies-an-introduction/ [https://perma.cc/H7RT-JSBE] (comparing the traditional IPO process with that of a SPAC IPO). In a traditional IPO, underwriters receive a "discount" of "5%–7% of the gross IPO proceeds." *Id.* In a SPAC IPO, the discount is "2% of the gross proceeds to be paid at the closing of the IPO, with another 3.5% deposited into the trust account and payable to the underwriters on closing of the De-SPAC transaction. If no De-SPAC transaction occurs, the deferred 3.5% discount is never paid to the underwriters . . . ." *Id.*

70. *See* Andrew R. Brownstein et al., *The Resurgence of SPACs: Observations and Considerations*, HARV. L. SCH. F. CORP. GOVERNANCE (Aug. 22, 2020), https://corpgov.law.harvard.edu/2020/08/22/the-resurgence-of-spacs-observations-and-considerations/ [https://perma.cc/7TU7-ZXHT] (focusing on the evolution of SPACs to their modern form and the key aspects of modern SPACs).

71. Tayler, *supra* note 69.

72. *See* Laura Anthony, *Proposed SPAC Rule Changes*, SEC. L. BLOG (July 24, 2018), http://securities-law-blog.com/2018/07/24/proposed-spac-rule-changes/ [https://perma.cc/J5F3-TVCA] (discussing proposed rule changes by the Nasdaq and NYSE for SPAC listing requirements).

73. *Id.*

74. *Id.*

75. *Id.*

76. *Id.*; *see infra* Part III.B.1 (discussing the advantages to the target company when a SPAC does not identify a target company prior to becoming an IPO).

poorer quality companies public.

SPACs are designed to avoid being classified as blank check companies under Rule 419 of the Securities Act of 1933. This is desirable because blank check companies are prohibited from trading securities until after the completion of their acquisition or merger.[77] This Note focuses on SPACs that are not designated as penny stocks under § 3a51-1 of the Securities Exchange Act of 1934 and are thus exempt from Rule 419 and eligible to be traded on national stock exchanges prior to a business combination.

## III. ANALYSIS

This Part begins by discussing the business combination process of a newly-public SPAC, otherwise known as the De-SPAC process. This is followed by an investigation into why SPACs have experienced their meteoric rise to popularity by comparing the advantages and disadvantages of SPACs and traditional IPOs. Finally, this Section looks at the incentive structure of SPAC management teams and the policy implications of the legal framework governing SPACs in the United States.

### *A. SPACs Post-IPO and the Business Combination (De-SPAC) Process*

Post-IPO, in the secondary market (commonly known as the stock market), SPACs are subject to the listing requirements of their chosen national exchange. In addition, they are immediately subject to filing a variety of regulatory forms and proxy statements with the SEC and must comply with Sarbanes-Oxley and the Dodd-Frank Act of 2012.[78] Traditionally, NASDAQ was the stock exchange of choice because of looser compliance standards around things like director independence requirements.[79] Recently, however, the NYSE has relaxed its rules to encourage SPAC listing. Both the NASDAQ and NYSE attempted to ease their listing standards further, but the SEC rejected these proposals.[80] This Note argues that the SEC should take the next step and standardize the NASDAQ and NYSE listing and reporting requirements to provide investors further protections.[81]

Furthermore, secondary market SPACs are subject to dissolution—with shareholders reimbursed—if a SPAC does not complete an acquisition within 18 to 24

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77. *See* Anna T. Pinedo et al., *What's the Deal? – Special Purpose Acquisition Companies*, MAYER BROWN (Aug. 10, 2020), https://www.mayerbrown.com/en/perspectives-events/publications/2020/08/whats-the-deal-special-purpose-acquisition-companies [https://perma.cc/8Q2S-M9H2] (discussing the basic structure, security issues, and benefits of merging into a SPAC).

78. Krus & Pangas, *supra* note 42, at 26.

79. *See SPAC 101, Transaction Basics and Current Trends*, WINSTON & STRAWN LLP, at 18 (2018), https://www.winston.com/images/content/1/3/v2/135061/Winston-Strawn-SPAC-Basics-Presentation-2018.pdf [https://perma.cc/ZK2C-PVHJ] [hereinafter *SPAC 101*]; *see also* Daniele D'Alvia, *The International Financial Regulation of SPACs Between Legal Standardized Regulation and Standardization of Market Practices*, 21 J. BANKING REG. 107, 113–15 (2020) (comparing and contrasting NYSE and NASDAQ listing requirements).

80. *See SPAC 101*, *supra* note 79, at 17; *see also* Eva Su, *SPAC IPO: Background and Policy Issues*, CONG. RSCH. SERV. (Sept. 29, 2020), https://crsreports.congress.gov/product/pdf/IF/IF11655; Carol Anne Huff, *SEC Rejects NYSE Proposal and Delays Action on Nasdaq's Latest Proposal to Tighten Certain Listing Standards*, SPACINSIDER (June 18, 2019), https://spacinsider.com/2019/06/18/sec-rejects-nyse-spac-listing-proposal-2/ [https://perma.cc/RHL5-F53B].

81. *See infra* Part IV.

months and spend at least 80% of the funds held in trust.[82] However, the time period may be extended with shareholder approval.[83] This time period requirement creates dichotomous incentives between the SPAC board and shareholders. For example, a SPAC board nearing the end of the two-year dissolution period would likely be incentivized to make any acquisition in order to receive compensation, while a SPAC shareholder would prefer a high-quality aquisition be made. Thus, this Note also discusses and argues for the expansion or elimination of this arbitrary time constraint.[84]

Once the management team of a SPAC identifies a desirable business combination target, the SPAC and target will sign an acquisition agreement, and then both file a combined registration/proxy statement with the SEC.[85] The SEC review process for the SPAC combination is "as thorough and rigorous as that for a traditional IPO."[86] Upon SEC review completion, there is a period (around 20 days typically)[87] where the SPAC is required by the SEC to send proxy statements to their shareholders, and the shareholders hold a vote on whether to approve the acquisition or not.[88] However, stock exchange rules do not necessarily require a SPAC shareholder vote.[89] Stock exchange rules only require shareholder votes in the event that the existing corporation is dissolved or 20% or more of outstanding stock is issued.[90] Accordingly, shareholder votes are effectively required to approve an acquisition, and thus, shareholders retain the right to reject the acquisition and redeem their shares of the SPAC for full value.[91] This shareholder protection is somewhat diminished, however, due to the fact that the SPAC sponsor, in exchange for their minor $25,000 contribution, receives founder shares equivalent to "20% of the total shares outstanding after completion of the IPO."[92] Since at least those

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82. FINRA Reg. Notice 08-54, *supra* note 40 (discussing what SPAC are and the recent changes the industry have undergone).

83. *See, e.g.*, Anthony, *supra* note 72 ("A SPAC generally has 24 months to complete a business combination; however, it can get up to one extra year with shareholder approval."); *see also* Ramey Layne et al., *Update on Special Purpose Acquisition Companies*, HARV. L. SCH. F. CORP. GOVERNANCE (Aug. 17, 2020), https://corpgov.law.harvard.edu/2020/08/17/update-on-special-purpose-acquisition-companies/ [https://perma.cc/25VE-N47X]. This is typically done by amending the SPAC charter (the SPAC must also offer investors the chance to redeem their shares and warrants for equity) and requiring a shareholder vote. In recent years, one-third of SPACs have completed their De-SPAC transaction after the time period for completion had elapsed. Nearly all of these required a shareholder vote, so they are commonplace.

84. *See infra* Parts III.D, IV (discussing SPAC incentive structures and recommending changes the SEC can take regarding SPACs).

85. *See* DELOITTE, ACCOUNTING AND SEC REPORTING CONSIDERATIONS FOR SPAC TRANSACTIONS 2 (Oct. 2, 2020), https://www2.deloitte.com/content/dam/Deloitte/us/Documents/audit/us-audit-accounting-and-sec-reporting-considerations-for-spac-transaction.pdf [https://perma.cc/47Q9-N4LU] (explaining the steps needed to be completed by SPAC before completing an acquisition).

86. *Id.*

87. *Id.*

88. FINRA Reg. Notice 08-54, *supra* note 40.

89. *See* SEC, *supra* note 5 (explaining to investor what SPAC are and the important concepts they need to consider before investing in a SPAC).

90. Raluca Dinu, *De-SPAC Process – Shareholder Approval, Founder Vote Requirements, and Redemption Offer*, GIGCAPITAL (Dec. 27, 2019), https://www.gigcapitalglobal.com/de-spac-process-shareholder-approval-founder-vote-requirements-and-redemption-offer/ [https://perma.cc/AG6H-B83Z].

91. *See* Wright & Soranno, *supra* note 10 (discussing the risks associated with SPAC and the differences between SPACs and IPOs).

92. *See* Layne & Lenahan, *supra* note 69.

20% of shares will be voted in favor of the combination, it means that only 37.5% of the public shares issued need to vote in favor to achieve majority and approve the merger.[93] If the shareholders approve the business combination and all "the financing and other conditions specified in the acquisition agreement are satisfied," the merger (otherwise known as the De-SPAC process) is completed.[94]

A private company going public through a SPAC is subject to the same SEC scrutiny and stock exchange standards that it would have been subject to had it gone through a traditional IPO. However, once the De-SPAC process is completed, the acquired firm is public and is not "afforded the typical one-year internal control compliance integration" that it would have had after a traditional IPO.[95] This means that the acquired firm is immediately "subject to all relevant filing requirements of the SEC, including earnings reports, disclosures, and compliance with the strict internal controls of the 2002 Sarbanes-Oxley Act."[96] Compliance with many of these requirements is done through the filing of the Super 8-K, which must be completed within four business days of the completed merger.[97] The Super 8-K contains all the information that would have been included if the target had done a traditional IPO and were filing an initial registration statement.[98]

So, if a private company merging with a SPAC still faces the same SEC inquiry and NASDAQ/NYSE requirements that they would have dealt with had they gone through a traditional IPO process, why are SPACs so sought after? What benefits do they provide? Are there risks to investors and companies? The next Section begins by looking at the advantages SPACs provide to the target company, the management team and initial sponsor, and to public investors.

### *B. The Advantages of SPACs Compared to Traditional IPOs*

As mentioned, SPACs have seen enormous growth over the last decade.[99] This growth trend is likely a combination of a growing economy through the 2010s, and the JOBS and FAST Acts making SPACs more appealing than ever. Furthermore, tumultuous market conditions over the last few years have made SPACs desirable safe harbors in stormy IPO markets, particularly during the COVID-19 pandemic.[100] It is instructive to identify the advantages SPACs provide to three distinct groups: the target company, the management team and initial sponsor, and the average public investor.

93. *Id.*
94. *Id.*
95. *See* Wright & Soranno, *supra* note 10.
96. KPMG, SPACS: A BIG DEAL AGAIN 4 (2019), https://advisory.kpmg.us/content/dam/advisory/en/pdfs/2019/spacs-are-back.pdf [https://perma.cc/RM2737FY].
97. *See* DELOITTE, *supra* note 85.
98. *Id.*
99. SPACINSIDER, *supra* note 4.
100. *See* Gretchen Frazee, *6 Factors That Fueled the Stock Market Dive in 2018*, PBS NEWS HOUR (Dec. 27, 2018, 1:54 PM), https://www.pbs.org/newshour/economy/making-sense/6-factors-that-fueled-the-stock-market-dive-in-2018 [https://perma.cc/3YGP-LGPU]; *see generally* , Mieszko Mazur et al., *COVID-19 and the March 2020 Stock Market Crash. Evidence from S&P1500*, FIN. RSCH. LETTERS, July 2020 (discussing the stock market plunge in March 2020).

*1. Advantages to the Target Company*

One crucial ability of SPACs is the ability to weather turbulent market conditions by pivoting between industries.[101] For instance, during 2019 and 2020, the oil and natural gas markets experienced enormous downturns.[102] As a result of the compensation the acquired company receives being set before they are brought public, SPACs are resistant to bear markets and are able to mitigate "the game-breaking elements of poor valuations and bad timing that discourage most traditional IPOs" in a volatile market.[103] This provides security for private companies looking to go public during an economic downturn, as the funds raised through combining with a SPAC are secured once the merger agreement is signed and are, thus, not subject to fluctuating market conditions.

Of course, SPACs offer a plethora of advantages during a growing economy as well, as shown by the growth in quantity and equity of SPACs over the last ten years. One major advantage SPACs offer is their speed of bringing a company to market. Compared to a typical IPO, a SPAC can bring a private company to market in as little as a few weeks.[104] This is partially because SPACs "have a lower reliance on debt than a typical PE deal."[105] In contrast, a typical IPO process can take more than a year.[106] This does not mean, however, that a SPAC business combination cannot take a significant amount of time. The speed of a SPAC merger is dependent on the negotiations between the SPAC and target company, the shareholder approval process, and the speed of SEC review, but the process can typically be accomplished in four to six months.[107]

Being brought public through a SPAC is often far more lucrative for the target company than remaining private because "SPAC deals can add up to 20 percent to a sale price, a reflection of the public-markets premium."[108] SPACs can also be cheaper than traditional IPOs as the funds for the merger are raised prospectively, eliminating the need to negotiate compensation with underwriters.[109] Another advantage to SPACs is the

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101. Layne et al., *supra* note 83. *See also*, CENDROWSKI ET AL., *supra* note 1, at 113 (stating that reverse takeovers—effectively what SPACs facilitate—are "considerably less susceptible to market conditions").

102. This is partially due to factors such as Saudi Arabian supply issues in 2019 and an enormous reduction in oil demand in 2020 due to the COVID-19 pandemic. *See* Laura He et al., *US Oil Prices had Their Biggest Spike in a Decade After Saudi Attack Disrupts Global Supply*, CNN BUSINESS (Sept. 16, 2019), https://www.cnn.com/2019/09/15/business/oil-prices-donald-trump-spr/index.html [https://perma.cc/GKA2-EQCN]; *see also* Nicholas Jasinski, *The SPAC Market is Deflating. Here's Why.*, BARRON'S (Aug. 16, 2020, 6:15 AM), https://www.barrons.com/articles/the-spac-market-is-deflating-heres-why-51597572900 [https://perma.cc/29Z9-EKZZ] (stating that, "As the broader stock market rebounded, SPACs came roaring back. . . . It was a sign of investors' demand for SPACs, which look particularly attractive in 2020's uncertain stock market—thanks to their downside protection and the chance to get in on the ground floor of a new stock.").

103. Wright & Soranno, *supra* note 10.

104. Luis Sanchez, *Why Chamath Palihapitiya Loves SPACs*, NASDAQ (July 11, 2020, 11:05 AM), https://www.nasdaq.com/articles/why-chamath-palihapitiya-loves-spacs-2020-07-11.

105. KEYU ZHU & JAMES BRANNAN, KPMG, SPACS: A BIG DEAL AGAIN 5 (2019).

106. CENDROWSKI ET AL., *supra* note 1, at 114.

107. Pinedo et al., *supra* note 77; *see also SPAC—An Alternate Route to Going Public*, FOUNDERS CIRCLE CAPITAL, https://www.founderscircle.com/spac-an-alternate-route-to-going-public/ [https://perma.cc/Z6S8-BRFL] (describing the speed at which SPACs can effectuate mergers).

108. ZHU & BRANNAN, *supra* note 105, at 5. Public-markets premium refers to the value of a company rising once it is available to be traded on a public exchange, as compared to when it was privately held.

109. Nate Nead, *Advantages of a SPAC*, INVESTMENTBANK (Dec. 15, 2014), https://investmentbank.com/

access to public markets which opens the door to more capital to fund the target company's operations and fuel growth. In addition, the operating company can structure the combination transaction in ways that are not available in traditional IPOs, such as allowing existing owners to cash out.[110] The target company is also able to appeal to potential investors in ways not available had they utilized a traditional IPO. For instance, the target company can include financial projections in the SEC proxy statement.[111] Finally, the nature of the SPAC being a brand-new shell company means the target company avoids the hassle of dealing with a company with a questionable history.[112]

The culmination of these factors creates a very desirable opportunity for private companies of all sizes looking to go public. The private company can get to market quicker, cheaper, and potentially earn more than a traditional IPO, while avoiding the uncertainty of fluctuating market conditions.

### *2. Advantages to the SPAC Management Team and Initial Sponsors*

A major advantage for the SPAC management team is the unlimited scope of the acquisition market or field. The management team retains the ability to shift between market sectors to seek out the best opportunity for acquisition, for example switching from the electric vehicle market to the pharmaceutical market. Furthermore, the SPAC management team can draw from a wider investor base (the public) than had they worked in venture capital and funded solely from private entities. SPAC managers can also create their own unique deal flows and continue to innovate in future SPACs.[113] One SPAC manager, Chamath Palihapitiya, stated that SPACs have a passive investor base relative to venture capital allowing SPAC managers to seek out the best deal they can.[114] Finally, SPAC managers are compensated with stock in the post-IPO SPAC.[115]

Initial sponsors, who can be investment banks or individuals, front 10% of the final capital of the SPAC and are rewarded with unique founder's shares giving them 20%

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special-purpose-acquisition-company/ [https://perma.cc/6V2S-7YEC]. For example, in a traditional IPO the value of the shares sold is variable so the company going public negotiates with the underwriter regarding compensation due to uncertainty regarding how much capital will be raised. In a SPAC, the amount of funding has already been secured by the SPAC and underwriter (often a private equity firm investing in the SPAC), so the amount of capital raised is known and compensation for the underwriter has long-since been determined.

110. CAROL A. HUFF, WINSTON & STRAWN LLP, SPAC 101 4 (2018), https://www.winston.com/images/content/1/3/v2/135061/Winston-Strawn-SPAC-Basics-Presentation-2018.pdf [https://perma.cc/C9CK-HPY7].

111. *Id.*

112. For example, non-shell companies could have been operating under questionable business practices that could result in scrutiny for the merged entity later down the road. To hedge against this, the private company would require a variety of disclosures from the public operating company looking to reverse merger, which would need review and would be time-consuming. Another disadvantage for a private company looking to merge with a public company with extensive operating history would be the lengthy period of time a thorough SEC review takes, delaying the merger further. *See generally* Layne & Lenahan, *supra* note 69 (stating that "[a]s a result, the SEC comments are usually few and not particularly cumbersome").

113. *See* Krus & Pangas, *supra* note 42, at 13–14 (giving two examples of how a deal flow could be altered). Altering deal flow could mean changing how many warrants the founders and board purchase, or whether the acquisition is done using trust fund equity or shareholder equity.

114. Sanchez, *supra* note 104.

115. *See* ZHU & BRANNAN, *supra* note 105, at 5 (noting management teams will retain stock and get public access for their holdings).

equity in the post-IPO SPAC.[116] These exorbitantly high returns for nominal investment create disjointed incentives between the sponsors and the SPAC investor. As such, Part IV goes in depth regarding the incentive structure for the management team and initial sponsors and argues for capping executive compensation.

### *3. Advantages to the Average Public Investor*

SPACs provide the average public investor the opportunity to partake in an investment that traditionally would have been handled by private equity firms.[117] In addition, SPAC founders are often famous and highly experienced, driving up the price of the post-IPO SPAC and earning public investors a sizeable profit for a short-term investment.[118] These experienced managers are also able to seek out and deliver highly sought-after companies.

Public investors also acquire a liquid asset by purchasing a share in the SPAC, meaning they can leave the SPAC should they wish to. Investors receive warrants in addition to their shares, giving them the right to purchase more common stock in the future. They are also afforded substantial downside protection until the time of the business combination, such as the ability to reject a proposed target company and the ability to redeem shares of the SPAC for a portion of the funds held in trust.[119]

The foregoing discussion presents a holistic view of why SPACs are highly sought after and useful for all actors. The recent surge in SPAC activity has been very useful for smaller investors looking to partake in an IPO market that was traditionally controlled by large institutional investors. That said, SPACs come with unique risks. The next Section investigates the disadvantages they pose to the target company, the management team and initial sponsor, and the average public investor.

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116. *See* Anthony, *supra* note 72; *see also The SPAC Hack*, ECONOMIST (July 30, 2020), https://www.economist.com/finance-and-economics/2020/07/30/the-spac-hack [https://perma.cc/Z32M-YKKR] (noting sponsors usually hold a 20% share of a SPAC) [hereinafter *The SPAC Hack*].

117. This is particularly desirable for a retail investor because it broadens the range of investment opportunities that they have access to, including some companies that may have been permanently held privately if SPACs had not been an option.

118. For example, famous investor Chamath Palihapitiya has brought six SPACs public, averaging a lifetime 137% return. *See* Chris Katje, *Chamath Palihapitiya's 12 SPAC, PIPE Deals: Tracking 2021 and Lifetime Performance*, BENZINGA (Feb. 10, 2021, 8:15 AM), https://www.benzinga.com/news/21/02/19550206/chamath-palihapitiyas-12-spac-pipe-deals-tracking-2021-and-lifetime-performance. Bill Ackman's SPAC Pershing Square Tontine Holdings Ltd. had returned 51% through February 12, 2021 without even announcing a merger target. *Compare* Tomi Kilgore, *Bill Ackman's Pershing Square Tontine Raises $4 Billion as IPO Prices at $20 a Share*, MARKETWATCH (July 22, 2020, 8:15 AM), https://www.marketwatch.com/story/bill-ackmans-pershing-square-tontine-raises-4-billion-as-ipo-prices-at-20-a-share-2020-07-22?mod=article_inline [https://perma.cc/3JXM-6KQE] (showing the initial IPO price of $20 per share), *with Pershing Square Tontine Holdings (PSTH)*, YAHOO! FINANCE, https://finance.yahoo.com/quote/psth/ [https://perma.cc/372K-T8YK] (showing the shares' price of $30.21 on February 13, 2021).

119. *See* Layne et al., *supra* note 83 (noting that SPAC shareholders that vote "no" on a particular acquisition are required to be offered the ability to redeem their shares for equity from the trust fund).

### *C. The Disadvantages of SPACs*

#### *1. Disadvantages to the Target Company*

SPACs have a few disadvantages. First, the 20% SPAC equity that sponsors receive acts as an indirect fee for the acquired firm, so going public is not a free ride.[120] Second, selling to SPACs comes with unusual risks. For instance, while the merger transaction may occur quickly, it may also occur slowly or not at all. The SPAC shareholder vote can result in merger deals falling through.[121] Target companies give up some control when they sell to a SPAC, as the SPAC usually has its own operating team.[122] Also, as in a traditional IPO, the acquired companies' shares enter a lock-up period of up to a year post-merger, meaning the target company cannot sell its SPAC shares.[123] Finally, as a result of selling to a blank check company, the target company is typically not granted a grace period for regulatory compliance by the SEC, meaning "from day one, the new company must satisfy a wide range of SEC requirements."[124] This means "[i]n addition to preparing the IPO paperwork, they must produce audited historical financial statements under public company auditing standards, and they must carry out extensive pre-acquisition due diligence."[125] The target company has to establish an oversight or auditing committee prior to completing the merger as they are immediately responsible for Sarbanes-Oxley internal reporting.[126]

#### *2. Disadvantages to SPAC Management and Initial Sponsors*

The 20% SPAC ownership sponsors receive for nominal compensation provided to initially fund the SPAC requires no real work from the sponsor. This means sponsors can profit even if a future acquisition fails as a public company, creating a potential disparity in objectives between the sponsors and management team and their shareholders.[127] Of

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120. *See The SPAC Hack, supra* note 116 (noting the costs typically associated with the creation of a SPAC).

121. *See* Tse & Baker, *supra* note 16 (noting ability of shareholders to cancel SPAC mergers); discussion *supra* Part III.A (noting different rules associated with SPACs); *see also* Wright & Soranno, *supra* note 10 (elaborating on risks of SPACs).

122. *See* Tse & Baker, *supra* note 16 (noting control structures of SPACs).

123. *See* ZHU & BRANNAN, *supra* note 105, at 2 (specifying restrictions on the acquired company's ability to sell its shares after the merger).

124. *See* Wright & Soranno, *supra* note 10 (noting drawbacks of SPACs compared to IPOs).

125. *See* ZHU & BRANNAN, *supra* note 105, at 7 (noting the increased requirements for SPAC filings).

126. Sarbanes-Oxley reporting involves strict compliance regarding accounting and fraudulent business practices. *See, e.g.*, Juliana De Groot, *What is SOX Compliance? 2019 SOX Requirements & More*, DIGITAL GUARDIAN (Sept. 29, 2020), https://digitalguardian.com/blog/what-sox-compliance [https://perma.cc/E9LKV42K] (explaining the requirements for anti-fraud reporting for public companies).

127. Consider a management team that has invested time and money into a SPAC that has nearly reached the date by which it must acquire a company or completely liquidate. If the SPAC was liquidated, the management team and sponsors would stand to lose their initial investment as well as any profit. Thus, they are highly incentivized to acquire a company of any quality so that they do not lose time and money. A shareholder's main recourse in this case would be through litigation. *See, e.g.*, Nicolas Grabar, et al., *SPAC Sponsors Beware: The Rising Threat of Securities Liability*, CLEARY GOTTLIEB (Oct. 21, 2020), https://www.clearygottlieb.com/-/media/files/alert-memos-2020/spac-sponsors-beware—the-rising-threat-of-securities-liability.pdf [https://perma.cc/MX96-7WMU]. Furthermore, with the surge in total SPACs, all with

course, initial sponsors receive this compensation because of the risk they incur. Because the investment sponsors provide is used to fund the IPO, ongoing SEC reporting, and the expenses of managing the SPAC, sponsors stand to lose their entire investment if the value of their founder shares does not appreciate considerably or if the SPAC is ultimately liquidated due to failure to secure an acquisition. Because 90% of the proceeds of the SPAC IPO are held in trust, the management team must be careful to retain enough money to pay those operating and reporting expenses and later the cost of the merger.[128] The management team also deals with possible arbitrage issues because public investors can buy into the SPAC and leave when they desire. If too many public investors decide to redeem their shares for funds from the trust, the SPAC may depreciate sufficiently to lack the funding to merge with a possible target.[129] Mass investment exodus could also spell failure if the SPAC is unable to acquire a target business with a fair market value meeting the requirement that the SPAC uses at least 80% of their trust account.[130] Due to the strict 18–24 month deadline to complete an acquisition—which may be extended by a year through a shareholder vote—the management team is in a race against the clock. This pressure means the management team is extremely susceptible to panic-merging with a company purely to fulfill their obligations, as the management team is only compensated with shares of the SPAC (and therefore the final post-merger entity).

*3. Disadvantages to the Average Public Investor*

Public investors in SPACs experience unique disadvantages. SPACS can be relatively risky investments, as they effectively have no real assets other than the

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time constraints for acquisition, the total number of quality targets is finite. This means that at least some SPAC management teams will begin loosening their standards for the quality of companies they seek to bring public (a similar conceptual situation to the 2008 financial crisis where mortgage brokers began issuing riskier and riskier mortgages to keep their profit machine churning, and with banks willingly purchasing them).

128. This can be an issue of varying severity. The general rule is that 2% of the SPAC's total value plus $2 million is held by the management team to cover "the initial underwriting fee . . . the operating expenses of the SPAC, from the initial cost to launch it, to legal preparation, accounting, and NYSE or NASDAQ filing fees." Connie Loizos, *Almost Everything You Need to Know About SPACs*, TECHCRUNCh (Aug. 22, 2020, 12:47 AM), https://techcrunch.com/2020/08/21/almost-everything-you-need-to-know-about-spacs/ [https://perma.cc/857K-SLVV]. The smallest SPAC only has $6 million in its trust account and regulatory compliance costs around $1.5 million per year, which means shareholders choosing to liquidate the meager funds held in trust is a substantial issue. Chris DeMuth Jr., *SPAC Size Matters*, SEEKING ALPHA (July 11, 2020, 9:41 AM), https://seekingalpha.com/instablog/957061-chris-demuth-jr/5471168-spac-size-matters#:~:text=Short%20the%20small,-Things%20look%20very&text=The%20smallest%20ten%20%E2%80%93%20(BRPAU),utterly%20unlike%20the%20largest%20SPACs [https://perma.cc/33Q5-NKUQ] (comparing the ten smallest and ten largest SPACs at the time). In comparison, a SPAC with $500 million held in trust is not nearly as concerned with investor liquidation.

129. From 2017 to 2019, there were only two SPACs that ended up being liquidated as compared to 19 SPACs that completed acquisitions, so this would be a relatively rare occurrence. *See* SPAC Research, *A Primer on SPACs*, SEEKING ALPHA (Apr. 25, 2018, 11:07 AM), https://seekingalpha.com/article/4165641-primer-on-spacs [https://perma.cc/PSC4-MMTH] (presenting the data of SPAC liquidation and completed acquisition). With 189 total SPAC IPOs added in 2020 alone, and the average IPO size being $336 million, this issue would likely only affect the smaller SPACs. *See* SPACInsider, *supra* note 4.

130. If a desirable firm was found that did not reach this 80% threshold, this requirement could hypothetically be circumvented by having enough SPAC shareholders liquidate their shares and shrinking the trust fund capital enough to reach 80% of the trust account.

individuals on the management team, and these managers could prove to be incompetent.[131] Although a public investor will not lose a substantial amount of their investment if the SPAC fails to merge with a company—or merges with an undesirable company—they are unable to redeem their investment in full if the SPAC fails. In fact, investors who redeem their SPAC shares only regain an average of 98 cents on the dollar from their initial investment, as a portion of their inventment is used for SPAC operating expenses.[132] In addition, if the SPAC ultimately fails to acquire a company, which could take two years or longer, the opportunity cost to the public investor can be rather substantial as the ten-year stock market has averaged a 9.2% annual return rate for the last 140 years.[133]

SPACs also have a somewhat questionable history, both regarding the quality of the company brought public and in terms of monetary return to the average investor. For example, the vast majority of SPACs actually trade below their initial ten-dollar IPO price, resulting in a loss in value for investors.[134] Between 2015 and July of 2020, SPACs averaged a loss of 18.8% in share value after completing an acquisition whereas traditional IPOs have averaged a return of 37.2% in after-market gains since 2015.[135] Since 2017, however, SPACs more closely resemble traditional IPO performance.[136]

Speculatively, these lackluster returns could be the result of companies brought public through SPACs desiring quick access to funds to fuel operations and growth, but

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131. For example, if a public investor were to invest in a regular company with day-to-day operations, they could evaluate the risk of the investment by looking at the company's balance sheet, earnings-per-share, free cash flow, or the value that company's business model or technology brings for future returns. In contrast, a SPAC has none of these performance markers and as such the investor is relying solely on the quality of the prospective merger. *See* Caplinger, *supra* note 15.

132. When compared to a one-year certificate of deposit which has had a guaranteed return of 0.24–0.9% from 2010 to 2020, a loss of 2–3% for two years of time invested is less than ideal. *See* Libby Wells, *Historical CD Interest Rates: 1984-2021*, BANKRATE (Jan. 8, 2021), https://www.bankrate.com/banking/cds/historical-cd-interest-rates/ [https://perma.cc/VSG9-Q37L].

133. *See* Liz Knueven, *The Average Stock Market Return Over the Past 10 Years*, BUS. INSIDER (June 14, 2021, 9:40 AM), https://www.businessinsider.com/personal-finance/average-stock-market-return [https://perma.cc/U5XM-6BYR] (according to data from Goldman Sachs).

134. *See* Ortenca Aliaj et al., *Can Spacs Shake Off Their Bad Reputation?*, FIN. TIMES (Aug. 12, 2020), https://www.ft.com/content/6eb655a2-21f5-4313-b287-964a63dd88b3 [https://perma.cc/5XZG-4XQZ] (arguing that the "poor investment record of many Spacs is a reminder that when Wall Street pushes a new product, clever financiers invariably find a way to shift the most risk on to ordinary investors . . . .").

135. *See* Su, *supra* note 80, at 2 (stating that "[s]ome industry research reportedly shows that, for the SPACs that completed de-SPAC transactions between 2015 and July 2020, their shares delivered an average loss of 18.8%. That compares with the average-market return from traditional IPOs of 37.2% since 2015."). *See also Updated: SPAC Returns Fall Short of Traditional IPO Returns on Average*, RENAISSANCE CAP. (Oct. 1, 2020), https://www.renaissancecapital.com/IPO-Center/News/71816/Updated-SPAC-returns-fall-short-of-traditional-IPO-returns-on-average [https://perma.cc/97KR-C768] [hereinafter RENAISSANCE CAP.] (stating that "[t]he common shares [of companies brought public through SPAC IPOs] have delivered an average loss of -9.6% and median return of -29.1%, compared to the average aftermarket returns of 47.1% for traditional IPOs since 2015.").

136. *See* Su, *supra* note 80, at 2 (stating that "[o]ther Bloomberg analysis shows that since 2017, SPACs have more closely tracked traditional IPO performance . . . ."); *see also* Preston Brewer, *ANALYSIS: De-SPACing Successes Refuel Hot SPAC IPO Market*, BLOOMBERG L. (July 23, 2020, 5:53 AM), https://news.bloomberglaw.com/bloomberg-law-analysis/analysis-de-spacing-successes-refuel-hot-spac-ipo-market [https://perma.cc/6E5K-BHHG].

not being sufficiently prepared for public operations and regulatory oversight, damaging their bottom line. Another possible explanation for SPAC underperformance is reliance on speculative valuations. For instance, there is evidence from recent successful SPAC giants such as the spaceflight company, Virgin Galactic Holdings, the sports betting company, DraftKings, and the zero-emissions vehicle manufacturer, Nikola, that the larger the SPAC merger, the better.[137] It appears that speculation and excited anticipation of the potential of a company brought public through a SPAC merger—rather than the actual quality of the company—is what has most consistently delivered value to the average investor.[138]

As a quick case study, the recent SPAC, Nikola Corporation, boasted intriguing hydrogen fuel cell technology that would be used to create electric vehicles. The electric vehicle market has exploded over the past few years, with Elon Musk's Tesla rocketing in valuation and cementing itself as a dominating presence in the electric vehicle market.[139] The surge of Tesla brought enormous, speculative pricing to electric vehicle companies and, therefore, to Nikola. Post-SPAC merger, Nikola quickly overtook the total market cap of Ford Motor Company.[140] Soon after, a report alleged the company had misrepresented the sophistication of its current technology. The valuation of Nikola plummeted, the founder was forced to resign, and the SEC and DOJ launched an investigation that culminated in the founder of the company being indicted for securities fraud.[141] A similar pattern played out with the 2020 SPAC Lordstown Motors Company, another electric vehicle company, quickly tripling in value before a report and subsequent

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137. *See* Brewer, *supra* note 136 (stating that "SPACs have had a reputation for underperforming compared to traditional IPOs."); *see also* RENAISSANCE CAP., *supra* note 135.

138. This is not to say that these SPACs perform significantly different than a company that undergoes an IPO over the long run. *See, e.g.*, RENAISSANCE CAP., *supra* note 135. It does imply that a short-term momentum trade investor could potentially profit from the large run-up these hyped SPACs experience post-merger announcement and immediately following the actual business combination. *See, e.g.*, WY Cap., *The Massive Opportunity in Pre-Merger SPACs*, SEEKING ALPHA (Jul. 15, 2020, 7:35 AM), https://seekingalpha.com/article/4358556-massive-opportunity-in-pre-merger-spacs [https://perma.cc/U73F-JP2C].

139. *See* Thomas Gersdorf et al., *McKinsey Electric Vehicle Index: Europe cushions a global plunge in EV sales*, MCKINSEY & CO. (July 17, 2020), https://www.mckinsey.com/industries/automotive-and-assembly/our-insights/mckinsey-electric-vehicle-index-europe-cushions-a-global-plunge-in-ev-sales [https://perma.cc/9JJU-TTRE]; *see also*, *Tesla Market Cap 2009-2020*, MACROTRENDS, https://www.macrotrends.net/stocks/charts/TSLA/tesla/market-cap [https://perma.cc/2ZQV-J9RP].

140. *See* Brewer, *supra* note 136.

141. *See Nikola: How to Parlay an Ocean of Lies Into a Partnership With the Largest Auto OEM in America*, HINDENBERG RSCH. (Sept. 10, 2020), https://hindenburgresearch.com/nikola/ [https://perma.cc/PJ8T-5D83] ("We examine how Nikola got its early start and show how Trevor [Founder and Executive Chairman of Nikola] misled partners into signing agreements by falsely claiming to have extensive proprietary technology."); s*ee also*, Michael Wayland, *Electric Truck Maker Nikola's Shares Fall as SEC, DOJ Reportedly Examine Short Seller's Fraud Claims*, CNBC (Sept. 15, 2020, 10:02 AM), https://www.cnbc.com/2020/09/15/nikolas-shares-fall-as-sec-reportedly-examines-short-sellers-fraud-claims.html [https://perma.cc/Y22J-AQ2V] ("The SEC and DOJ are reportedly looking into the merits of a short seller's claims that electric vehicle manufacturer Nikola misled investors."); *see also*, Michael Wayland, *Grand Jury Indicts Trevor Milton, Founder of Electric Carmaker Nikola, on Three Counts of Fraud*, CNBC (July 29, 2021, 8:38 AM), https://www.cnbc.com/2021/07/29/us-prosecutors-charge-trevor-milton-founder-of-electric-carmaker-nikola-with-three-counts-of-fraud.html [https://perma.cc/V7HN-BC7V] ("A federal grand jury charged Nikola founder Trevor Milton with three counts of criminal fraud . . . .").

SEC investigation revealed that the company's executives misrepresented pre-order sales, leading to the resignation of both the CEO and CFO.[142] Nikola and Lordstown Motors serve to show that the SEC should impose greater disclosure requirements on SPACs and the companies they bring public to provide greater protection to SPAC investors.

This also delivers a key point to the average SPAC investor pre-merger: aim for larger SPAC mergers with reputable managers that are likely to acquire highly sought-after companies in order to have the greatest likelihood of positive returns.[143] These failed SPACs also serve to breathe a word of caution to SPAC investors: investors receive very limited disclosures about the company being brought public. Finally, regulatory agencies are on notice that certain aspects of SPAC structure should be reconsidered in order to prevent the next Nikola and Lordstown Motors. Currently, an average investor lacks rights typically afforded to a shareholder of a company, such as the ability to present proxy proposals.[144] For example, only sometimes are the investors informed about what company the management team is currently targeting—which the average investor also has no say in. Information about sponsor and management team compensation and incentive structure is also not typically disclosed.[145] SPAC underperformance could further be tied to expensive management team and sponsor compensation. As such, this Note argues that SPAC shareholders should be given more say in selecting SPAC targets and should receive increased disclosure regarding executive compensation and SPAC targets.[146] The next Section looks at the incentive structure for management teams and sponsors, and their misaligned interests with investors.

### *D. The SPAC Incentive Structure*

Why would an asset manager choose to control a SPAC instead of, for example, a hedge fund? Famous investors and managers, such as Chamath Palihapitiya, believe that

142. *See* Sean O'Kane, *Lordstown Motors CEO Resigns After Investigation into Preorders*, VERGE (June 14, 2021, 8:49 AM), https://www.theverge.com/2021/6/14/22532976/lordstown-motors-ceo-steve-burns-resign-short-seller-investigation [https://perma.cc/TV79-2BK9] ("Steve Burns, the CEO of General Motors-backed startup Lordstown Motors, has resigned following an investigation into allegations that he and other executives lied about preorders for the company's electric pickup truck.").

143. For example, legendary investor Bill Ackman's most recent SPAC Pershing Square Tontine Holdings, without even announcing a target, rose from its $20 opening SPAC IPO price to more than $31 less than five months later (a 51% return), all driven by Ackman's renown. *See, e.g.*, Faizan Farooque, *Buying Pershing Square Tontine Holdings Here is a Good Investment in Bill Ackman*, NASDAQ (Feb. 11, 2021, 6:55 AM), https://www.nasdaq.com/articles/buying-pershing-square-tontine-holdings-here-is-a-good-investment-in-bill-ackman-2021-02 ("Ackman is certainly a controversial figure in the financial world, but it's tough to argue against his track record."). Ackman's SPAC has since returned to its SPAC IPO price after failing to acquire part of Universal Music Group, but this instills the value of investing in a SPAC run by a renowned manager, an investor could have made a substantial profit throughout most of the SPACs' first year. *See, e.g.*, Mark R. Hake, *Pershing Square Tontine Holdings Will Languish Until a New Merger Announcement*, INVESTORPLACE (July 26, 2021, 3:45 PM), https://investorplace.com/2021/07/psth-stock-is-likely-to-languish-as-the-spac-looks-for-a-new-merger-candidate/ [https://perma.cc/NT7Y-U3X9] ("Bill Ackman's special purpose acquisition company (SPAC) Pershing Square Tontine Holdings (NYSE:PSTH) just dumped its complicated deal to acquire 10% of Universal Music Group (UMG) for the SPAC.").

144. *See* Riemer, *supra* note 19.

145. *See* Su, *supra* note 80 (discussing the current lack of transparency in SPACs).

146. *See infra* Part IV (arguing for increased SPAC investor protection).

a typical SPAC investor base is more easily managed than a venture capital fund investor base.[147] Additionally, the compensation scheme for sponsors and managers of SPACs is incredibly generous. In a hedge fund, portfolio managers typically receive 15–20% of the profit of their portfolio; in a SPAC sponsors receive 20% in equity of the total company brought public.[148] A sponsor will typically purchase founder shares prior to SPAC filing and pay a nominal amount (around $25,000) in return for the 20–25% of the total number of shares being offered to the public.[149] The average SPAC size in 2020 was $336 million, meaning that a sponsor of such a SPAC would receive $67–84 million for their initial investment of $25,000.[150] As famous investor Bill Ackman notes, even if the stock were to fall 50% after deal closure, "the sponsor's common stock will be worth $50 million . . ." while IPO investors lose half of their investment.[151] This is an issue because "[s]ponsors do not make money unless a successful business combination is completed and the value of their ownership increases enough to justify the time and capital commitment of acting as a sponsor."[152]

This creates disjointed incentives between the sponsor and management team as compared to the investor in the SPAC. The sponsor and management team are compensated regardless of meeting any financial target. When combined with a strict time period to complete a business combination, this creates a strong incentive for the sponsors and management team to simply complete an acquisition—any acquisition—to fulfill their obligations and receive their shares. Meanwhile, an investor in the SPAC is hoping the SPAC will merge with a desirable company at a good price. SPAC investors are at a disadvantage in this situation, as they receive very limited disclosure regarding the management team and sponsor's compensation or what company the management team is looking to combine with.[153] Furthermore, they have no power to steer what company the SPAC acquires and are afforded fewer rights than a typical investor in a corporation, with their only options being to vote yea or nay to a particular acquisition or to liquidate their holdings.[154]

But, if investors can reject a merger and retain their warrants, why is it an issue if the management attempts to force a merger near the end of the combination period?[155] First, the investor is put in a precarious situation. They have a sunk opportunity cost due to holding the SPAC shares and warrants rather than other securities, meaning they are

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147. *See* Sanchez, *supra* note 104 (highlighting SPACs easier management structure); *see also* discussion Section III.B.1 (comparing SPAC advantages to IPOs).

148. *See, e.g.*, Michelle Celarier, *Egregious Founder Shares. Free Money for Hedge Funds. A Cluster***k of Competing Interests. Welcome to the Great 2020 SPAC Boom.*, INSTITUTIONAL INV. (Sept. 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 [https://perma.cc/Z3F3-MPHM] (discussing the problems with SPACs).

149. *See* Layne & Lenahan, *supra* note 69.

150. Celarier, *supra* note 148; *see also* SPACINSIDER, *supra* note 4 (displaying SPAC statistics).

151. *Id.*

152. *See* Anthony, *supra* note 72 (proposing new SPAC rules).

153. *See, e.g.*, D'Alvia, *supra* note 79, at 108 (discussing the information asymmetry, moral hazard, and agency costs associated with SPACs).

154. *Supra* Part II.A.

155. *See generally* Morrison & Foerster LLP, *SPAC 101 – Selected Q&A*, JDSUPRA (Feb. 3, 2021), https://www.jdsupra.com/legalnews/spac-101-selected-q-a-1857463/ [https://perma.cc/N6F5-XBDV].

somewhat coerced into accepting the merger. Second, they are reliant on the management team's expertise and face a collective action problem when it comes to rejecting the acquisition. Finally, the sponsors and management team holding founder shares, constituting at least 20% of the total shares outstanding, gives the management team and sponsors an enormous head start in reaching the majority threshold to approve the merger, with only 37.5% more public shares needed to ratify the merger.[156] The combination of these factors means that investors are very susceptible to being forced into a poor merger near the SPAC dissolution deadline.

## IV. RECOMMENDATION

Ideally, the benefits that SPACs provide (such as the speed and ease of going public for private companies) should be maintained while investor protection is increased. After all, SPACs create healthy competition to traditional IPOs. This Note recommends the SEC re-implement Dodd-Frank executive disclosure requirements while allowing SPACs to continue to qualify as emerging growth companies. The SEC should formally define SPACs and standardize SPAC listing and reporting requirements. In addition, the SEC should require that SPACs comply with Rule 419 of the Securities Act of 1933 and retain SPAC's penny stock exemption to the Securities Exchange Act of 1934. This Note further recommends tying board compensation to the success of the post-merger company by requiring the board to retain their stock for a period of time and placing a reasonable cap on executive compensation. The SEC should also extend the time period for SPAC acquisitions as currently it serves to harm the SPAC overall. This Note also recommends that SPAC shareholders be given more say in what targets the SPAC pursues.

First, this Note recommends the SEC standardize the NYSE and NASDAQ SPAC listing and reporting requirements. This would not only remove an element of due diligence imposed on the investors, but it would also afford them more protection. This change would also mean that SPACs can be more uniformly regulated going forward and would allow SPACs to IPO quicker by spending less time evaluating listing on various exchanges.

Second, this Note recommends that SPACs continue to qualify as emerging growth companies going forward to retain their competitive advantage over IPOs. SPACs are not legally defined by any national legislation and currently have a variety of business models and compensation structures.[157] Because of this, SPACs qualify as emerging growth companies, allowing them to benefit from the JOBS Act IPO on-ramp. As a result, they are allowed eased Dodd-Frank executive compensation requirements and are subject to more lenient financial and regulatory reporting.[158] Being labeled as EGCs is crucial for enabling SPACs to be competitive in bringing private companies to the public market and saving the post-IPO SPAC on regulatory compliance costs.

This Note further recommends the Dodd-Frank executive compensation requirements be reinstituted. The JOBS Act has been a double-edged sword. SPACs

156. *See* Layne & Lenahan, *supra* note 69.
157. *See generally* D'Alvia, *supra* note 79.
158. *See supra* Section II.A. (discussing SPACs post-IPO and the business combination process).

benefited by being able to go public quicker, but investor protections were diminished due to potentially runaway executive compensation packages creating discordant incentives between investors, sponsors, and management regarding the target company merger. As such, regulatory agencies should re-implement Dodd-Frank's Pay Ratio Disclosure requirement.[159] In the case of SPACs, this would require the SPAC to disclose the compensation scheme of its board members. This would help the SPAC investors understand the incentives and goals of the SPAC board.

This Note also recommends the SEC make SPAC compliance with Rule 419 of the Securities Act of 1933 mandatory. SPACs have, until this point, voluntarily complied with Rule 419 regulations, such as placing proceeds of the SPAC IPO in trust. Since SPACs are already complying with those regulations, it would be best to codify it and ensure their compliance so that future SPAC managers cannot push the boundaries.[160] In addition, this Note recommends that SPACs be allowed to retain the penny stock exemption to Rule 419, which enables them to trade on national exchanges. SPACs are currently not subject to Rule 419 and are only allowed to trade on national exchanges due to their penny stock exemption.[161] Without this penny stock exemption, they would be unable to be traded on national exchanges and would be moot as alternatives to IPOs.

To address the misaligned incentives that animate SPAC board members and SPAC shareholders, this Note recommends making executive compensation contingent on the success of the company-bought public by making the management team retain their shares for a specified period. Former SEC Chairman Jay Clayton indicated that the SEC is evaluating SPAC disclosures, particularly executive compensation, signaling SEC openness to reconsidering how SPACs are structured and regulated.[162] He mentioned that it is not the place of the SEC to dictate what the compensation structure is, only that compensation is fairly disclosed to investors.[163] This fixing of the information asymmetry between management and investor is crucial. However, the SEC should also consider placing a reasonable upper limit on management team compensation or regulating how those groups earn their compensation.[164] While making the average

159. Press Release, SEC, SEC Adopts Rule for Pay Ratio Disclosure: Rule Implements Dodd-Frank Mandate While Providing Companies with Flexibility to Calculate Pay Ratio (Aug. 5, 2015), https://www.sec.gov/news/pressrelease/2015160.html#:~:text=Pay%20Ratio%20Disclosure%20Requirement,compensation%20of%20its%20CEO%3B%20and [https://perma.cc/KLY5-467W]. Rather than the ratio of compensation between a CEO and median average of employees, in this case it would be an average of the SPAC board members. *Id.*

160. *See supra* Section II.A. (discussing the origin of Rule 419 and why SPACs chose to comply with it, despite being exempted). By formally requiring SPACs comply with Rule 419, the SEC can ensure that SPACs do not renege on those restrictions at their discretion. Furthermore, there would not be any additional cost to SPACs, as they are already in compliance with this regulation. *See, e.g.*, Riemer, *supra* note 19, at 945.

161. *Id.*

162. *SEC Chairman Jay Clayton on Disclosure Concerns Surround Going Public Through a SPAC*, CNBC (Sept. 24, 2020, 9:46 AM), https://www.cnbc.com/video/2020/09/24/sec-chairman-jay-clayton-on-disclosure-concerns-surround-going-public-through-a-spac.html [https://perma.cc/6KFB-BFDM] (stating in the video broadcast that ideal disclosure requirements would be a two-step process, "One is at the initial distribution of the SPAC into the market and then the second is when the transaction takes place with what we'll call the 'operating company.' In both those situations we expect the disclosure to be such that an investor can understand all of those [incentive] motivations.").

163. *Id.*

164. Currently the SPAC as a whole gets a certain percentage of the final merged company. The board has

investor aware of the executive compensation structure is useful, it does little to fix the issue of sponsors and management teams being incentivized to simply complete any acquisition to secure their compensation. Placing an upper limit on compensation helps to incentivize the management team to seek out the best deal possible and align them with the interests of the investors.

This Note also recognizes that the acquisition time limit helps to perpetuate these misaligned incentives and recommends increasing, or eliminating, the time period for a SPAC to complete a merger. The current two-year time requirement for an acquisition is arbitrary and helps to create the issue of the management team forcing a merger. Historically, SPACs have underperformed compared to the S&P 500 or the Russell 2000 indices, partially because the SPAC time constraint puts the management team at a disadvantage in negotiations with the target company.[165] Furthermore, the explosion of the number of SPACs IPOing over the past year-and-a-half shows an issue quickly approaching.[166] There are only a finite number of quality private companies with which to be merged, and SPAC board members are highly incentivized to merge with any company, lest they lose their initial investment. This situation perpetuates a slip in quality of SPAC mergers which can be alleviated by increasing the time period for SPACs to complete their mergers.

Finally, this Note recommends that SPAC investors be presented options for acquisition and be allowed to have a say in what companies the SPAC will acquire. Currently, SPAC shareholders are limited to voting only on approval of a proposed acquisition. Shareholders in other companies can vote and have a say in a variety of items, such as by submitting proxy proposals or voting for a company's management through voting for the board of directors. Outside of the above options, SPAC investors have no recourse or power in how a SPAC is managed—or mismanaged—other than the acquisition vote, liquidating their holdings, or suing.[167] Increasing the rights of SPAC shareholders further protects them while they invest in SPACs and encourages investment in SPACs going forward.

## V. CONCLUSION

SPACs have come a long way and currently fill a useful niche by allowing private companies to come to market quicker and more consistently during turbulent market

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typically earned a 20% stake in the merged company; however, this is not a limit. The board could decide to increase their compensation, which would directly detract from the stake that the SPAC shareholders earn. Capping executive compensation protects SPAC shareholders. *See, e.g.*, Tom Huddleston Jr., *What is a SPAC? Explaining One of Wall Street's Hottest Trends*, CNBC (Feb. 23, 2021, 11:13 PM), https://www.cnbc.com/2021/01/30/what-is-a-spac.html#:~:text=The%20SPAC%20sponsors%20typically%20get,their%20money%20back%20with%20interest [https://perma.cc/22Z3-JAGH].

165. *See* Nicholas Jasinski, *SPACs Outperform at First, but Postmerger Is Another Story, Goldman Sachs Finds*, BARRON'S (Aug. 4, 2020, 1:40 PM), https://www.barrons.com/articles/spacs-performance-ipo-merger-goldman-sachs-analysis-russell-2000-51596562450 [https://perma.cc/2YJL-453U].

166. *See* discussion *supra* note 33.

167. *See, e.g.*, Christopher Kercher, et al., *Litigation Risk in the SPAC World*, JDSUPRA (Oct. 1, 2020), https://www.jdsupra.com/legalnews/litigation-risk-in-the-spac-world-88058/ [https://perma.cc/SL9F-7FWU]. For example, shareholders could sue for negligence, failure of duty of care or loyalty, or material misrepresentation.

conditions. SPACs also offer public investors the opportunity to invest in what would typically be a private equity transaction and benefit from investing alongside famous investors and experienced managers. That said, the process should be more structured and regulatory bodies should act to ensure investors are protected and informed about how the SPACs are operating, rather than allowing management teams to act as black boxes accountable to no one.