

# How SPACs Made Old Things Old Again

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When the SPAC boom began in the summer of 2020, a common way to explain the phenomenon was to say that SPACs were something new. SPACs raised \$83 billion in 2020<sup>1</sup>—nearly double the total raised in the previous ten years—and another \$97 billion in just the first three months of 2021.<sup>2</sup> They spread so rapidly that the public had little way of making sense of them other than to think that they represented a novel innovation, a kind of contagion for which American finance had no previous immunity. The SPAC boom started at almost the exact moment the American public began locking down against COVID-19—starting a process of viral replication in the financial markets to mirror the one happening in cities.

But like COVID, SPACs were not altogether new—they evolved from creatures that came before. And like a real virus, SPACs are now living through a cycle of spread, response, and equilibrium that has also played out for its evolutionary ancestors. The essays in this online symposium take stock of some aspects of this cycle and offer suggestions for how to deal with it. As the legal scholar and former SEC official Henry Hu has argued, the cycles of novelty and innovation in finance are actually quite old.<sup>3</sup> What pass as “innovations” are often just modifications that merely liberate existing practices from regulation by pulling them out of their regulatory categories. These innovations grow in popularity and then eventually produce the same problems the old regulations were designed to address, until the new innovations invite new regulations and new skepticism. By repeating many of the failures and successes of other innovations that came before, SPACs are taking this old cycle and making it old again.

SPACs first became a distinct species in 1993, when an investment banker named David Nussbaum led the IPOs for a series of thirteen companies that went public with nothing more than aspirations to acquire or combine with already operating private companies.<sup>4</sup> Though Nussbaum’s innovation was understood at the time as something new, in fact he patterned his vehicles after other innovations that came before. His SPACs mimicked most closely the features of

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1. Hank Tucker, *Chamath Palihapitiya and Nine Other New Billionaires Minted by the SPAC Frenzy*, FORBES (Apr. 6, 2021) <https://www.forbes.com/sites/hanktucker/2021/04/06/chamath-palihapitiya-and-nine-other-new-billionaires-minted-by-spac-frenzy/?sh=118007eed19a> [<https://perma.cc/4QK7-Y7GX>].

2. *Id.*

3. Henry T. C. Hu, *Swaps, the Modern Process of Financial Innovation and the Vulnerability of a Regulatory Paradigm*, 138 U. PA. L. REV. 333, 337-40 (1989).

4. Daniel S. Riemer, Note, *Special Purpose Acquisition Companies: SPAC and SPAN, or Blank Check Redux?*, 85 WASH U. L. REV. 931, 945 (2007).

older and much smaller blank check acquisition companies that were not allowed to list on stock exchanges and that the SEC had recently regulated by Rule 419.<sup>5</sup>

Those early blank check companies were not the only ancestors of SPACs. Other relatives of the SPAC include the conventional IPO, which SPACs are often said to replicate by merger rather than direct sale, and the many types of investment funds that SPACs resemble in terms of their structure and management. The investment fund analogy is especially interesting because, like a private equity, venture capital, hedge, closed-end, exchange-traded, or mutual fund, a SPAC is set up to be managed externally. It has no full-time employees or operational resources and depends entirely on a professional investment management firm that dominates it from the outside. This pattern of organization introduces into SPACs the same unusual agency conflicts that have long troubled investment funds.<sup>6</sup> Given the peculiar similarity in the organization of SPACs and investment funds, it is no accident that many of the same investment advisory firms that manage investment funds now also sponsor SPACs, including Goldman Sachs, Pershing Square, Cerberus, and Apollo, to name just a few.

One precedent for the modern SPAC craze can thus be found in the investment funds of the original Roaring Twenties. The booming IPO market of 1929 brought with it a purportedly novel financial innovation that now looks uncomfortably similar to a SPAC. So-called “closed-end investment funds” were established by investment banks in the early 1920s for the purpose of buying stock in newly public companies.<sup>7</sup> Like SPACs, they were set up as independent entities but managed and dominated from the outside by investment banks and other financial professionals who specialized in their promotion and management. And like SPACs, closed-end funds took money from the public in IPOs and then invested it in the equity of other companies—often companies that were going public for the first time. In 1929, in what was then the greatest IPO market in history, closed-end funds were so popular that they accounted for 30% of all new stock issues.<sup>8</sup>

What investment bankers loved about closed-end funds was the same thing they now love about SPACs: the chance to double dip on banking fees by doing an IPO upon an IPO. They first took underwriting fees on the shares in the closed-end funds that they sold to the public and then took fees again by underwriting the shares of operating companies, which the bankers then dumped into the same closed-end funds that they had previously underwritten and continued to manage.<sup>9</sup> The bankers got paid twice: once for underwriting the closed-end fund’s IPO and again for underwriting the IPOs of the companies in which the

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5. *Id.*

6. John Morley, *The Separation of Funds and Managers*, 123 YALE L.J. 1228 (2014).

7. MATTHEW FINK, *THE RISE OF MUTUAL FUNDS* (2007); JOHN KENNETH GALBRAITH, *THE GREAT CRASH 1929*, 43-65 (1988); John Morley, *Collective Branding and the Origins of Investment Fund Regulation*, 6 VA. L. & BUS. REV. 341 (2012).

8. Morley, *supra* note 7, at 350; SECURITIES AND EXCHANGE COMMISSION, *INVESTMENT TRUSTS AND INVESTMENT COMPANIES*, H.R. DOC. NO. 707 pt. 2, at 186 tbl.59 (1938-1942).

9. Morley, *supra* note 7, at 352-53.

closed-end fund invested. The main difference between a closed-end fund and a SPAC was that the closed-end fund invested in a portfolio of several new companies, whereas a SPAC invests in only a single company. But the double-dipping and the enormous profits closed-end funds produced for bankers, fund managers, and other financial professionals were substantially the same as what we find in a modern SPAC.

The investing public bought up these closed-end funds with an excitement that now feels familiar, too. Closed-end funds promised a kind of financial alchemy, in which the funds could be made to trade at premiums to the values of their underlying assets.<sup>10</sup> A closed-end fund would hold a portfolio of securities whose aggregate value as measured by stock-exchange list prices was, say, \$100, but the fund's stock would trade at a premium such as \$105, \$110, or even \$120. Through these premiums, a closed-end fund could take a fixed amount of money and immediately transform it into something more. Closed-end funds amplified the premiums by taking on leverage and by investing in other closed ends funds, with the premiums to the underlying portfolio values growing at each level in the pyramids of ownership.<sup>11</sup> As the economist John Kenneth Galbraith later showed, the resulting departure from the real value of the underlying assets created an explosive boom that could never be sustained and whose role in fueling the speculative fervor behind the Great Crash of 1929 remains underappreciated today.<sup>12</sup>

It is no surprise, then, that in the SPAC boom of 2020, investment bankers and fund managers claimed once again to have discovered a way to generate premiums through financial engineering. When the boom began in the middle of 2020, SPACs often traded at large mark-ups to the values of their underlying assets. A SPAC could take \$10 per share from its IPO investors and buy U.S. government securities worth approximately the same amount. The government securities would then remain stable in value, but the stock price of the SPAC would go up. By the beginning of March of 2021, the average SPAC traded at a premium of nearly 27% over its asset value, with some trading at mark-ups as high as 40%.<sup>13</sup> The only basis for this astounding growth in valuation was the public's belief that something novel had been discovered—a new way to create value where none had existed before through the genius of the sponsors and their innovative acquisitions of private companies.

But novelty has a way of getting old. By late March 2021, investors realized that what had been true for decades about SPACs remained true even after the

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10. Morley, *supra* note 7, at 351.

11. *Id.*

12. GALBRAITH, *supra* note 7, at 43-65.

13. Nicholas Jasinski, *The SPAC Boom is Over, That's Creating Bargains for Investors*, BARRON'S (Apr. 6, 2021), <https://www.barrons.com/articles/a-risk-free-way-to-profit-from-spacs-51617657934> [<https://perma.cc/5RXR-F3ET>]; Yun Li, *These SPAC Stocks are Trading at the Highest Premiums, So They Better Deliver with Good Deals*, CNBC.com, (Mar. 3, 2021), <https://www.cnbc.com/2021/03/03/these-spac-stocks-are-trading-at-the-highest-premiums-so-they-better-deliver-with-good-deals.html> [<https://perma.cc/R6K7-6NMW>].

boom of 2020: they achieved terrible returns for investors. The huge fees taken out by sponsors combined with the rushed diligence and poor incentives in SPAC deals to yield some of the worst returns of any asset class in the public markets.<sup>14</sup> The premiums disappeared and pre-merger SPACs returned to trading at the values of their underlying assets.<sup>15</sup> As more and more traders woke up in mid-2021 to the realization that a SPAC's only real value was the right it gave investors to redeem and take a share of the SPAC's portfolio of government securities, these investors came to understand that a SPAC was just another repeat of something familiar that had already come before—a costly, tax-inefficient, and depressing substitute for a money market mutual fund.<sup>16</sup>

Just as the Great Crash of 1929 eventually produced the securities laws of 1933, 1934, and 1940, the great SPAC cooling and the bear market of 2022 are now giving way to the new regulations of 2022. In April of 2022, the SEC proposed a series of regulations that promise to apply some of the lessons of history by forcing SPACs into some of the old regulatory boxes that SPACs initially purported to escape through the shiny packaging of novelty.<sup>17</sup>

The essays in this collection try to make sense of the old problems raised by SPACs and the new regulatory tools the SEC may use to address them. Usha Rodrigues and Michael Stegemoller point to the incomprehensibility of disclosures for retail investors, and how the pervasiveness of empty voting guts the meaning of SPAC merger votes.<sup>18</sup> Michael Klausner, Michael Ohlrogge, and Harald Halbhuber provide a “nuts and bolts” approach to disclosure, showing how SPACs could be required to explain, in a comprehensible way, just how much they are diluting investors.<sup>19</sup> And Harald Halbhuber proposes a sweeping reform of SPAC regulation that would focus on economic substance, one that would directly engage with the novel vocabulary in which SPACs have wrapped themselves in order to address the much older substantive reality of what SPACs are actually doing.<sup>20</sup>

What SPACs can teach is thus something we already knew: the *process* of financial innovation is even more interesting than the *substance* of it. As the

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14. Lora Dimitrova, *Perverse Incentives of Special Purpose Acquisition Companies, the “Poor Man’s Private Equity Funds,”* 63 J. ACCOUNTING & ECON. 99 (2017); Michael Klausner, Michael Ohlrogge & Emily Ruan, *A Sober Look at SPACs*, 39 YALE J. ON REGUL. 228 (2022).

15. Jasinski, *supra* note 13.

16. Sam Goldfarb, *Some Investors Find Stability in SPACs*, WALL ST. J. (Oct. 12, 2021), <https://www.wsj.com/articles/some-investors-find-stability-in-spacs-11634007742> [https://perma.cc/4SED-R6DC]; Byrne Hobart, *SPACs as a Call Option on Hype*, THE DIFF (July 17, 2020) <https://www.thediff.co/p/spacs-as-a-call-option-on-hype> [https://perma.cc/PP43-7LWR] (“To the SPAC investor, it’s a subpar money market fund with a Kinder Surprise Egg-style option attached . . .”).

17. Special Purpose Acquisition Companies, Shell Companies, and Projections, SEC Release Nos. 33-11048; 34-94546; IC-34549 (Mar. 30, 2022) <https://www.sec.gov/rules/proposed/2022/33-11048.pdf> [https://perma.cc/23X5-WC9F].

18. Usha Rodrigues & Michael Stegemoller, *Disclosure’s Limits*, 40 YALE J. ON REGUL. BULLETIN 37 (2022).

19. Michael Klausner, Michael Ohlrogge & Harald Halbhuber, *Net Cash Per Share: The Key to Disclosing SPAC Dilution*, 40 YALE J. ON REGUL. BULLETIN 18 (2022).

20. Harald Halbhuber, *Economic Substance in SPAC Regulation*, 40 YALE J. ON REGUL. BULLETIN 44 (2022).

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SPAC boom ages and the cycle of boom, bust, and regulation spins its creaky wheels yet again, we will all have to think critically about how much in the SPAC craze is new and how much is already very, very old.