

Economic Substance in SPAC Regulation

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Introduction

This Essay lays out an economic substance approach to regulating special purpose acquisition companies (SPACs) as sales of stock for cash. The approach presented here charts an alternative to the SEC's recent rule proposal¹ that better reflects the economic reality of SPAC transactions and is more firmly grounded in the structure of our existing securities laws. While the SEC's approach does address certain gaps in the current rules, its primary drawback is that it still treats SPAC mergers as a special type of business combination that requires its own regulatory regime. We already have a regime for sales of stock to the public for cash. The SEC should adopt rules that simply apply this regime to the stock sale for cash that, in economic substance, occurs in SPAC mergers.

Merging with a SPAC has become a popular alternative to an initial public offering (IPO) as a path for going public. Data has consistently shown that public investors often fare poorly in SPAC mergers,² compared to the "sponsors" controlling SPACs, who frequently realize outsized gains. One recent study found that SPAC merger investments made by the public underperformed the market by close to 60% at the median after twelve months while SPAC sponsors earned median market-adjusted returns of almost 200% over the same period.³

Each SPAC starts its life by selling its shares to initial investors in its own IPO. The IPO proceeds, typically \$10 per share, are escrowed in a trust account while the SPAC has 18 to 24 months to search for a private target company to take public by acquiring it in a merger. After the SPAC has identified a target, SPAC shareholders are entitled to have their escrowed cash returned to them by redeeming their shares. Only the cash of nonredeeming shareholders is invested in the target, and their shares effectively turn into target stock.

Current regulation conceives of the merger as the transaction in which the SPAC invests the capital it raised in its IPO. This does not reflect economic reality. The SPAC's role in the merger is to find investors, not to invest its own cash. In fact, the SPAC has no cash of its own,⁴ because all the funds escrowed in its IPO are held by an independent trustee to be returned to redeeming

1. Special Purpose Acquisition Companies, Shell Companies, and Projections, 87 Fed. Reg. 29458 (May 13, 2022) [hereinafter Proposing Release].

2. See Tim Jenkinson & Miguel Sousa, *Why SPAC Investors Should Listen to the Market*, 21 J. APPLIED FIN. 38, 44 (2011) (finding average cumulative raw returns of -24% and -55% after six and twelve months, respectively, from merger date); Johannes Kolb & Tereza Tykova, *Going Public via Special Purpose Acquisition Companies: Frogs Do Not Turn Into Princes*, 40 J. CORP. FIN. 80, 92 (2016) (observing six-month and 60-month buy and hold abnormal returns of -29% and -102%, respectively); Minmo Gahng, Jay R. Ritter & Donghang Zhang, *SPACs 4* (Dec. 14, 2021) (unpublished manuscript), <https://ssrn.com/abstract=3775847> [<https://perma.cc/N36F-X6CP>] (finding one-year market-adjusted return of -24.6%, assuming purchase at the first post-merger closing price rather than at \$10).

3. Michael Klausner, Michael Ohlrogge & Emily Ruan, *A Sober Look at SPACs*, 39 YALE J. ON REGUL. 228, 256 tbl.6 (finding -59.4% median excess return over Nasdaq for nonredeeming SPAC shareholders), 264 fig.11 (finding 198% median excess return over Nasdaq for SPAC sponsors).

4. In future work, I will explore whether under applicable accounting guidance, a SPAC's balance sheet should in fact reflect an asset for the cash or marketable securities in the trust account, as is the current practice. Recording the SPAC's interest in the trust account as a subscription receivable, which is contra-equity entry rather than an asset, would seem to accord better with economic reality.

shareholders. As I plan to show in future work, the escrowed funds should best be accounted for not as assets of the SPAC at all.⁵ Before they decide whether to redeem, SPAC shareholders have merely parked their cash. They have not yet committed it. In economic substance, the merger is thus the transaction in which each nonredeeming shareholder, not the SPAC, invests their cash in the target.

The Essay's key insight for future regulation is that a SPAC shareholder's decision to invest their escrowed cash in the target should be treated as the economic equivalent of purchasing target stock for cash. This allows for a better understanding of SPACs' economic substance and offers a sound legal basis for crafting new rules that level the playing field between SPACs and IPOs.

The original purpose of the escrowed cash feature was merely to protect against the uncertainty of investing in a blank check company. Its unintended effect, however, has been to cause what are effectively capital raising transactions to be regulated as business combinations. This has led to serious gaps in investor protection by rendering inapplicable rules about disclosure liability, underwriter regulation and offering regulation, all of which apply in IPOs.

In SPAC mergers, targets raise capital not from the SPAC, but from the public. Interestingly, this starts not with the SPAC's initial investors, but in the secondary market. Most investors that buy in a SPAC's IPO have no intention ever to invest risk capital in the target. They seek to sell their shares for more than their escrowed cash and will otherwise typically redeem their shares. Redemption is profitable for these initial holders because in the SPAC's IPO they also receive warrants that have value if the merger closes. The SPAC and target therefore try to find new investors who replace those initial holders by buying their shares. Ideally, these new investors then elect not to redeem. SPAC shares thus effectively become target shares that can freely be sold to the public for cash.

SPACs act as intermediaries in this sale process, effectively selling target stock to public investors for a fee. They advertise target shares as an investment, validate target quality, and receive compensation only if the transaction closes. In other words, SPACs function as underwriters for target stock. They may utilize investment banks for support, but investors rely primarily on the SPAC's due diligence, experience, and reputation. The underwriting that SPACs provide does not come cheap, and empirical research has found that SPAC costs are largely borne by public investors.

The failure of existing SEC rules to regulate SPAC mergers in accordance with their economic substance as sales of securities for cash has opened up wide gaps in investor protection. These include the fact that companies going public in SPAC mergers are not subject to the same disclosure liability and investment bank gatekeeping as traditional IPO issuers. The SEC's recent rule proposal

5. Harald Halbhuber, *What SPACs Own* (May 10, 2022) (unpublished manuscript) (on file with author) (arguing that trust account cash should be accounted for as a contra-equity, similar to outstanding subscription receivables).

seeks to impose IPO-level disclosure liability and investment bank gatekeeping, but in many ways remains conceptually tied to the existing regulatory framework that views SPAC mergers as transactions in which SPACs invest the cash they raised in their IPOs.

The economic substance analysis presented in this Essay helps identify other gaps in investor protection created by the current regulation of SPAC mergers. It shows that SPACs effectively act as underwriters for target stock without being subject to any of the rules of underwriter regulation. In traditional public stock offerings, these rules prohibit excessive underwriting compensation that comes at the expense of public investors and creates unhealthy incentives; they require an independent review when an underwriter has a conflicting financial interest; and they ensure that all investors pay the same stated price by prohibiting secret side deals. These protections are completely absent in the stock sales that, in economic substance, take place in SPAC mergers, and the SEC's proposed rules do little to remedy that.

The current regulatory regime also leaves material gaps in offering regulation that increase risks for investors in SPAC mergers compared to IPOs. SPACs, targets, and their respective affiliates can induce or execute purchases of SPAC shares, thereby potentially inflating the price on which public investors rely when deciding to invest. In addition, companies are able to fan investor exuberance by conditioning the market with publicity and to promote sales that take place well before SEC-cleared disclosure, both of which are strictly prohibited in IPOs.

Building on its functional analysis, this Essay develops a blueprint for rules that close these gaps in investor protection and level the playing field between SPACs and IPOs. The SEC has clear authority to adopt these rules. The Essay does not take a position on whether the regime for IPOs and other traditional capital raising transactions always strikes the right balance between investor protection and capital formation. It does, however, suggest that there is no policy rationale for the stark difference in regulatory treatment between SPACs and IPOs that currently prevails.

The heart of this blueprint is a new SEC rule that would treat a SPAC shareholder's decision to invest their escrowed cash as equivalent to the purchase of stock for cash. This recognition of economic substance would allow the SEC to regulate SPAC mergers as stock sales and SPACs (and potentially their sponsors) as underwriters and, effectively, brokers that targets hire to sell their stock for transaction-based compensation. This proposal provides the most comprehensive framework for SPAC regulation to date and is fully grounded in our existing securities laws.

I. The Economic Substance of SPACs

This Part of the Essay analyzes the economic substance of SPACs. It demonstrates that a SPAC shareholder's decision to invest their escrowed cash by not redeeming their shares at the time of the merger is the economic

equivalent of purchasing stock for cash. This has two consequences. First, this cash purchase can be used to raise capital from the public at the time of the merger, turning SPAC mergers in economic substance into stock sales. Second, it enables SPACs to function as the equivalent of underwriters for those sales.

A. Investment of Escrowed Cash is Equivalent to Purchase of Stock

When a SPAC closes its IPO, the entire purchase price that initial investors pay for the shares is deposited into a trust account held in the name of a reputable financial institution, where it is invested in U.S. Treasury securities. For simplicity, I refer to this as the escrowed cash. If the SPAC fails to merge with a target within a specified period, typically eighteen to twenty-four months from its IPO, the escrowed cash is returned to shareholders and the SPAC liquidates.⁶ After the SPAC has identified a target, each SPAC shareholder is entitled to have their portion of the escrowed cash returned to them at the merger closing by redeeming their shares. While most SPAC mergers are submitted to a shareholder vote, shareholders have that entitlement no matter how they mark their ballots and regardless of whether a vote is held at all.

It is important to understand that, in economic substance, a SPAC shareholder's decision not to redeem their shares represents a cash investment at the time of the merger.⁷ When SPAC shareholders initially deposit their cash in escrow in the SPAC's IPO, they remain the beneficial owners of that cash. The SPAC has no right to that cash for any purpose,⁸ and that cash is not exposed to any real-world risk.⁹ It is only after a SPAC merger has been proposed that shareholders decide whether to invest that cash or have it returned to them through redemption.

Standard SPAC documentation presumes that shareholders elect to invest rather than redeem unless they notify the SPAC otherwise, but that default election does not affect the economic substance of a shareholder's investment decision. That investment is the economic equivalent of paying cash to purchase shares in the SPAC at the moment it turns into the post-merger company. Given that the SPAC is a shell and the post-merger company consists of the target, it is also tantamount to buying target stock for cash.

This cash investment decision fundamentally distinguishes SPAC mergers from other business combinations in which a private company obtains a listing

6. SPACs can ask for an extension by shareholder vote. If the extension is approved, each shareholder, regardless of how they vote, has the right to have their escrowed cash returned to them by redeeming their shares.

7. See recently, in the state law fiduciary context, *In re MultiPlan Corporation Stockholders Litigation*, which held that "stockholders' funds held in trust did not belong to [the SPAC] until those stockholders opted not to redeem but to invest." 268 A.3d 784, 802 (Del. Ch. 2022).

8. Except for a de minimis amount to pay taxes.

9. See, e.g., *In re Royal Bus. Sch., Inc.*, 157 B.R. 932, 940-41 (Bankr. E.D.N.Y. 1993) (holding that under New York law, escrow funds are not the property of the estate of the party with contingent claims and therefore not subject to claims of that party's creditors). SPAC trust accounts are typically governed by New York law. See generally Thomas M. Byrne, *Escrows and Bankruptcy*, 48 BUS. LAW. 761 (1993) (discussing treatment of escrow funds in bankruptcy).

by merging with a smaller public one. Those transactions are often referred to as reverse mergers. Unlike SPAC mergers, they do not involve individual shareholder-by-shareholder decisions on investing cash in the target. The SPAC shareholder's decision is also substantially different from that made by holders of other redeemable securities whose initial cash investment is exposed to the issuer's business risk.

B. SPAC Mergers Function as Stock Sales for Cash

In contrast to the acquiring company in a traditional merger, a SPAC does not invest its own cash in the target. That cash investment is made by individual SPAC shareholders. Rather, the SPAC enables the target to raise cash by effectively selling target stock to the investing public without being subject to rules that normally govern such sales.

In practice, most of the cash the target raises in the SPAC merger comes primarily from a new set of investors, not the initial shareholders who bought in the SPAC's IPO. Those initial holders typically exit at the time of the merger¹⁰ because, from the outset, they have no interest in ever investing their escrowed cash in the target that the SPAC will eventually identify, no matter its quality. By exiting, those initial holders still earn attractive returns¹¹ without any downside risk because they retain the warrants that they received in the SPAC's IPO.¹² These warrants compensate them for the opportunity costs of tying up their cash in a low-yielding escrow.

To complete their exit, most of those initial holders will redeem any shares they cannot sell for more than the escrowed cash before the merger closes. Raising permanent capital therefore requires finding new investors who will buy those shares at a premium over that cash. SPACs refer to this as the "recycling" or "remarketing" of the shares, with an "IPO-style roadshow"¹³ of investor meetings. Unlike traditional IPOs, however, which are only marketed to customers of the underwriting banks, SPAC mergers, as a communications

10. Klausner et al., *supra* note 3, at 244, report mean and median divestment rates, defined as the percentage of shares held by pre-merger announcement large institutional holders that were either sold or redeemed, of 92% and 98%, respectively, based on Form 13F ownership reports. Institutional holders that file these reports account for the overwhelming majority of shares sold in SPAC IPOs. *Id.* at 241.

11. In a recent study, the mean annualized return for SPAC IPO investors that redeemed their shares and sold their warrants at closing was 11.6%. *Id.* at 232.

12. For the \$10 that SPAC IPO investors pay per share, they generally also receive somewhere between a fifth and a whole of a warrant to purchase more shares for \$11.50 per share after the merger closes. With a five-year term from the merger closing and high volatility in stocks of former SPACs, these warrants have significant value even if immediately following the merger the stock price of the post-merger company is only \$10 or even less.

13. Edward S. Best & Anna T. Pinedo, *De-SPACing: Overview, Securities Law and Financial Statement Considerations and Derisking the Process with a PIPE Transaction*, MAYER BROWN LLP (Jan. 27, 2021), <https://www.mayerbrown.com/en/perspectives-events/events/2021/01/de-spacing-overview-special-securities-law-and-financial-statement-considerations-and-derisking-the-process-with-a-pipe-transaction> [https://perma.cc/D7SG-Y8XS].

advisor recently noted, provide an “opportunity to market the deal to EVERY investor, both institutional and retail.”¹⁴

From a legal and regulatory perspective, the investors purchasing the shares as a result of this remarketing exercise do so on the open market. In economic substance, however, these purchases are not ordinary secondary market trading but rather a critical step in the capital raise. The SPAC’s IPO effectively creates public shares that can be put on the shelf, with the initial buyers acting as placeholders, until the SPAC has found a home for those shares with new investors after the announcement of the merger. New investors must pay a premium over the escrowed cash to incentivize the SPAC’s initial shareholders to sell rather than redeem.¹⁵ The SPAC’s share price therefore becomes a gauge for the success of the capital raise.

C. SPACs Function as Underwriters

Understanding SPAC mergers as sales of stock for cash allows us to see the role played by SPACs themselves more clearly. They function as financial intermediaries. Just like conventional underwriters would in an IPO, they market target shares to investors and validate the merits of the investment through their due diligence, experience, and reputation, thereby bridging information asymmetries. And as is characteristic of underwriters, SPACs get to charge for their services only if the transaction closes. While SPAC sponsors have been characterized as co-investors rather than underwriters, I show below that this label is often misplaced and does not diminish SPACs’ underwriter role. Despite their underwriter function,¹⁶ however, SPACs are not subject to underwriter regulation.

1. *Marketing*

At the core, targets hire SPACs as salesmen for their stock. They select SPACs for their public-company and capital-markets experience and for their network and reputation with investors rather than primarily the price that SPACs purport to offer. As the SPAC selection process has been described from the target’s perspective, “[y]ou are not trying to maximize price [. . .]; it’s a capital

14. Don Duffy, *A SPAC IPO Renaissance and the De-SPAC Communications Necessities*, BUS. WIRE (Aug. 13, 2020), <https://blog.businesswire.com/a-spac-ipo-renaissance-and-the-de-spac-communications-necessities> [https://perma.cc/369P-ADFW].

15. The greater that premium, the higher the risk-free return for those initial holders. A recent study calculates the mean annualized return for SPAC IPO investors that sold both shares and warrants just prior to the merger closing at a staggering 19.1% and 26.1% for SPACs that went public in 2018 and 2019, respectively. The average for all SPACs that went public from 2010 through 2019 was 15.9%. This includes SPACs that had to liquidate. *See* Gahng et al., *supra* note 2, at 51, panel A. The authors assume that initial holders sell (or redeem if redemption value is higher) shares and warrants at the market closing price five trading days prior to merger closing.

16. This Part of the Essay uses the term “underwriter” in the functional sense, similar to its use by economists. Part III addresses the question of the SPAC’s statutory underwriter status under Section 2(a)(11) of the Securities Act.

markets exercise.”¹⁷ This does not mean that targets do not care about the price they can realize—they do. But since SPACs have no cash of their own to invest, the price offered by a SPAC is meaningless unless the SPAC can persuade investors to pay it. SPACs run by successful sponsors and teams excel at telling a target’s unique story and capturing investors’ imagination. Target companies may therefore “choose the SPAC whose sponsors are best equipped to pitch their business model to the investor community.”¹⁸ SPACs compete for merger mandates from targets in “SPAC-offs” that resemble “bake-offs” among investment banks vying for IPOs.¹⁹

When SPACs present a merger to the public market, they universally extol the merits of the target as an investment, just as they would if they were brokers pitching a stock. In roadshow meetings with investors and stock analysts they explain how they have valued the business and how the target is a great opportunity at the proposed valuation. Here is a representative example of the kinds of statements that SPAC executives make to investors:

This transaction provides a very compelling opportunity to invest [...] at an attractive valuation both on a revenue basis as well as an adjusted free cash flow basis. It’s also worth mentioning that this is based on conservative forecasts and doesn’t factor in the really superior growth profile. If you look at the valuation metrics on the growth adjusted basis, the embedded discount to the peer group is even further amplified.²⁰

This is similar to how a conventional underwriter’s equity salesforce might market a traditional IPO to investors. SPACs, however, perform this crucial sales function for the target largely themselves. Investment banks may still have a supporting role in SPAC mergers²¹ by providing lists of potential investors, setting up initial meetings, and helping with post-meeting follow-up.²² Banks are generally counseled, however, not to engage in active marketing.²³

17. Sarah Pringle, *When Picking the Right SPAC Partner, It’s Not Price You’re After*, PE HUB (Mar. 25, 2021), <https://www.pehub.com/when-picking-the-right-spac-partner-its-not-price-youre-after/> [<https://perma.cc/MD2L-NY6B>].

18. Ross Matican, *How SPAC-Offs Can Sweeten Merger Deals*, THE INFORMATION, (Nov. 9, 2020), <https://www.theinformation.com/articles/how-spac-offs-can-sweeten-merger-deals> [<https://perma.cc/K49V-6R8K>].

19. Amrith Ramkumar, *SPAC Pullback Pressures Creators to Find Quality Mergers*, WALL ST. J. (June 1, 2021), <https://www.wsj.com/articles/spac-pullback-pressures-creators-to-find-quality-mergers-11622494564> [<https://perma.cc/WH75-D6EN>].

20. Ascendant Digital Acquisition Corp., Call Transcript (Form 425) (Apr. 15, 2021).

21. SPACs’ reliance on investment banking support will depend on a variety of factors, including the strength of their own relationships with potential investors and their knowledge of the target’s industry.

22. *E.g.* 57th St. Gen. Acquisition Corp., Supplemental Memorandum to the SEC, 4-5 (Apr. 16, 2010) (discussing tasks performed by the SPAC’s advisors).

23. *See What’s the Deal: SPACs*, MAYER BROWN 7 (2020), <https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2020/08/whats-the-deal--spacs.pdf> [<https://perma.cc/98WZ-NUP2>] (counseling investment banks to limit their activities to ministerial functions to avoid being viewed as soliciting proxies for the vote of SPAC shareholders on the merger).

2. *Validation*

From the perspective of investors, SPACs validate the quality of the target as an investment. In their communications to potential buyers of the stock, SPACs describe the due diligence they conducted on the target. For example, they may discuss how they hired an experienced industry consultant who then “came back with a resounding yes” to the question of whether the target’s technology was “really that truly differentiated.”²⁴ They may report on diligence conversations they had with the target’s key customers and the “extraordinarily powerful” responses they received.²⁵ Or they may simply talk in general terms about the comprehensive due diligence they undertook. The SPAC’s due diligence and its valuation of the target is critically important for investors because investors themselves are not able to conduct the same thorough investigation. In substance, as financial economists have also noted, SPACs act as informational intermediaries,²⁶ performing the certification role that conventional underwriters play in IPOs.²⁷

3. *Transaction-Based Compensation*

Targets pay SPACs for their efforts by assuming dilutive equity securities and cash payables. The securities are the so-called “founder shares” and warrants held by the SPAC’s sponsor²⁸ and the public warrants originally issued to the initial SPAC IPO investors. Neither founder shares nor warrants come with any underlying cash. The payables are amounts that the SPAC owes to its advisors. The target must assume all these securities and payables to induce the SPAC to engage in the transaction. Just as with the compensation of conventional underwriters, targets incur this cost only if the transaction closes.

4. *Co-Investor Label*

SPACs and their sponsors have sometimes been characterized as investors rather than underwriters. A frequent claim is that SPACs offer public investors

24. Atlantic Coastal Acquisition Corp., Investor Call Transcript (Form 425) (Dec. 1, 2021).

25. Churchill Capital Corp III, Analyst Call Transcript (Form 14a-12) (Aug. 19, 2020) (describing conversations SPAC had with senior executives at customers representing about 65% of the target’s revenue base).

26. See Jessica Bai, Angela Ma & Miles Zheng, *Segmented Going-Public Markets and the Demand for SPACs* (Sept. 23, 2021) (unpublished manuscript), <https://ssrn.com/abstract=3746490> [<https://perma.cc/2653-W4K2>] (modeling SPAC sponsors as non-bank certification intermediaries); Gahng et al., *supra* note 2, at 9 (characterizing SPAC sponsors as ad-hoc underwriters).

27. *Cf.*, e.g., Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 618-21 (1984) (arguing that investment banks serve as information intermediaries).

28. The sponsor receives the founder shares for free when it incorporates the SPAC and gets its warrants in exchange for its “at-risk” funding of SPAC IPO costs and pre-merger expenses. All founder shares and warrants are worthless if the SPAC does not close a merger. Sometimes SPACs agree to cancel some of their founder shares or subject them to vesting based on earnout provisions tied to the company’s post-merger stock price.

“a way to co-invest side-by-side” with sponsors.²⁹ For many SPAC mergers, however, the co-investor label for sponsors misses the mark. Not only are sponsors not required to provide any cash funding for the merger,³⁰ data for January 2019 to June 2020 mergers shows that the median sponsor in fact contributed practically *no cash at all* to the target.³¹

Some sponsors do invest cash by buying additional shares,³² but since they already own founder shares and warrants, they pay a much lower blended price than the \$10 effectively paid by nonredeeming public shareholders. Only if founder shares and warrants are not treated as a price subsidy can those sponsors be described as genuine co-investors. In this case, however, those securities must constitute primarily payment for their SPACs’ underwriting³³ and, perhaps, for any post-merger mentoring that sponsors may provide through board representation.

II. Gaps in Investor Protection

The failure of existing SEC regulation to treat SPAC mergers in accordance with their economic substance as stock sales for cash has led to wide gaps in investor protection. This part of the Essay identifies these gaps, which it groups into three categories: disclosure liability and gatekeeping, underwriting regulation, and offering regulation.

29. *SPACs: Special Purpose Acquisition Companies*, NASDAQ, <https://www.nasdaq.com/solutions/spac> [<https://perma.cc/SH9L-VBHS>]; *see also, e.g.*, Christopher M. Barlow, C. Michael Chitwood, Howard L. Ellin, Michelle Gasaway & Gregg A. Noel, *Skadden Discusses the “Year of the SPAC,”* CLS BLUE SKY BLOG (Feb. 18, 2021), <https://clsbluesky.law.columbia.edu/2021/02/18/skadden-discusses-the-year-of-the-spac/> [<https://perma.cc/3FWM-QGE8>] (explaining that the SPAC structure “allows public shareholders to invest alongside the sponsor team”); *Perspective—Private Equity Industry Insights*, ROPES & GRAY 8 (Fall 2019), https://www.ropesgray.com/-/media/Files/alerts/2019/11/20191126_PERSpectives.pdf [<https://perma.cc/98NH-2NDD>] (“[A] SPAC provides an opportunity to invest alongside experienced industry experts and deal professionals”); Khoa Tran, *SPAC: Lessons Learned*, IPOHUB (Mar. 18, 2021), <https://www.ipohub.org/spac-lessons-learned/> [<https://perma.cc/NCX4-C6B2>] (“For public investors, a SPAC is a great way to co-invest with successful founders, who are usually well-respected investors and bankers in the industry.”).

30. SPAC sponsors receive their founder shares for free. Their warrants are not associated with a cash investment at the time of the merger because the cash sponsors paid to acquire those warrants has been largely spent at that point to fund the SPAC’s pre-merger expenses.

31. Klausner et al., *supra* note 3, at 240 (median sponsor PIPE represented 0% of total cash delivered).

32. *See, e.g.*, Gahng et al., *supra* note 2, at 9-10 (sponsor investment serves as certification to attract PIPE investors or induce SPAC shareholders not to redeem); *see also* Klausner et al., *supra* note 3 (reporting how, in merger cohort, sponsor PIPEs represent 11% of total cash delivered at the 75th percentile).

33. Those include coaching target management on how to navigate the going-public process, an ancillary service that also conventional underwriters offer to companies, even if some SPAC sponsors are in fact better at it.

A. Gaps in Disclosure Liability and Gatekeeping

The federal securities laws are based on the premise that companies have incentives to underdisclose.³⁴ SEC rules therefore mandate disclosure of information relevant to investor decision-making. These mandates are effective because they are backed by liability provisions that hold companies accountable to investors for deficient disclosures. Investors' need for strict disclosure liability is greatest when new companies ask them to part with cash in exchange for stock. Investment banks involved in stock sales to the public for cash play an important role as gatekeepers for the accuracy of disclosure and face potential liability if their efforts were not reasonable. These liability standards and gatekeeping rules do not apply in SPAC mergers.

1. *Lacking Federal Securities Law Liability to Investors*

Companies that effectively sell their stock to the public for cash through a SPAC merger do not face the same disclosure liability to investors as those that do so through a traditional securities offering. In a traditional IPO, the company's executive officers that sign the SEC disclosure document and all the directors and control persons face strict liability for the accuracy and completeness of the disclosures unless they can establish their due diligence.³⁵ All that injured investors need to prove is a material misstatement or omission and their damages. This very investor-friendly liability regime does generally not apply to targets in SPAC mergers and their insiders.

2. *Laxer Federal Securities Law Liability for Projections*

Companies that raise capital from the public in SPAC mergers are also not subject to the same liability standards for financial projections that apply in IPOs. There, investors are generally entitled to expect that an opinion expressed by the company, which would include an estimate of future earnings, is honestly held and "fairly aligns with the information in the issuer's possession at the time."³⁶ In SPAC mergers, by contrast, financial projections may be protected by a statutory safe harbor meant to encourage companies that are already public to share forward-looking information with the market without fear of liability.³⁷ The safe harbor provides immunity from federal securities law liability to private plaintiffs absent actual knowledge of falsity, which is hard to prove, especially

34. By this, we mean that companies have incentives to disclose less information than would be socially optimal.

35. Securities Act of 1933 § 11, 15 U.S.C. § 77k (2018).

36. *Omnicare, Inc. v. Laborers Dist. Council Const. Ind. Pension Fund*, 575 U.S. 175, 189 (2015).

37. Securities Exchange Act of 1934 § 21(e), 15 U.S.C. § 78u-5 (2018); Securities Act of 1933 § 27A, 15 U.S.C. § 77z-2 (2018).

with regard to statements about the future. By its terms, the safe harbor does not in apply IPOs.³⁸

This potentially laxer liability standard compared to IPOs seems problematic not only for reasons of regulatory consistency. The pressure to embellish projections may be especially pronounced in SPAC mergers because SPACs and their sponsors have incentives that are quantitatively and qualitatively different from those of conventional underwriters.³⁹ Empirical research⁴⁰ has found that most SPACs fail to meet their projections with many dramatically underperforming.

3. Gatekeeper Arbitrage

The current regulation of SPACs does not provide investment banks working on them with the same incentives to act as disclosure gatekeepers as in IPOs.⁴¹ Investment banks advising on mergers or private placements are not viewed as disclosure gatekeepers with responsibility for the information that companies provide to public investors.⁴² If SPAC mergers were treated as sales of securities of the target company to the public for cash, investment banks advising on them may conduct IPO-level due diligence even if not required, the same way they do in direct listings.⁴³ There, investment banks have adopted such

38. John Coates, then the Acting Director of the SEC's Division of Corporation Finance has suggested that the safe harbor may also not apply to SPAC mergers to the extent they resemble IPOs because they take private companies public. *See* Statement, John Coates, Acting Dir., Div. of Corp. Fin., Sec. & Exch. Comm'n, SPACs, IPOs and Liability Risk under the Securities Laws (Apr. 9, 2021), <https://www.sec.gov/news/public-statement/spacs-ipos-liability-risk-under-securities-laws> [<https://perma.cc/WZP8-JMFJ>] (citing legislative history).

39. *See* discussion *infra* Sections II.B.1, II.B.2.

40. *See* discussion *infra* Section III.B.2.

41. Regulators rely on gatekeepers to enhance compliance by primary actors when direct deterrence reaches its limits. This dilemma arises when, for example, when expected payoffs from violations are too large relative to expected penalties discounted by the probability of detection and enforcement. Investment banks acting as underwriters are the paradigmatic example. *See, e.g.*, Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J.L. ECON. & ORG. 53, 82-83, 94-100 (1986) (using underwriters as core gatekeeper example).

42. Investment bank liability for merger proxy statement disclosure has generally been based on their fairness opinions. *See* *Herskowitz v. Nutri/System, Inc.*, 857 F.2d 179, 189-90 (3d Cir. 1988) (holding an investment bank rendering a fairness opinion to a negligence standard under Section 14(a) of the Exchange Act because it was aware that the opinion would be used to solicit shareholder approval). Also under state law, merger financial advisors are not treated as gatekeepers for public markets. *See, e.g.*, *RBC Capital Mkts. v. Jervis*, 129 A.3d 816, 865 n.191 (Del. 2015) (holding that financial advisors in M&A transactions are not gatekeepers); Andrew F. Tuch, *M&A Advisor Misconduct: A Wrong Without a Remedy?*, 45 DEL. J. CORP. L. 177, 196-98 (2021) (summarizing law). They incur liability only for intentionally aiding and abetting a fiduciary breach. Tuch, *supra*, at 199-210.

43. *See, e.g.*, *NYSE Proposes Letting Companies Raise Funds in a Direct Listing*, DAVIS POLK (Nov. 26, 2019), https://www.davispolk.com/sites/default/files/2019-11-26_nyse_direct_listing_proposal.pdf [<https://perma.cc/F65W-ACBR>] (explaining that SEC rules require investment banks to participate as financial advisers and accept underwriter liability, causing basic registration and due diligence process to remain largely as it is for underwritten offerings); Ran Ben-Tzur and James D. Evans, *The Rise of Direct Listings: Understanding the Trend, Separating Fact from Fiction*, FENWICK (Dec. 5, 2019), <https://www.fenwick.com/insights/publications/the-rise-of-direct-listings-understanding-the-trend-separating-fact-from-fiction> [<https://perma.cc/C38S-YGGF>] (explaining that in a

a due diligence approach due to a perceived risk of underwriter qualification⁴⁴ and the fact that investment banks trading the shares of the newly public company within 25 days of the listing must deliver a prospectus.⁴⁵ Investment banks that advise on business combinations are not underwriters, and without treating the SPAC merger as the IPO of the target there is no requirement to deliver a prospectus in secondary market trades. The current regulation of SPACs thus allows companies to obtain investment banking support for raising capital from the public without the associated gatekeeping.⁴⁶

B. Gaps in Underwriting Regulation

Underwriter regulation addresses the economics of public capital raising head-on, recognizing that disclosure liability alone may be insufficient to protect investors against high costs and powerful incentives. The regime limits how much underwriting can cost relative to the amount of capital raised and requires clear quantitative disclosure about that cost. It addresses conflicts of interest created by an underwriter's financial stake in the success of a particular offering, and it prohibits underwriters from granting side deals that undermine the integrity of the stated offer price. SPACs effectively function as underwriters without having to comply with these rules.

1. *Uncapped and Unquantified Compensation*

While SPACs perform the role of underwriters by marketing shares to public investors, they are not subject to any of these rules governing underwriting compensation. These rules limit how much financial intermediaries can charge companies for marketing securities to the public at 10% of the cash raised.⁴⁷ This reflects a concern that the cost of high underwriting compensation is ultimately borne by investors because it creates a value hole that must be filled before investors can see a return. Conventional underwriters must also quantify their compensation, expressing the value of non-cash items, such as shares or other

direct listing, “investment banks and their legal counsel put companies through the exact same due diligence process as in a traditional IPO”).

44. See, e.g., John C. Coffee, Jr., *The Spotify Listing: Can an “Underwriter-less” IPO Attract Other Unicorns?*, CLS BLUE SKY BLOG (Jan. 16, 2018), <https://clsbluesky.law.columbia.edu/2018/01/16/the-spotify-listing-can-an-underwriter-less-ipo-attract-other-unicorns/> [<https://perma.cc/R5YS-P3HM>] (explaining that financial advisers risk being classified as underwriters).

45. Securities Act of 1933 § 4(a)(3), 15 U.S.C. § 77d(a)(3) (2018); 17 C.F.R. § 230.174 (2022).

46. Commentators have bemoaned the lack of investment bank gatekeeping. See, e.g., Usha Rodrigues & Michael Stegemoller, *Redeeming SPACs* 13 (U. Ga. L. Sch. Rsch. Paper No. 2021-09, 2021), <https://ssrn.com/abstract=3906196> [<https://perma.cc/PF7T-TL82>].

47. FIN. INDUS. REGUL. AUTH., FINRA MANUAL, RULE 5110(a)(1) (requiring that underwriting compensation must not be “unfair or unreasonable,” which is generally understood to impose a cap of 10% of cash proceeds raised). FINRA, the Financial Industry Regulatory Authority, is a self-regulatory association that regulates investment banks. It operates under SEC oversight.

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securities, in dollar terms⁴⁸ and present this information to investors in convenient table format.⁴⁹

Aggregate cost from (and thus the target's compensation for) SPAC underwriting consists of the assumption of SPAC founder shares, warrants, and cash payables. A recent study calculated that cost at a staggering 58% of cash raised on average for mergers that closed between January 2019 and June 2020.⁵⁰ Econometric research has found that, on average, high SPAC costs eventually come largely at the expense of public investors.⁵¹ SPACs are also not required to quantify, in dollar terms, the compensation that targets must pay for SPAC services, making it harder for investors to understand those costs.

2. *Unregulated Conflicts*

SPACs are not subject to the conflict of interest rules that govern conventional underwriters in public stock offerings. These rules apply when underwriters have a special financial interest in a particular offering that goes beyond earning the customary commission that they receive in the many other transactions they work on. Under these rules, a separate independent underwriter must then be brought in to conduct its own due diligence and assume liability for the disclosure to investors.

SPACs and their controlling persons have similar special financial interests in the success of the mergers that they market to public investors. Without a merger, the SPAC must liquidate, rendering worthless all securities held by its sponsor and other control persons. If the merger closes, however, it provides an opportunity for an outsized return. Empirical data supports the conclusion that SPAC conflicts affect outcomes. SPAC shares on average underperformed the IPO index by -50.9% after twelve months and -100.4% as of November 1, 2021,⁵² even after excluding the first-day "pop" in IPOs.⁵³ Despite this conflict, SPACs are not required to retain independent underwriters for a more disinterested check on their investigation of the target and their disclosure to investors.

48. FIN. INDUS. REGUL. AUTH., FINRA MANUAL, RULE 5110, at Supplementary Material .05.

49. FIN. INDUS. REGUL. AUTH., FINRA MANUAL, RULE 5110(b)(1), at Supplementary Material .05 (requiring disclosure "in the section on distribution arrangements in the prospectus"); Regulation S-K, Item 508(e), 17 C.F.R. § 229.508 (2022) (requiring tabular disclosure of all items considered underwriting compensation by FINRA).

50. Klausner et al., *supra* note 3, at 252. *See also* Gahng et al., *supra* note 2, at 48 panel A (finding that the median SPAC cost was 48.3% of cash raised for Jan. 2015 to Mar. 2021 mergers). Both studies include PIPE cash.

51. Klausner et al., *supra* note 3, at 262.

52. *Id.* at 256, tbl.6.

53. *Id.* at 255 (discussing IPO index construction).

3. *Preferential Pricing*

SPACs also do not need to comply with rules against preferential pricing. Conventional underwriters must sell securities at the stated price and cannot grant discounts to some investors but not others.⁵⁴ This enables investors to rely on participation by others as a meaningful signal for their own investment decision. SPACs and their affiliates are not subject to this rule. In theory, all public investors that invest their escrowed cash in the target pay the same price of \$10 plus interest per share by electing not to redeem. In practice, however, there is a significant opportunity for side deals that effectively lower the price for some investors but not others by offering incentives not to redeem,⁵⁵ making the price paid by others non-transparent.

C. Gaps in Offering Regulation

Offering regulation deals with three different issues that rules about disclosure, disclosure liability, and underwriting do not address. First, it seeks to protect investors' reliance on the integrity of a stock's market price against price distortion due to purchases induced or effected by companies themselves when they are looking to sell shares of that stock. Second, concerned about investor exuberance, offering regulation limits the permissible publicity for an upcoming capital raising transaction. Third, it prohibits companies from having stock sold for their benefit before the SEC has cleared the relevant disclosure. None of these rules apply in SPAC mergers.

1. *Purchases During Distribution*

SPAC mergers are not subject to the strict prohibition against purchases (or purchase inducements) during a distribution of securities. In traditional stock offerings, this prohibition prevents companies and their affiliated purchasers and underwriters from affecting the price of securities that are of the same class as those that are being distributed.⁵⁶ This protects investors that rely on the integrity of the market price when deciding to buy in the offering.

The absence of this prohibition⁵⁷ enables SPACs and targets and their respective affiliates and financial advisers to purchase or induce others to purchase the SPAC's shares. This has the potential to inflate the share price,

54. FIN. INDUS. REGUL. AUTH., FINRA MANUAL, RULE 5141.

55. A typical formulation refers to "transactions with investors and others to provide them with incentives to acquire public shares, vote their public shares in favor of our initial business combination or not redeem their public shares." ST Energy Transition I Ltd., Prospectus, (Form 424(b)(4) (Dec. 2, 2021).

56. Regulation M, 17 C.F.R. §§ 242.100-102 (2021).

57. A restriction on purchases would apply during the period that the target's shareholders need to make their decision on the merger. *See infra* Section II.C.3. in the definition of restricted period in Rule 100(b) of Regulation M; *see also* SEC Staff Legal Bulletin No. 9 (Oct. 27, 1999, Revised November 22, 2019) (noting that in a merger the Regulation M-restricted period is based solely on the target company's shareholder vote). Since the SPAC target is typically closely held, its shareholder vote often occurs before the merger has even been announced.

which investors in turn will interpret as signaling the market's belief in the value of the post-merger company when deciding to invest their escrowed cash. The risk of price-inflating activity is real. SPAC IPO prospectuses expressly contemplate potential purchases by the SPAC's sponsor and others in connection with the merger, including from holders that otherwise would have redeemed their shares.⁵⁸

2. *Unrestrained Publicity*

Since SPAC mergers are not being treated as stock sales for cash, they are not subject to the publicity restrictions that apply to traditional capital raising transactions. In IPOs, those restrictions prohibit companies from generating public interest before they have filed a comprehensive disclosure document with the SEC.⁵⁹ That prohibition is designed to forestall “publicity efforts which . . . condition the public mind or arouse public interest” before the public has full information.⁶⁰ After the full disclosure document has been filed for SEC review and is publicly available, soft restraints still enforce a “quiet period” in IPOs during which companies do not give interviews to the press or appear on TV to discuss the offering.⁶¹ Empirical research has confirmed the vulnerability of individual investors to publicity: they are more likely to buy stock that has been in the news,⁶² and their investment decisions tend to be driven more by sentiment than by fundamental analysis.⁶³

SPACs “engage in all forms of marketing and communications to generate interest in the transaction,”⁶⁴ often involving interviews with journalists and appearances on business news programs and internet channels.⁶⁵ This embrace of unrestrained publicity is especially problematic in light of the sometimes high

58. See, e.g., Churchill Capital Corp. III, Prospectus, at 19-20 (Form 424(b)(4) (Feb. 14, 2020).

59. Securities Act Section 5(c), 15 U.S.C. § 77e(c).

60. Carl M. Loeb, Rhoades & Co., 38 S.E.C. 843 *6 (1959).

61. This quiet period stems from a statutory provision limiting written and TV marketing that can be used after the disclosure document has been filed to the SEC-compliant prospectus that contains all relevant information. It was designed to ensure that potential buyers appreciated the complexity of the decision they were faced with when making an investment. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 752–53 (1975) (noting that the prospectus and registration requirements were intended to prevent high pressure salesmanship through limitation of the selling arguments and frighten potential buyers with the intricacy of the transaction).

62. Brad M. Barber & Terrance Odean, *All That Glitters: The Effect of Attention and News on the Buying Behavior of Individual and Institutional Investors*, 21 REV. FIN. STUDS. 785 (2008).

63. Daniel Dorn, *Does Sentiment Drive the Retail Demand for IPOs?*, 44 J. FIN. QUANT. ANALYSIS 85 (2009) (finding that retail investors consistently overpay for IPOs, based on data from when-issued trading in German IPOs).

64. *10 Questions with Don Duffy*, THE ACTIVIST REPORT (Sept. 2020), <https://westwicke.com/wp-content/uploads/10-Questions-with-Don-Duffy-1.pdf> [<https://perma.cc/3DDJ-8A25>].

65. For example, in a recent transaction, the target CEO scored four different interviews just at the announcement. See *Bright Lights Acquisition Corp.*, Filing Under Securities Act Rule 425 of Certain Prospectuses and Communications in Connection with Business Combination Transactions (Form 425) (Nov. 23, 2021); *Bright Lights Acquisition Corp.*, Filing Under Securities Act Rule 425 of Certain Prospectuses and Communications in Connection with Business Combination Transactions (Form 425) (Nov. 24, 2021).

level of retail participation in SPAC mergers⁶⁶ and recent empirical research linking abnormal market returns and retail trading with the level of revenue growth in the SPAC's projections publicized at the time of the merger.⁶⁷ Publicity may also have contributed to "narratives" about SPACs.⁶⁸

3. *Sales Before SEC Disclosure*

In SPAC mergers, shares are sold to the public before SEC-reviewed disclosure is available. In IPOs and other public stock sales by issuers, new securities must not be sold until a comprehensive disclosure document has been filed and there has been an opportunity for SEC review.⁶⁹ This is designed to provide buyers with fulsome information before they make their investment decisions. SPACs and their targets, in contrast, can actively solicit buyers for sales that move shares from initial holders who would otherwise redeem into the hands of new investors that intend to make a cash investment. The only public disclosure that exists when these sales commence is a press release and a slide deck, neither designed to offer a balanced view of the risks and opportunities of the investment.

After the SEC disclosure about the SPAC merger is available, investors that bought in the market earlier can still redeem, but they are protected only for the portion of their purchase price that represents their escrowed cash, which leaves them exposed for the excess. That excess can be significant, with SPAC shares trading at \$15.77 on average on the day after the merger announcement in the last quarter of 2020 and the first quarter of 2021.⁷⁰ Prices like this are currently less common, but they can always come back, as demonstrated by the SPAC

66. Net purchases of pre-merger SPACs were especially high in the fourth quarter of 2020 and the first quarter of 2021, and rose again in October 2021. See Bailey Lipschultz, *Trump-Tied SPAC Fuels Day Trader Return to Blank-Check Stocks*, BLOOMBERG (Oct. 28, 2021), <https://www.bloomberg.com/news/articles/2021-10-28/trump-tied-spac-fuels-retail-trader-return-to-blank-check-stocks> [<https://perma.cc/7J8B-J2GZ>] (reporting data from Vanda Research showing retail investors' five-day net purchases of pre-merger SPACs between \$50 million and close to \$400 million during that period and describing a recent return to similar levels).

67. Michael Dambra, Omri Even-Tov & Kimberlyn George, *Should SPAC Forecasts be Sacked?* (Jan. 24, 2022), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3933037 [<https://perma.cc/FR2D-VPYZ>] (documenting positive association between compound annual growth rate in projected revenue and both market returns and abnormal retail trading during the five-day event window around the publication of the projections); Kimball Chapman, Richard Frankel & Xiumin Martin, *SPACs and Forward-Looking Disclosure: Hype or Information?* (Oct. 21, 2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3920714 [<https://perma.cc/4QBA-2FC6>] (concluding that SPAC projections on average do not mislead small investors, but their study fails to account for the size of the projected growth, which is arguably the most important aspect of SPAC projections; instead, they measure only number and tone of forecasts, making their conclusions less powerful).

68. See Philippe Maupas & Luc Paugam, *Regulatory Arbitrage on Narrative Steroids: The Case of SPACs*, CFA SOC'Y FR. (Dec. 20, 2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3985936 [<https://perma.cc/QV2R-SNYW>] (analyzing promotional investment narratives disseminated by SPACs and arguing that those narratives partially explain growth of SPAC market).

69. Securities Act Section 5(a)(1), 15 U.S.C. § 77e(a)(1) (2018).

70. Klausner et al., *supra* note 3, at 292; see also Rodrigues & Stegemoller, *supra* note 46, at 46 (noting that investors that purchased at higher price but then redeem suffer a loss).

scheduled to merge with former President Trump’s social media company, whose stock traded at \$55 at the end of 2021. Behavioral effects may also make new investors reluctant to redeem.⁷¹

III. Leveling the Playing Field

Having described the gaps in investor protection created by the current regulation of SPAC mergers, I now present a four-step blueprint for addressing these gaps through SEC rulemaking. This blueprint differs from the SEC’s own recent proposal by focusing on the substance of the investment decision that SPAC shareholders make when they invest their escrowed cash in the post-merger company. This allows for a simpler framework that achieves greater regulatory consistency between IPOs and SPAC mergers and avoids gaps left open by the SEC’s own proposal.

The core of the blueprint consists of a new SEC rule that treats a SPAC shareholder’s decision to invest their escrowed cash as the purchase of shares for cash. As a second step, this new rule would then enable the SEC to address several of the existing regulatory gaps with minimal incremental effort through fairly basic regulation. The third step involves intermediate regulation that, building on the same principle, would apply conventional underwriter regulation to SPACs. The fourth and final step suggests advanced regulation that would require actual changes in the SPAC structure to achieve full investor protection parity with IPOs.

A. Investment of Escrowed Cash Deemed Purchase and Sale of Stock

The SEC has broad authority to adopt rules that implement the federal securities statutes,⁷² thereby regulating transactions based on their economic substance rather than their legal form.⁷³ As demonstrated in Part II, a nonredeeming SPAC shareholder’s decision to invest their escrowed cash at the time of the merger is the *economic* equivalent of a purchase of shares in the SPAC when it turns into the post-merger company, and therefore also to a purchase of target stock, for cash.⁷⁴ An SEC rule deeming that decision to be also

71. See, e.g., Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 *ECONOMETRICA* 263 (1979) (demonstrating that individuals avoid sure losses); Markku Kaustia, *Market-Wide Impact of the Disposition Effect: Evidence From IPO Trading*, 7 *J. FIN. MKTS.* 207 (2004) (observing that when IPO stock opens below offer price, turnover increases significantly when stock exceeds offer price for the first time).

72. Securities Act § 19(a), 15 U.S.C. § 77s(a) (2018) (granting authority to adopt rules necessary to carry out the statute’s provisions and define accounting, technical and trade terms); Securities Exchange Act § 3(b), 15 U.S.C. § 78c(b) (2018) (granting power to define terms consistently with the statute’s provisions and purposes).

73. See, e.g., *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 849 (1975) (“Congress intended the application of the federal securities statutes to turn on the economic realities underlying a transaction, and not on the name appended thereto.”).

74. Interestingly, in 2009, the SEC staff appears to have briefly considered treating the redemption right as creating a new investment decision at the time of the merger when a SPAC did not

the *legal* equivalent of a cash purchase (triggering a corresponding sale) would be a small step. Focusing on the economic substance of the decision would overcome the fact that nonredeeming holders technically do not receive new shares but hold onto SPAC shares when those effectively turn into target stock.⁷⁵

Assessable stock at one point presented an analogous problem. That stock enables companies to assess additional cash that holders must pay if they want to keep their shares. If they fail to meet the assessment, their stock can be forcibly sold to raise the assessed amount. This was being used to avoid the regulation of stock sales. Companies took the position that since the investors funding the assessment were technically already shareholders and not buying additional shares, there was no sale of stock. The SEC, however, issued a rule that deems a sale of stock to occur when holders of assessable stock pay their assessment.⁷⁶ The SEC explained that those holders are making an additional investment in the enterprise that presents the same need for protection as the original investment.⁷⁷

SPAC shareholders are in a similar situation. By investing their escrowed cash, they are technically not buying new shares, but are nevertheless faced with a decision whether to place cash at risk and stand to lose their shares if they do not. What makes this conceptually confusing is the mistaken notion that SPAC shareholders already paid their cash at the time of the IPO, so they cannot be paying it “again” at the time of the merger. In economic substance, however, SPAC shareholders never paid cash that the SPAC could actually use without the shareholders’ permission. To receive their shares initially, they merely parked their cash in a trust while retaining absolute discretion on whether to invest that

hold a shareholder vote, although it ultimately did not pursue the issue. *See* Michael R. Clappitt, Letter from Michael R. Clappitt of the Division of Corporation Finance of the SEC Regarding 57th St. General Acquisition Corp. Form S-1 (Dec. 11, 2009); Michael R. Clappitt, Letter from Michael R. Clappitt of the Division of Corporation Finance of the SEC Regarding 57th St. General Acquisition Corp. Form S-1 (Jan. 8, 2010). The SPAC’s responses were not particularly persuasive. They included the assertion that treating the investment decisions made by SPAC shareholders as involving sales of securities would necessarily mean doing the same for any redeemable securities and for any major acquisition by a public company. *See* 57th St. General Acquisition Corp., Response to SEC Comment dated December 11, 2009 (Dec. 21, 2009); 57th St. General Acquisition Corp., Response to SEC Comment dated January 8, 2010 (Jan. 22, 2010).

75. It is well recognized that the federal securities laws are designed to protect investment decisions. *See, e.g.,* SEC v. Ralston Purina Co., 346 U.S. 119, 124 (1953) (stating that the Securities Act is designed to ensure informed “investment decisions”). Their application may therefore hinge on the presence or absence of such a decision, rather than on whether there has been a sale in the common law sense. *See, e.g.,* Goodman v. Epstein, 582 F.2d 388, 414 (7th Cir. 1978) (finding that a contribution by limited partner in response to capital call constituted a “purchase” of a security under Exchange Act antifraud rule, even when investment decision remained to be made); Radiation Dynamics, Inc. v. Goldmuntz, 464 F.2d 876, 891 (2d Cir. 1972) (time of “purchase or sale” under Exchange Act antifraud rule to be determined as the time when parties to the transaction are committed, not when transaction is executed); Bryan B. Edwards & Jon J. Bancone, *Modifying Debt Securities: The Search for the Elusive “New Security” Doctrine*, 47 BUS. LAW. 571 (1992) (SEC treats modifications of financial terms of debt securities as a sale of new securities).

76. 17 C.F.R. § 230.136 (2022).

77. SEC Release No. 33-3903, 1958 WL 6411 (March 5, 1958). For additional context, see James C. Sargent, Commissioner, SEC, Current Problems in Federal Regulation on the Sale of Mining Industry Securities (Feb. 5, 1959), <https://www.sec.gov/news/speech/1959/020559sargent.pdf> [<https://perma.cc/SB27-JLSN>]. At the time, the SEC seemed focused primarily on ensuring adequate disclosure. For SPACs, SEC rulemaking would be motivated by the regulatory gaps identified in Part II.

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cash at a later time, once the target had been identified. Escrowed cash does not, as is often said, provide SPACs with “dry powder,” but merely with the ability to find buyers for the shares who will then invest that cash.⁷⁸

The purchase and sale of SPAC shares deemed to occur when SPAC shareholders invest their escrowed cash would also constitute the purchase and sale of *target* stock. This is consistent with the SEC’s long-standing co-issuer rule for companies whose principal business it is to acquire the securities of a target company and to fund that acquisition by selling their own securities.⁷⁹ The rule treats such a sale of securities as a simultaneous sale of the underlying securities of the target company. In fact, when the SEC adopted the rule about assessable stock discussed earlier, it was specifically concerned about shell companies with assessable stock that were using assessments to finance the purchase of stock of target companies, thereby effectively distributing target stock to public investors against cash payment.⁸⁰ This is exactly analogous to SPACs.

B. Basic Regulation

Treating a nonredeeming SPAC shareholder’s investment of their escrowed cash as the purchase and sale of stock would close several of the gaps in investor protection compared to IPOs on its own or with only minimal incremental SEC rulemaking. This is the low-hanging fruit of SPAC regulation. Specifically, this treatment would result in strict disclosure liability, IPO parity in liability for projections, gatekeeping incentives for investment banks, the prohibition of purchases during the distribution of securities, and more balanced publicity.

1. *Strict Disclosure Liability*

The proposed deemed purchase and sale would level the playing field between SPAC mergers and IPOs when it comes to disclosure liability. Each SPAC merger would be treated as a public offer and sale of shares that would need to be registered with the SEC on Form S-1, just like a traditional IPO. The registration statement would be signed both by the SPAC and the target, subjecting both to strict liability for the accuracy and completeness of the disclosure made to investors. Technically, the SPAC would be an underwriter with respect to the target’s stock, potentially affording it the underwriter’s due

78. As a result, SPACs resemble companies with non-recourse assessable stock that will be able to raise capital from an assessment only if they can find investors willing to pay it.

79. 17 C.F.R. § 230.140 (2022). The SEC could interpret or amend the rule to clarify that it applies regardless of whether the proceeds are paid to the owners of the target or used to provide working capital for the combined company. Distinguishing between primary transactions (where the cash raised remains in the company) and secondary ones (where it is used to fund payments to the target’s owners) would be arbitrary.

80. See SEC Release 33-3903, *supra* note 77.

diligence defense for target information.⁸¹ In practice, this is unlikely to be of much relevance because the target, which does not have that defense,⁸² is merging with the SPAC. The same disclosure liability would apply to their respective directors, relevant executive officers, auditors and control persons, subject to applicable due diligence defenses. The disclosure liability would include SPAC sponsors as control persons.⁸³

Overall, the SEC's recent proposal to treat SPAC mergers as sales of securities that require registration is broadly consistent with the view advanced in this Essay, although there are nuanced differences. The proposal presented here is more comprehensive than the SEC's, which would hold only those target directors liable that sign the SPAC merger registration statement. It is also more internally consistent by treating the target as a co-registrant not just for purposes of the signature requirements, as the SEC rule would.⁸⁴ In addition, the proposed SEC rule would treat any merger of a public shell company as implicating a sale of securities to the shareholders of the public shell—

even when those shareholders make no decision in connection with the merger.⁸⁵ Such a change would be in tension with the long-standing view that the relevant statute is designed to ensure informed investment decisions.

2. *IPO Parity in Liability for Projections*

In addition, the deemed purchase and sale proposed here would eliminate the existing differential treatment between SPAC mergers and IPOs with respect to the required rigor for financial projections. Since a SPAC merger would be quite literally the “initial public offering” of the target's stock, the liability for financial projections would be the same as in an IPO, because the statutory safe harbor for forward-looking statements, by its terms, does not cover IPOs. I do not take a view here on whether laxer liability standards for IPOs would be desirable to encourage greater use of projections in IPOs.

The SEC has also proposed to subject financial projections in SPAC mergers to the same liability standard that would apply in IPOs. Yet this proposal rests on shaky legal ground. By its terms, the safe harbor is not available in offerings by blank check companies. Indeed, as currently defined by the SEC, blank check companies *exclude* SPACs. The SEC now proposes to disapply the safe harbor in SPAC mergers by changing the definition of “blank check company” such that it *includes* SPACs (which would then *exclude* SPACs from the safe harbor).⁸⁶ Such a change could prove problematic, because the SEC's

81. See Securities Act §11, 15 U.S.C. § 77k (2018); Securities Act § 12(a)(2), 15 U.S.C. § 77l (2018).

82. The target would have strict liability under Securities Act § 11, 15 U.S.C. § 77k (2018).

83. When I refer to the sponsor here, I mean in the first instance the legal entity that the SPAC identifies as such, which is typically a limited liability company that owns the founder shares and private placement warrants.

84. Proposing Release, *supra* note 1 at 29463.

85. Proposed Rule 145a, Proposing Release, *supra* note 1 at 29567.

86. Proposing Release, *supra* note 1 at 29482.

existing definition of blank check company was already in place when Congress enacted the statute. It is also not clear that a SPAC merger constitutes an offering “by” a blank check company as intended by Congress. What occurs in fact is really an offering of securities in the post-merger company, which, even under the SEC’s revised definition, is not a blank check company.

3. *Appropriate Gatekeeping Incentives*

Several commentators have suggested that investment banks involved in SPAC mergers should have gatekeeper responsibility as if they acted as underwriters in an IPO.⁸⁷ In other words, they should be held liable for the disclosure to investors if they did not conduct a reasonable investigation. The legal basis for imposing such responsibility, however, remains unclear. The federal securities laws treat investment banks as disclosure gatekeepers when they act as underwriters, but not otherwise, and the SEC has no authority to expand that responsibility. Whether an investment bank acting in connection with a sale of securities qualifies as an underwriter is a facts-and-circumstances determination that depends on the bank’s involvement.

Treating SPAC mergers as stock sales for cash, however, would ensure that investment banks working on them have due diligence incentives that are commensurate with the level of their involvement and at least comparable to those in direct listings,⁸⁸ even if there would not necessarily be underwriter liability. For example, investment banks making a market in the shares of the post-merger company would be required to deliver a prospectus for a certain period following the transaction.⁸⁹ In fact, in SPAC mergers the banks’ due diligence incentives could be even greater than in direct listings insofar as they have more interaction with investors, depending on the transaction.

The SEC’s proposal takes a different approach by deeming SPAC IPO underwriters that participate in any capacity in the SPAC merger to be underwriters with respect to a distribution occurring in the merger,⁹⁰ even when they are not involved in finding investors for the public shares. The SEC clearly hopes that this will motivate investment banks to act as gatekeepers, but a desire for gatekeepers is not a legal theory. Without a coherent limiting principle, the SEC’s references to the broad definition of “underwriter” in the relevant federal statute prove too much. The SEC’s theory seems premised on some notion of latent underwriter liability that could apply to all sorts of actors and would not stop at SPACs. This stretches the fabric of the statute, and courts may ultimately not follow the SEC if this broad underwriter concept is challenged in litigation.

87. See Klausner et al., *supra* note 3, at 286-87 (noting absence of Securities Act liability for investment banks in SPAC mergers and suggesting introducing that liability to level the playing field with IPOs); Rodrigues & Stegemoller, *supra* note 46 (arguing that investment banks should face liability for SPAC merger disclosure).

88. Investment banks acting as the issuer’s financial advisers in direct listings generally apply the same due diligence procedures as banks acting as underwriters in IPOs.

89. Securities Act § 4(a)(3), 15 U.S.C. § 77d(a)(3) (2018).

90. Proposing Release, *supra* note 1 at 29486.

4. *No Purchases During Distribution*

The deemed stock purchase and sale would activate the SEC's existing prohibition against purchases or purchase inducements by companies and their affiliates⁹¹ during a distribution of securities.⁹² This prohibition is designed to ensure the integrity of the market price on which the public is relying when deciding to purchase in the distribution. Efforts to encourage holders not to redeem would be considered a distribution of those shares.⁹³ The SEC could clarify exactly how its existing prohibition would apply to SPAC mergers. These clarifications could include the beginning and end of the relevant restricted period.⁹⁴ SPACs and targets and their respective affiliated purchasers⁹⁵ would then no longer be permitted to purchase shares themselves⁹⁶ during this period or offer side payments to induce others to purchase shares. Simply soliciting purchases of shares in the market for the purpose of getting those new purchasers to invest in the target would be permitted.⁹⁷ But offering a side payment, hedge, or other economic incentive to those new investors would not be allowed.⁹⁸

Using a different legal analysis (treating the redemption right as creating a tender offer), a recent SEC staff interpretation at least seeks to cap the price at which SPAC sponsors and their affiliates can execute such purchases and require

91. The relevant concept is "affiliated purchaser."

92. See Regulation M, 17 C.F.R. § 242.100-105 (2022) (defining distribution as an offering of securities that is distinguished from ordinary trading transactions by the magnitude of the offering and the presence of special selling efforts and selling methods).

93. The SEC could interpret Regulation M to deem purchases of SPAC shares after the merger announcement to constitute purchases of the underlying target shares to clarify application of the rule to the target and its affiliates.

94. The restricted period could commence when SPAC shareholders can first deliver their shares for redemption, which is typically when the proxy statement for the merger vote is being mailed. The SEC could also take the view that the distribution commences with the solicitation of purchases by SPACs and targets after the merger announcement. SPACs and targets arguably have an incentive to raise the share price already at that point. In either case, restrictions would run until shareholders can last decide to invest their escrowed cash, which is usually the time of the shareholder vote.

95. The prohibition also applies to any "distribution participants." This could potentially include investment banks acting as advisers to SPAC or target, depending on their level of involvement. See Spotify Technology S.A., SEC No-Action Letter, 2018 WL 1531993 (Mar. 23, 2018).

96. In non-SPAC distributions, persons participating in a distribution and their affiliated purchasers can themselves purchase in the distribution if the purchase is genuinely for investment. The SEC will need to consider how to apply this concept in SPAC mergers. Arguably, the financial stakes that the SPAC sponsor and the target have in the transaction are so fundamentally different from those of other investors that any purchases by them, or by persons that hold an economic interest in them, should not be considered to be "for investment" and should therefore be prohibited even if the purchaser intended to hold on the purchased shares.

97. See Regulation M, 17 C.F.R. § 242.102(b)(5) (2022) (solicitation of offers to buy the securities being distributed is permitted).

98. The SEC could also consider how to treat inducements that are offered to SPAC investors for shares they already own to prevent those from being redeemed. It could argue that such inducements are prohibited during a restricted period because they, too, go beyond the simple solicitation of offers to buy the securities being distributed that Regulation M permits. It is not clear that the SEC has historically taken the position that an inducement offered to a potential purchaser in a distribution violates Regulation M if it goes beyond the mere solicitation of that purchaser's offer to buy, but that may be because the question has not presented itself quite as sharply outside the SPAC context.

relevant disclosure.⁹⁹ However, it does not prohibit such purchases altogether, nor does it necessarily cover purchases by the target or financial advisers involved in the transaction.

5. *More Balanced Publicity*

The deemed purchase and sale would automatically subject SPAC mergers to the same publicity restrictions as IPOs. This would prohibit marketing while permitting strictly factual communications.¹⁰⁰ One rule of thumb that the SEC uses in other contexts to draw that distinction is that historical financial results are factual while projections of future performance are not.¹⁰¹ This would delay the publication of projections until the filing of the SEC disclosure document. Limiting communications in this way is possible but problematic because SPAC shares and warrants would continue to trade, with the market clamoring for forward-looking information.

In fact, I believe that the SEC should expressly permit communications that would otherwise be prohibited due to the deemed purchase and sale. The SEC could, however, mitigate the risks from publicity by requiring that initial press releases and PowerPoint decks be more balanced. It could also consider limiting publicity to press releases and SEC filings, preventing marketing over the media. Overall, the deemed purchase and sale would give the SEC a fair amount of discretion in how far it wants to go in reigning in publicity. Implementing full IPO-style publicity restrictions without affecting information flow to an existing trading market would require changes to the SPAC structure.¹⁰² The SEC's proposed rules do not address the question of publicity.

C. Intermediate Regulation

The deemed purchase and sale would also underpin the next level of regulation, which the current SEC proposal does not address. This additional rulemaking would close gaps in investor protection that currently exist because

99. Compliance & Disclosure Interpretations, Tender Offers and Schedules, Question 166 (Mar. 22, 2022) <https://www.sec.gov/divisions/corpfin/guidance/cdi-tender-offers-and-schedules.htm#166.01> [<https://perma.cc/RU26-2TFT>].

100. The existing permission for pre-filing communications in stock mergers does not extend to publicity that has “the primary purpose or effect of conditioning the market for another transaction, such as a capital-raising or resale transaction.” See 17 C.F.R. § 230.165 (preliminary note) (2022) and 17 C.F.R. § 230.166 (preliminary note) (2022). Technically only applicable to registered stock mergers, these provisions express a broader principle. In light of the largely perfunctory nature of the merger vote, the SEC could argue that the “primary purpose” of SPAC pre-filing communications is conditioning the market for the capital raise, not providing shareholders with critical information for the vote. In addition, the safe harbor which theoretically permits the use of written communications in traditional IPOs after the prospectus has been filed is not available for SPACs because they are shell companies. See 17 C.F.R. § 230.164(e) (2022). The deemed purchase would therefore enable the SEC to limit permissible written marketing to the full prospectus, effectively prohibiting slide decks and media interviews.

101. See 17 C.F.R. § 230.168-169 (2022) (distinguishing between factual business information and forward-looking information such as financial projections, establishing communication safe harbor limited to factual business information).

102. See *infra* Section III.D.

SPACs are not subject to rules for conventional underwriters. Those rules apply to persons that are registered as brokers with the SEC under the Exchange Act and therefore members of the Financial Industry Regulatory Authority (FINRA).¹⁰³ Ultimately, the reason SPACs are not already regulated as brokers is that existing SEC rules do not treat SPAC mergers as sales of target stock for cash. The deemed purchase and sale would reverse that treatment, enabling the SEC to require SPACs to comply with conventional underwriter regulation.

1. *SPACs as Brokers*

Persons hired to sell stock for transaction-based compensation are regulated as brokers. This is the case whether or not they are also underwriters.¹⁰⁴ The Exchange Act defines as a broker any person “engaged in the business of effecting transactions in securities for the account of others.”¹⁰⁵ To be “effecting” transactions in securities has been interpreted as participating “in such transactions at key points in the chain of distribution.”¹⁰⁶ Typical broker activity includes assistance to an issuer in structuring securities transactions, advertising the transaction and actively soliciting investors, negotiating between issuer and investors, and preparing valuations as to the merits of the investment.¹⁰⁷ Structuring and soliciting are strong indicators of broker status, particularly when combined with transaction-based compensation.¹⁰⁸

Once SPAC mergers are viewed as sales of target stock for cash, what SPACs do is typical broker activity: finding an issuer for which the SPAC can structure the sale of securities to the public, coming up with a valuation,

103. Securities Exchange Act § 15(b)(8), 15 U.S.C. § 78o(b)(8) (2018) (providing that it is unlawful for registered brokers to effect transactions in any security unless they are members of a securities association or effect transactions solely on a national securities exchange of which they are members). Most brokers are also dealers (persons engaged in the business of buying and selling securities for their own account). See Andrew F. Tuch, *The Self-Regulation of Investment Bankers*, 83 GEO. WASH. L. REV. 101, 110-13 (2014) (providing an overview of broker-dealer self-regulation).

104. While they overlap, underwriters and brokers are separate legal categories. There are many examples of persons that may be deemed statutory underwriters under Section 2(a)(11) of the Securities Act, 15 U.S.C. § 77b(a)(11) (2018), without necessarily being brokers, such as purchasers in a private placement that resell their securities into the public market without observing a holding period but are not engaged in the business of selling securities for others. Conversely, someone can be a broker because they are in the business of selling securities for others, but unless their sales are both for the account of the issuer or its affiliates and into the public market, they are not acting as underwriters.

105. Securities Exchange Act § 3(a)(4), 15 U.S.C. § 78c(a)(4). See, e.g., JAMES A. FANTO, JILL I. GROSS & NORMAN S. POSER, *BROKER-DEALER LAW AND REGULATION* § 7.01 (5th ed. Supp. 2022-1); Robert L.D. Colby, Lanny A. Schwartz & Zachary J. Zweihorn, *What is a Broker-Dealer?*, in *BROKER-DEALER REGULATION* ch. 2 (Clifford E. Kirsch ed., Supp. July 2021); see also Guide to Broker-Dealer Registration, SEC, <https://www.sec.gov/reportspubs/investor-publications/divisionsmarketregbdguidehtm.html> [<https://perma.cc/3KNL-9G3A>].

106. Colby et al., *supra* note 105, at 2-13 (internal quotation marks omitted); see also FANTO et al., *supra* note 106, text accompanying nn.38-39 (participating in significant stages of a securities transaction).

107. See, e.g., Colby et al., *supra* note 105, at 2-13 to 2-14; FANTO et al., *supra* note 105, text accompanying n.23.

108. Colby et al., *supra* note 105, at 2-15. Indeed, compensation that hinges on the success of the transaction is itself a key factor. See FANTO et al., *supra* note 105, text accompanying n.26.

identifying potential investors and soliciting purchases, and all of this for compensation that is only earned if the transaction closes. For simplicity, the following discussion will focus on the activity of SPACs themselves, but much of their activity can potentially be attributed to their controlling sponsors, who might then themselves be treated as brokers. The SPAC's transaction-based compensation would weigh heavily in favor of broker classification because it causes SPACs to have what has been referred to as a "salesman's stake"¹⁰⁹ when they pitch the target's stock to investors.¹¹⁰

Under the deemed purchase and sale approach, SPACs would be conducting this broker activity for the account of others, namely their targets. Their broker activity would, by definition, be a "business" that they are engaged in.¹¹¹ In fact, it would be their *only* business. For their entire existence, until they have completed a merger or liquidated, SPACs do *nothing else*. They first search for the right target company to take public, and then try to sell shares of that company to hundreds or thousands of public investors, seeking to raise tens or hundreds of millions of dollars. That SPAC sponsors sometimes invest their own cash (at a deeply discounted blended price) or stay involved after the merger through board seats does not affect that conclusion.

In principle, the deemed purchase and sale of target stock would thus enable the SEC to classify SPACs as brokers.¹¹² Indeed, selling securities for transaction-based compensation is normally a highly regulated activity. In addition to rules about public offerings, broker regulation includes a host of other rules designed to protect investors and our capital markets.¹¹³ Compliance with this entire regime is not likely to be practical for SPACs. It may also not be necessary for achieving regulatory parity between SPACs and IPOs. The SEC has broad discretion in deciding which rules should apply. For example, the SEC

109. Colby et al., *supra* note 105, at 2-20 (quoting 1st Global, Inc., SEC Staff No-Action Letter, [2011 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,119 (May 7, 2001)).

110. This also encompasses the SPAC's role in selling additional target shares to PIPE investors, which also constitutes broker activity. *See id.* at 2-24 (noting that private placement agents generally required to register as brokers).

111. While a certain "regularity" of broker activity is sometimes mentioned as a factor in broker classification, *see, e.g.*, SEC v. Hansen, 1984 WL 2413, at *10 (S.D.N.Y. 1984), that is because it indicates that the activity is indeed part of a "business," *see, e.g.*, SEC v. Kenton Cap., Ltd., 69 F.Supp. 2d 1, 12 (D.D.C. 1998).

112. "Finders" that do nothing more than connect buyers and sellers but are not involved in the actual discussion of the sale have been considered exempt from broker status or at least from SEC registration. *See, e.g.*, FANTO et al., *supra* note 105, text accompanying nn.42-69. In contrast to mere finders, however, SPACs play an active role in pitching target shares to investors. While investors that buy SPAC shares after the merger announcement need to place buy orders with conventional brokers, the role that those brokers play is mechanical. It is the SPAC that is effectively selling those shares through its marketing and validation. Similarly, SPACs could not rely on the limited exception the SEC staff has created for M&A brokers that facilitate sales of private companies to private acquirers. SPACs would fail to meet important conditions, including that the sale must not involve a public offering of securities. *See* M&A Brokers, SEC Staff No-Action Letter, Fed. Sec. L. Rep. (CCH) ¶ 77,609 (Jan. 31, 2014).

113. For example, brokers are subject to SEC investigations, inspections and disciplinary actions, and special recordkeeping requirements. Financial Industry Regulatory Authority (FINRA) has its own enforcement powers and examination authority. Broker personnel must pass exams and background checks.

could use its exemptive authority to permit SPACs to avoid registration as brokers and FINRA membership if they comply with requirements that are substantially similar to those applicable to conventional underwriters in terms of compensation, conflicts of interest, and pricing transparency.¹¹⁴

2. *Fair and Transparent Compensation*

If SPACs were treated as brokers, the compensation that targets must pay to hire them would have to meet the same standards that apply to conventional underwriters. I do not take a position here on whether those standards are appropriate for investor protection. They may well represent outmoded paternalism that unnecessarily shuts out high-risk, high-growth companies from public markets by preventing underwriters from being adequately compensated for associated liability exposure.¹¹⁵ However, keeping these compensation standards in place for IPOs while continuing to exempt SPACs seems difficult to defend from a regulatory parity perspective.¹¹⁶

Application of rules for conventional underwriters would also require SPACs to quantify the dollar value of all the securities that targets pay for transacting with a SPAC and to present all that value in one clearly labeled section of the SEC disclosure document.¹¹⁷ This would enable investors to quickly determine the effective price after SPAC costs at which the target is willing to sell its shares in the merger. Of course, the SEC could mandate this for SPAC mergers even without classifying SPACs as brokers, simply based on its general disclosure authority.¹¹⁸

The failure to conceive of SPAC mergers as stock sales for cash, and of SPACs as underwriters for target stock, also afflicts the SEC's proposals to enhance disclosure about SPAC costs (which consists of a combination of cash costs and equity dilution). The SEC's vision of dilution in SPAC mergers remains mired in concepts of book value that result in disclosure that is

114. In a different context, FINRA created a special category of so-called "capital acquisition brokers" that can elect to be subject to a more limited "broker lite" regulatory regime.

115. See Bai et al., *supra* note 26, passim (noting that, due to reduced liability, SPACs can match yield-seeking investors with smaller and riskier companies, while investment banks take larger and safer companies public in IPOs).

116. Continuing differential treatment would seem to require clear evidence that SPACs at least on average provide substantial incremental value to public investors that outweighs their significantly higher cost. Existing empirical work appears to point the other way. See Lucian A. Bebchuk, Alon Brav & Wei Jiang, *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085, 1122 (2015) (finding abnormal announcement period returns of approximately 6% for activist stakes, consistent in magnitude with findings in prior work). If it is determined that compensation should be permitted to be greater when it is paid in equity, or when the underwriter is making a concurrent cash investment, then this should apply across the board and not just to SPACs.

117. FIN. INDUS. REGULATORY AUTH., FINRA MANUAL, RULE 5110(b)(1), at Supplementary Material .05 (requiring disclosure "in section on distribution arrangements in the prospectus"); Regulation S-K, Item 508(e), 17 CFR § 229.508(e) (requiring tabular disclosure of all items considered underwriting compensation by FINRA).

118. See Securities Act §§ 7(a)(1), 10(c), 15 U.S.C. §§ 77g(a)(1), 77j(c) (2018) (registration statement and prospectus shall contain such information as SEC may require as being necessary or appropriate in the public interest or for the protection of investors).

unnecessarily complex and ultimately unhelpful. In a separate Essay in this symposium, professors Klausner and Ohlrogge and I present a proposal for more user-friendly disclosure on this point.¹¹⁹

3. *Regulated Conflicts*

New regulations could recognize that SPACs have a significant financial interest in the success of the merger that goes beyond earning a customary underwriting commission. Applying the rules for conflicted underwriters would require each SPAC to retain a qualified independent underwriter that would conduct its own due diligence and assume liability for the disclosure to investors. This seems more practicable than the SEC's proposal of a statement about the "fairness" of the transaction to public stockholders and the corresponding support from third-party fairness opinions. As I plan to show in future joint work with Professor Tuch, the utility of fairness opinions in SPAC mergers is subject to inherent limitations.¹²⁰ No such statements or opinions are required in IPOs.

4. *Transparent Pricing*

Treated as brokers, SPACs would also not be permitted to offer investors shares below the stated public offering price, which would be the per share amount of escrowed cash. Additional guidance may be helpful to clarify how to apply the anti-discounting rule for conventional underwriters to SPACs. It could expressly note, for example, that any side payments, post-closing price protections, or other incentives offered to investors that lower their effective purchase price would be prohibited.¹²¹ The SEC may be able to accomplish some of this result by issuing rules deeming such incentives manipulative. The SEC's rule proposal contemplates the disclosure of payments the SPAC sponsor makes to investors in connection with any related financing transaction (such as a PIPE)¹²² but does not address payments and other incentives offered to prevent redemptions.

D. Advanced Regulation

In this last section, the Essay sketches out additional regulation. As I explain below, achieving full parity in investor protection between SPACs and IPOs would require changes to the structure of future SPACs. Again, the SEC's current proposal does not engage with these issues.

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

120. Harald Halbhuber & Andrew Tuch, *Fairness Opinions in SPAC Mergers* (Apr. 11, 2022) (unpublished manuscript) (on file with author).

121. In the same way that multi-price offerings are permitted for conventional underwriters, incentives such as volume discounts that are available to all investors in accordance with transparent criteria may be allowed.

122. Proposing Release, *supra* note 1 at 29565.

1. *Sales Before SEC Disclosure*

In a traditional IPO, no sales are permitted until the issuer has filed a registration statement with the SEC that has become effective.¹²³ In a SPAC merger, SPAC shares trade following the merger announcement effectively as potential target shares, but without a fulsome SEC-reviewed disclosure document in the form of a registration statement. Under the deemed purchase and sale approach advocated here, the SEC could take the position that secondary market sales that occur after the merger announcement are already part of the distribution of the target's shares for the benefit of the target¹²⁴ by moving shares from holders who would likely redeem into the hands of the actual ultimate investors. This would prohibit the solicitation of purchasers for those sales before fulsome SEC-reviewed disclosure is available. Just as in the case of rules for publicity, strictly enforcing this prohibition would require distinguishing between the permissible communication of factual information and impermissible solicitation. As I mentioned earlier in the discussion of publicity restrictions, however, I am skeptical about limiting information flow to an existing trading market.

2. *Purpose of SPAC Trading Market*

Both the publicity for the offering and the sales of shares without SEC-cleared disclosure create risks for investors. Strictly enforcing conventional rules would have undesirable consequences for the trading market by curtailing the flow of information. Regulators could therefore consider suspending trading after the target has been identified until the SEC-cleared disclosure becomes available. This resembles the approach that the U.K. financial market regulator used to apply.¹²⁵ Cutting investors off from liquidity, however, even temporarily, is certainly not ideal.

If this trading market gets in the way of leveling the playing field between SPACs and IPOs, we need to ask what purpose it serves. First, it is the mechanism through which new investors acquire their shares in the target, allowing targets access to public equity capital that can be flexibly sized based on investor demand. This contrasts with IPOs or primary direct listings, which

123. See Securities Act § 5(a)(1), 15 U.S.C. § 77e(a)(1) (2018).

124. There is precedent for treating ostensibly secondary sales as part of a distribution when they are the result of active remarketing by the issuer and the issuer has a financial interest in those sales. *See, e.g.,* SEC, Div. of Corp. Fin., Securities Act Sections, Interpretive Responses Regarding Particular Situations ¶ 239.14 (Nov. 26, 2008) (noting that even after initial offering has terminated, the issuer may still be engaged in primary offerings of the issuer's securities to the extent the issuer pays a remarketing or auction agent or otherwise is involved in subsequent sales such as in remarketings or auctions); CHARLES J. JOHNSON, JR., CORPORATE FINANCE AND THE SECURITIES LAWS 851-55 (2004) (discussing registration requirements in connection with the remarketing of previously issued securities).

125. See *Investor Protection Measures for Special Purpose Acquisition Companies: Changes to the Listing Rules*, FIN. CONDUCT AUTH. 3 (July 2021), <https://www.fca.org.uk/publication/policy/ps21-10.pdf> [<https://perma.cc/UED9-YBEP>] (noting the general use of suspension after acquisition announcement to protect investors from disorderly markets due to insufficient information).

both require companies to fix a transaction size prior to launch. Further, the SPAC structure does not compress execution into a brief roadshow or the initial morning auction in a primary direct listing, but instead allows for price discovery over a span of several months.

Second, this post-announcement trading incidentally affords investors a “try before you buy”¹²⁶ period during which they can still decide whether to definitely invest their cash or redeem. This allows them to observe the stock price and to react to updated information about the target as well as changes in equity markets generally. The reliability of this provisional market may be limited, however. Due to thin trading and other factors, the pre-closing share price could be a weak signal, and may even provide investors with false comfort for their final decision.¹²⁷

3. *Towards a New SPAC Structure*

It may be possible to accomplish both of these goals—flexible capital raise for the target, and a trial period for investors—without the need to commence trading before SEC-cleared disclosure. The existing SPAC structure gets shares into the hands of actual investors at the time of the merger, but it seems oddly inefficient at performing this largely mechanical task. The SPAC’s initial IPO investors effectively act as highly-compensated placeholders until their shares are sold to new buyers for investment in the target. It seems preferable to defer the SPAC IPO until after the SPAC has identified a target and cleared SEC disclosure. SPAC shares would still be redeemable for some time, affording investors a trial period like they have today, backed up by cash in escrow that would be funded from the price investors pay when they buy their shares.¹²⁸

Conclusion

This Essay has highlighted how conceiving of SPAC mergers as business combinations has led to gaps in investor protection and also hampered the SEC’s recent rule proposal on SPACs. Analyzing the economic substance of SPACs, the Essay has demonstrated that the investment made by nonredeeming SPAC

126. I am grateful to Michael Ohlrogge for suggesting this term.

127. For example, in Altimeter Growth Corporation’s merger with Grab, SPAC shares closed at \$13.26 on November 26, the last day of the redemption period. Holders of 99.98% of public shares decided not to redeem, but by December 2, the day after closing, the stock had fallen by a third to \$8.75, while the overall market remained flat (Nasdaq down 0.7%). See Riley de León, *Softbank-Backed Grab Falls More Than 20% in First Day of Trading Following Largest-Ever SPAC Merger*, CNBC (Dec. 8, 2021, 8:04 PM), <https://www.cnbc.com/2021/12/02/softbank-backed-grab-begins-trading-after-completing-spac-merger.html> [<https://perma.cc/DTL2-RHUY>].

128. Perhaps SPAC shares can be replaced with tradeable call options on target stock, as Bill Ackman has proposed in a structure currently under review by the SEC. See Letter from William A. Ackman, Chief Executive Officer, Pershing Square Capital Mgmt. to Vanessa A. Countryman, Secretary, SEC (Sep. 26, 2021), <https://www.sec.gov/comments/sr-nyse-2021-45/srnyse202145-9287412-259149.pdf> [<https://perma.cc/8HKW-4WBT>]. In economic substance, SPAC shares arguably already represent such call options today after the announcement of the merger. The proposal contemplates trading before SEC-cleared disclosure, however, which seems problematic.

shareholders in the target is the economic equivalent of purchasing stock for cash. The Essay has shown how this turns SPAC mergers into stock sales and SPACs (and perhaps their sponsors) into underwriters, without being regulated as such. Building on this functional analysis, the Essay has put forward a proposal for new SEC rules to level the playing field between SPACs and IPOs.

The Essay's findings raise the question why the economic substance of SPAC mergers as stock sales for cash and the associated regulatory gaps went unnoticed for so long. The origin of the escrowed cash as an investor protection device¹²⁹ may have made it harder to realize that, paradoxically, it could in fact weaken regulatory safeguards. It addressed blank check uncertainty and seemed to protect SPAC shareholders against their board overpaying in a merger, a protection not present at other companies that make major acquisitions.¹³⁰ In addition, SPAC mergers bear a superficial resemblance to other reverse mergers. Reverse mergers were viewed as a well-established, if sometimes problematic, loophole in going-public regulation.¹³¹

The Essay's analysis highlights intermediary incentives, their impact on our capital markets, and their regulation as fruitful areas for further empirical and theoretical inquiry.¹³² Existing literature on the regulation of conventional underwriters has largely focused on their role as disclosure gatekeepers and their associated statutory liability. The Essay suggests that the key regulatory arbitrage that fueled the explosive growth of SPACs may lie in their ability to circumvent the substantive regulation of financial intermediaries rather than primarily in reduced disclosure liability. It thereby also contributes to the literature on regulatory arbitrage, showing how an economic substance approach can help identify precisely which regulations a particular legal structure is able to avoid and which policy interests may be affected by that avoidance.

129. See, e.g., Usha Rodrigues & Mike Stegemoller, *Exit, Voice & Reputation: The Evolution of SPACs*, 37 DEL. J. CORP. L. 850, 912-915 (2012) (describing development of escrow feature as a valuable constraint on SPAC managers).

130. See Afra Afsharipour, *A Shareholder's Put Option: Counteracting the Acquirer Overpayment Problem*, 96 MINN. L. REV. 1018 (2012) (describing acquirer overpayment problem and weak shareholder protections under existing Delaware law, proposing shareholder put right as a remedy); Afra Afsharipour & J. Travis Laster, *Enhanced Scrutiny on the Buy-Side*, 53 GA. L. REV. 443 (2019) (noting that Delaware protections for acquirer shareholders are limited and proposing to extend enhanced scrutiny to the buy-side to induce more frequent buy-side shareholder votes).

131. See William K. Sjostrom, Jr., *The Truth About Reverse Mergers*, 2 ENTREPRENEURIAL BUS. L. J. 743 (2008) (describing a reverse merger with a shell company as a "non-traditional way of going public"). Before SPACs, reverse mergers with shell companies did not play a significant role for listed markets because major stock exchanges would refuse to list shell companies.

132. See also Kathryn Judge, *Intermediary Influence*, 82 U. CHI. L. REV. 573 (2015) (finding that intermediaries promote structures that generate high fees for them).