CATO INSTITUTE | Center for Monetary and Financial Alternatives

June 13, 2022

Ms. Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Re: *File No. 07-13-22*
Special Purpose Acquisition Companies, Shell Companies, and Projections

Dear Ms. Countryman:

My name is Jennifer Schulp, and I am the director of financial regulation studies at the Cato Institute's Center for Monetary and Financial Alternatives. I appreciate the opportunity to comment on the Securities and Exchange Commission's proposed rules "intended to enhance investor protection in initial public offerings by special purpose acquisition companies ('SPACs') and in subsequent business combination transactions between SPACs and private operating companies."[1] The Cato Institute is a public policy research organization dedicated to the principles of individual liberty, limited government, free markets, and peace, and the Center for Monetary and Financial Alternatives focuses on identifying, studying, and promoting alternatives to centralized, bureaucratic, and discretionary financial regulatory systems. The opinions I express here are my own.

At the outset, I note that the time period permitted for comment on this rule proposal does not allow for meaningful public comment. The Commission permitted only 30 days for public comment on this proposal, even though the Notice runs to 372 pages and seeks public comment on more than 180 separate topics. This is an inadequate amount of time for interested members of the public to consider how these proposed rules will affect the SPAC market and investors, even were this proposal to stand on its own. This proposal, however, is part of a flurry of Commission proposals since the end of 2021, leaving market participants with even less time to analyze and comment on any particular proposal and to consider how those proposals will interact with each other.[2] At a minimum, the Commission should have permitted

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[1] Notice of Proposed Rule, "Special Purpose Acquisition Companies, Shell Companies, and Projections," SEC Release Nos. 33-11048; 34-94546; IC-34549; File No. S7-13-22 at 1, https://www.sec.gov/rules/proposed/2022/33-11048.pdf (Notice).

[2] *See* Kevin Zambrowicz, Joe Corcoran and Sean Campbell, "The SEC's Current Far-Ranging & Aggressive Rulemaking Agenda Will Raise Regulatory Uncertainty and Risks Unintended, Negative Consequences," *SIFMA*, April 25, 2022, https://www.sifma.org/resources/news/the-secs-current-far-ranging-aggressive-rulemaking-agenda-will-raise-regulatory-uncertainty-and-risks-unintended-negative-consequences/.

60 days for public comment—the standard advised by long-standing Executive Order—but in light of the large number of outstanding rulemakings, a longer period of 90 days or more would have provided a more appropriate length of time for public comment.[3]

Turning to the substance of the proposal, special purpose acquisition companies (SPACs) are companies formed specifically for the purpose of raising money to merge with an existing private company. The result is that the private operating company assumes the SPAC's place as a listed public company. While not a new corporate form, SPACs rode an unprecedent wave of popularity in 2020 and 2021, outpacing the listings of traditional initial public offerings (IPOs). While this surge in SPAC popularity was likely the result of several factors, SPACs are viewed by some investors as a way to invest in younger, higher growth companies than those that typically access the markets through traditional IPOs. Some investors also view SPACs as providing easier access to newly listed companies than traditional IPOs, which typically allocate few shares to individual investors.

The recent growth in SPACs is obviously motivating the Commission's rule proposal. As SPACs have developed, many of their conventional terms are governed by exchanging listing rules, not by Commission-mandated requirements. Invoking a concern that "a significant proportion of companies in the coming years that enter the U.S. public securities markets will do so through de-SPAC transactions," the Commission now seeks to justify additional regulation.[4] But there is little danger that SPACs will displace IPOs, and some significant questions as to how large a role SPACs will play going forward as market forces—including limited merger targets and less than stellar post-merger financial performance—have cooled their popularity with investors. Throughout the SPAC boom, SPAC terms and disclosures have also continued to evolve to meet investor demand.

Many of the changes proposed stray beyond the Commission's investor protection responsibilities and instead seek to disadvantage and discourage SPACs by imposing unjustified liability and burdens. As Commissioner Hester Peirce put it: this proposal "imposes a set of substantive burdens that seems designed to damn, diminish, and discourage SPACs because we do not like them, rather than elucidate them so that investors can decide whether they like them."[5]

While some of the additional disclosure proposed may help investors make more informed decisions about their investment, many of the proposed changes are intended to raise costs for

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[3] *See* Center Forward, "The SEC's Comment Periods for New Regulations," *Center Forward*, https://center-forward.org/the-secs-comment-periods-for-new-regulations/; Jennifer J. Schulp and Nicholas Anthony, "The SEC Short-Changes Public Comment," *Cato Institute*, January 14, 2022, https://www.cato.org/blog/sec-short-changes-public-comment.

[4] Notice at 64.

[5] Statement of Hester M. Peirce, "Damning and Deeming: Dissenting Statement on Shell Companies, Projections, and SPACs Proposal," *Securities and Exchange Commission*, March 30, 2022, https://www.sec.gov/news/statement/peirce-statement-spac-proposal-033022 (Peirce Statement).

SPACs and to limit investor opportunities to take advantage of alternative paths to public listing. As the Commission acknowledges, "some aspects of this rulemaking may deter some forms of communications or some transactions that might otherwise be efficient or to the economic benefit of issuers and investors. They may also deter some business combinations that otherwise would have created value."[6] That high price is not justified.

I highlight below four interrelated aspects of the proposed rules that are especially troublesome and impose higher burdens on SPACs and de-SPAC transactions than on traditional IPOs. Rather than purportedly "leveling the playing field," these changes will put a thumb on the scale against SPACs and should not be adopted.

PSLRA Safe Harbor

The Private Securities Litigation Reform Act (PSLRA) provides a "safe harbor" against private actions based on a false statement or material omission with respect to "forward-looking statements." This safe harbor incentivizes the disclosure of potentially valuable information as to a company's future outlook.

The PSLAR safe harbor is subject to a number of exceptions, including for "blank check companies." At the time the PSLRA was passed, the Commission's rules defined a "blank check company," as a development stage company that has no specific business plan or purpose or has indicated that its business plan is to engage in a merger or acquisition with an unidentified company or companies and issues penny stock.[7] Penny stock is defined by regulation stock that does not meet certain thresholds, including that the issuer has stockholders' equity of $5 million (or meets other value or income requirements) and the stock trades at $5 per share.[8] Under these definitions—which have remained substantively unchanged since before the PSLRA was passed—SPACs generally are not blank check companies because they do not issue penny stock.

The Commission, however, proposes to eliminate the penny stock requirement from the definition of blank check company for the purposes of the PSLRA. This would have the effect of excluding SPACs from the PSLRA's safe harbor.[9] First, it is important to point out that projections made by SPACs, even when able to take advantage of the PSLRA safe harbor, are not immune from liability. Financial projections made in connection with a de-SPAC transaction can be challenged by shareholders if they are not properly identified as forward-looking, not accompanied by meaningful cautionary language, or knowingly false when made (in addition to any number of other state and federal claims that may be brought). This rule change then does not attach potential liability to statements that were wholly immune, but rather attaches the heightened liability that the PSLRA explicitly reserved for certain situations.

[6] Notice at 168.
[7] 17 C.F.R. § 230.419(a)(2).
[8] 17 C.F.R. § 240.3a51-1.
[9] Notice at 84.

Second, the Commission justifies this change by equating statements in de-SPAC transactions with statements in traditional IPOs, which are also exempt from the PSLRA's safe harbor. But this is a false equivalency: this change will place higher burdens on SPACs because SPACs will not be able to avoid liability by refraining from speaking, as many traditional IPOs do.[10] SPAC sponsors generally must provide forward-looking information in connection with the de-SPAC transaction to satisfy state fiduciary requirements in connection with mergers. As a result, SPAC sponsors will be placed in the difficult position of trying to provide the minimum information necessary to satisfy state law while trying to avoid heighted liability for any information that is not strictly required to be disclosed. While this likely will result in less information being disclosed, SPACs will nevertheless be open to more liability than an IPO.

Third, projections can provide valuable information about the de-SPAC target's prospects. The Commission admits that to the extent that the proposed amendment reduces the amount of potentially relevant information presented to investors—which it undoubtedly will—"this may negatively affect investors' ability to accurately value these companies and allocate their investments accordingly."[11] Carefully crafted disclosure obligations may assist investors in judging the reliability of such forward-looking statements, but it is not clear that less information for investors to judge the merits of the merger is a positive outcome. The Commission is concerned that investors are misled by forward-looking statements, but some researchers have found that hype, if present, does not sway investors and that forecasts are often related to positive outcomes.[12] These types of findings should lead the Commission to question whether an effective prohibition on forward-looking disclosure in traditional IPOs is itself a good policy idea where it may inhibit price discovery and capital formation.[13]

Finally, this change alters the scope and effect of the PSLRA by substantially revising the definition that Congress relied on when it wrote the statute. Such an alteration to the statute's scope should be made by Congress, not the Commission.[14]

Fairness Opinions

The proposal also requires that the SPAC state "whether it reasonably believes that the de-SPAC transaction and any relating financing transaction are fair or unfair to unaffiliated security

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[10] Amanda M. Rose, "SPAC Mergers, IPOs, and the PSLRA's Safe Harbor: Unpacking Claims of Regulatory Arbitrage," *SSRN*, May 19, 2022, at 42, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3945975.

[11] Notice at 248.

[12] Kimball Chapman, Richard Frankel and Xiumin Martin, "SPACs and Forward-Looking Disclosure: Hype or Information," *SSRN*, October 20, 2021, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3920714.

[13] Chapman, Frankel and Martin; Rose at 42-46; *see also* Usha Rodrigues and Mike Stegemoller, "Why SPACs: An Apologia," *University of Georgia School of Law Legal Studies Research Paper No. 2022-04*, May 26, 2022, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4072834.

[14] Indeed, legislation has been proposed to make similar alterations, but as of this time, has not been acted on by Congress. *See, e.g.,* Carlos Juarez, "SPACs Face Legislative Scrutiny," *Harvard Law School Forum on Corporate Governance*, December 11, 2021, https://corpgov.law.harvard.edu/2021/12/11/spacs-face-legislative-scrutiny/; Jessica DiNapoli, "U.S. Senator Warren plans bill to crack down on blank check deals," *Reuters*, May 31, 2022, https://www.reuters.com/business/us-senator-warren-plans-bill-crack-down-blank-check-deals-2022-05-31/.

holders" and disclose "any outside report, obligation, or appraisal relating to the fairness of the transaction."[15] This requirement, rather than putting SPACs on a level playing field with IPOs, disadvantages SPACs by requiring them to undertake potentially expensive disclosure not required of IPOs. This disclosure will also expose SPACs to additional liability, mandating additional disclosure that would not be subject to the PSLRA safe harbor as amended by this proposal.

In a traditional IPO, there is no affirmative requirement that the issuer or its sponsor make any disclosure regarding the fairness of the transaction and any related financing. Yet, the Commission proposes to require such disclosure of SPACs. Sponsors are likely to want to bolster their statements with outside analysis, meaning that fairness opinions would become common under this rule proposal. But as the Commission acknowledges, obtaining a fairness opinion is unusual: 85% of de-SPAC transactions in 2021 did not disclose that a fairness opinion was obtained.[16] Moreover, where an opinion was obtained and the costs were disclosed, the Commission identifies the average costs as approximately $270,000.[17] This cost—not insignificant—can be expected to be passed along to the SPAC's shareholders. The absence of this type of disclosure as a matter of current SPAC practice may imply that shareholders do not view the benefits of the disclosure as outweighing the potential costs.

Importantly, this requirement may also increase the need to include projections in de-SPAC disclosure documents in support of the SPAC sponsor's statement as to the fairness of the transaction.[18] This only further adds to the cadre of mandated forward-looking disclosure that will not be subject to the PSLRA safe harbor if the Commission's proposal were to go into effect, raising potential liability for SPACs.

Underwriter Liability

The expanded liability that the Commission proposes for SPAC transactions, however, does not end with SPAC sponsors or merger targets. The Commission also proposes expanding underwriter liability in connection with SPACs in a number of ways, including by "clarifying that person who has acted as an underwriter in a SPAC initial public offering" and "participates in the de-SPAC transaction" will be deemed to be an underwriter for the distribution of securities for the surviving public entity in a de-SPAC transaction.[19] This expansion of potential underwriter liability also places those underwriters potentially liable for projections as well, multiplying the risks to which involved individuals and entities may be subject.

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[15] Notice at 46.
[16] *Id.* at 228.
[17] *Id.*
[18] *See* Gail Weinstein, Philip Richter and Brian Hecht, "Proposed Restrictions Stand to Add SPACs Risk," *Law360*, April 19, 2022, https://www.law360.com/securities/articles/1482478/proposed-sec-restrictions-stand-to-add-spacs-risk.
[19] Notice at 96.

Initially, equating a de-SPAC transaction with the registered offering of securities that takes places in an IPO is a false equivalence. An advisor in a de-SPAC transaction is more akin to a merger advisor than to an investment bank taking part in an underwritten offering. The distinct roles should be recognized and not treated the same for underwriter liability.[20]

But from a more operational perspective, the Commission underestimates—or dismisses—the effect that these changes will have on SPACs. While the Commission ties the effects of the rules to "the extent to which [SPAC IPO underwriters] do not already perform due diligence that would be sufficient," it ultimately admits that "[p]otential Section 11 liability may deter a SPAC IPO underwriter from participating in the de-SPAC transaction or any related financial transactions by increasing their costs."[21] But it is not simply a matter of producing higher quality due diligence, as Commissioner Pierce understands: "[a] more likely result is that SPAC underwriters will do everything possible to avoid being captured by the rule."[22] Indeed, a host of law firm analyses of the proposed rules counsel caution for potential underwriters and analysis of whether to continue to participate in SPAC transactions.[23] This will disrupt the continuity of advice that a SPAC receives and will drive up the costs of finding, retaining, and using financial advisors for the de-SPAC transaction. To the extent that potential SPAC underwriters do not avoid SPACs altogether, they likely will alter their compensation arrangements, demanding all compensation up front or requiring higher fees. All of these outcomes are likely to raise costs to SPAC shareholders, based on a misconception about the role of advisors in de-SPAC transactions.

Investment Company Act Safe Harbor

Finally, the proposed rules set out a safe harbor for SPACs to avoid under the Investment Company Act. The problem with this provision is two-fold.

First, it is not clear that such a provision is necessary. The Commission attempts to justify the regulatory safe harbor by stating that "the longer a SPAC operates with its assets invested in securities and its income derived from securities, the more likely investors will come to view the SPAC as a fund-like investment and the more likely the SPAC will appear to be deviating from its stated business purpose."[24] But the Commission points to no evidence that such

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[20] *See* Rodrigues and Stegemoller at 41.
[21] Notice at 250.
[22] Peirce Statement.
[23] *See, e.g.,* Christopher Anthony, Andrew L. Bab, Morgan J. Hayes, William D. Regner, and Gregory V. Gooding, "Debevoise & Plimpton Discusses SEC's Proposed SPAC Rules and Investment Banks," *The CLS Blue Sky Blog*, May 2, 2022, https://clsbluesky.law.columbia.edu/2022/05/02/debevoise-plimpton-discusses-secs-proposed-spac-rules-and-investment-banks/ (discussing potential liability for investment banks under these proposed rules and noting that "investment banks will need to reassess their participation in SPAC transactions, what risks they are willing to bear and how they go about mitigating those risks"); *see also* Rodrigues and Stegemoller at 25 (noting that the SEC's proposed rules have caused many investment banks to flee the market); *id*. at 41 (arguing that imposing section 11 liability on the de-SPAC will kill even value-increasing deals, because "[i]f banks are subject to this same level of liability, then they will prefer an IPO over a de-SPAC").
[24] Notice at 139.

circumstances are happening, and certainly no evidence that they are happening with any regularity.[25] Investors do not appear to be confused about the purpose of SPACs, and there seems to be no widespread use of SPACs as investment funds. To the extent that novel SPAC structures stretch these bounds, there is little indication that traditional analysis under the Investment Company Act is insufficient.

Were the safe harbor merely unnecessary, the problem would be limited. But the provisions of the safe harbor itself—and the intention of the Commission to ensure that most SPACs rely on that safe harbor—are themselves an issue.[26] The safe harbor imposes unnecessary and arbitrary conditions on SPACs that alter the structure and timelines for de-SPAC transactions.

A SPAC's governing documents and listing requirements govern how long a SPAC has to complete a de-SPAC transaction. While listing requirements permit SPACs up to 36 months to complete their deals, most SPACs adhere to shorter timelines, typically 24 months.[27] The Commission's proposed safe harbor, however, arbitrarily imposes an additional deadline into the process, requiring a SPAC to have reached a merger agreement by 18 months. As the Commission recognizes, there are a lot of potential costs to such a deadline, including forcing liquidation of SPACs that cannot meet the 18-month deadline even though they may have been able to complete a value-enhancing transaction by 24 months and incentivizing sponsors to complete a de-SPAC transaction even if liquidation would have been the better choice.[28] In short, the proposed duration limitations may lead SPACs to complete less profitable SPAC transactions or fail to complete a transaction at all.

The proposed safe harbor would also require a SPAC to complete the de-SPAC by 24 months. While a 24-month deadline is generally consistent with current market practice, that deadline is the product of market forces and is itself subject to evolution and flexibility. Some SPACs allow shareholders to extend the deadline for completing the SPAC, but under the Commission's proposal, those shareholder choices would be constrained.

All of these costs are high, especially where there is little justification for imposing an artificial deadline by which an agreement must be reached or the de-SPAC must be completed. These requirements have the potential to harm SPAC shareholders and to interfere with the market

[25] As Commissioner Pierce recently noted: "SPACs have been around for a long time, and the Commission has not suggested that it thinks that any of them, let alone many of them, are investment companies." Statement of Hester M. Peirce, "Statement Regarding SPAC Matter," April 15, 2022, https://www.sec.gov/news/statement/peirce-spac-20220415.

[26] *See id.* (quoting Division of Investment Management Director William Birdthistle: "I would just say, certainly for those SPACs that also fall outside the safe harbor, I would expect that the staff would also be taking a look at them.").

[27] *See* Securities and Exchange Commission, "What You Need to Know About SPACs – Updated Investor Bulletin," May 25, 2021, https://www.sec.gov/oiea/investor-alerts-and-bulletins/what-you-need-know-about-spacs-investor-bulletin.

[28] *See* Notice at 269-70.

evolution of SPACs.[29] The safe harbor is unnecessary and should not place new restrictions on the form of SPACs in the name of protecting investors from the imaginary problem of SPACs being used as investment companies.

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As a final matter, any proposed rules that are adopted should not apply retroactively to SPACs that have already gone public at the time the rules go into effect. The retroactivity that would apply to many of these changes as proposed would unfairly and disruptively change the rules to which a SPAC is subject, including the amount of time that it may have to complete a transaction and the availability of its financial counselors. Such changes have the potential to harm investors and should not be implemented mid-stream.

The traditional IPO process plainly fails as a "one-size-fits-all" approach, with many companies choosing to remain private rather than run the IPO gauntlet. Instead of stymieing innovation in public listings, the focus should be on reforming and streamlining the traditional IPO.

Thank you for the opportunity to comment on these proposed rules, and I am happy to answer any questions or further engage on this topic.

Sincerely,

Jennifer J. Schulp
Director of Financial Regulation Studies
Center for Monetary and Financial Alternatives
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[29] *See* Minmo Gahng, Jay R. Ritter and Donghang Zhang, "SPACs," *SSRN*, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3775847 (describing SPACs as "evolving towards a more sustainable equilibrium").