GOING PUBLIC: SPACS, DIRECT LISTINGS, PUBLIC OFFERINGS, AND THE NEED FOR INVESTOR PROTECTIONS

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GOING PUBLIC: SPACS, DIRECT LISTINGS, PUBLIC OFFERINGS, AND THE NEED FOR INVESTOR PROTECTIONS

Monday, May 24, 2021

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON INVESTOR PROTECTION,
ENTREPRENEURSHIP, AND CAPITAL MARKETS,
COMMITTEE ON FINANCIAL SERVICES,
Washington, DC

The subcommittee met, pursuant to notice, at 12:01 p.m., via Webex, Hon. Brad Sherman [chairman of the subcommittee] presiding.

Members present: Representatives Sherman, Scott, Himes, Foster, Vargas, Gottheimer, San Nicolas, Casten, Cleaver; Huizenga, Wagner, Hill, Emmer, Mooney, Davidson, Gonzalez of Ohio, and Steil.

Ex officio present: Representatives Waters and McHenry.

Chairman SHERMAN. The Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets will come to order.

Without objection, the Chair is authorized to declare a recess of the subcommittee at any time. Also, without objection, members of the full Financial Services Committee who are not members of this subcommittee are authorized to participate in today's hearing.

As a reminder, I ask all Members to keep themselves muted when they are not being recognized by the Chair. The staff is instructed not to mute Members except where a Member is not being recognized by the Chair and there is inadvertent background noise.

Members are also reminded that they may only participate in one remote proceeding at a time. If you are participating today, please keep your camera on. And if you choose to attend a different remote proceeding, please turn your camera off.

I want to commend Sean Casten for being the new Vice Chair of this subcommittee, and I will endeavor to figure out ways to transfer as many of the tedious and unpleasant duties of the Chair to Sean, and we are now trying to think through exactly what that would be.

Today's hearing is entitled, "Going Public: SPACs, Direct Listings, Public Offerings, and the Need for Investor Protections."

I now recognize myself for 4 minutes for an opening statement.

Every year, there are hundreds of trillions of dollars in securities transactions. But what matters not to investors, but to the economy as a whole, to people who are just working for a living, is when money flows into companies that they can use to expand, provide jobs, and build factories. Of that money, $2.1 trillion is going into the issuance of corporate bonds, $312 billion going into companies that are selling stock who are already public, and $132 billion for initial public offerings (IPOs).

But this $132 billion, of the trillions of dollars of securities transactions, is probably the most important for the average American, because these are the companies that are going to make our future in the second half of this century. And that $132 billion is basically broken down between traditional IPOs and Special Purpose Acquisition Companies (SPACs).

In looking at these IPOs, there are three elements we need to look at. The first is, how is the company treated, since our goal is to get money into companies that can expand in the future. Seven percent for smallish to medium-sized companies goes to underwriting fees in a traditional IPO. A recent study shows that 11 percent goes if it is a SPAC transaction. But what I hear most from companies thinking about going public is a concern about underpricing. That is to say, in addition to the fee, they are selling all their shares for, say, $20 a share, and wouldn't you know it, 2 days after the offering, the shares are worth $30. Who gets that extra $10? Not the company. So, the company is worth $30 a share but is getting only $20 a share in the transaction.

The second issue is protecting the investor. We have strict liability when a company first goes public in the traditional system, strict liability for projections that are made about the future. But if a company goes public through the SPAC mechanism, we have a lower level of liability, unless Mr. Coates is right and somehow it is a higher level of liability. We don't know. It is up to Congress to clarify what level of liability, what level of investor protection we have for IPOs, and it should be the same whether it is done through the SPAC mechanism or the regular mechanism. If we need to hold the underwriters accountable for misstatements about the future projections, then we need to do it for both. If we don't need to do it, then we should do it for neither.

The second issue is the investor—as I was saying, I was talking about protecting the investor. With SPACs, we see 70 percent of those who invest in SPACs take their money out before the transaction goes forward, and then we see that those who choose to remain see their investment diluted with the Private Investment in Public Equity (PIPE), the investors who come in afterwards.

Finally, there is the allocation of this great opportunity to invest in the IPO, as most IPOs do go up on their first day, in their first week, or in their first month. First, who gets these good opportunities to invest in a new IPO, and are retail investors missing out?

And second, do we have, in effect, a system of bribery where an underwriter can go to someone with a fiduciary duty, a CFO of a big corporation, the trustee of a large charitable foundation, and give them for their own account a chance to buy a $30 stock for $20, and then go back a month later and do business not with the individual whom they have enriched but with the big company or the big charitable trust that they control?

So, we have a lot to cover in a limited amount of time. I believe my time has expired.

The Chair now recognizes the Chair of the full Financial Services Committee, the gentlewoman from California, Chairwoman Waters, for a 1-minute opening statement.

Chairwoman WATERS. Thank you very much, Chairman Sherman.

Special purpose acquisition companies, known as SPACs, are blank check companies and have skyrocketed in popularity as a way for private companies to go public and avoid the public scrutiny of an initial public offering, or IPO, process.

In 2020, the amount of proceeds raised by SPACs jumped an astounding 462 percent over the previous year. I have deep concerns about the lack of transparency and accountability that is a hallmark of the SPAC process, and it appears that SPAC mergers are structured to ensure that Wall Street insiders receive huge profits, and retail investors pay the cost.

I look forward to discussing with our witnesses what Congress and the SEC can do to better protect investors and ensure that our markets are fair.

I yield back the balance of my time.

Chairman SHERMAN. Thank you, Madam Chairwoman.

I now recognize the very patient ranking member of the subcommittee, the gentleman from Michigan, Mr. Huizenga, for 4 minutes.

Mr. HUIZENGA. Thank you, Mr. Chairman.

In a challenging global economy, the strength of our capital markets is vital to long-term economic growth, yet regulatory burdens and bureaucracy are preventing small businesses from thriving and hindering the United States' ability to compete globally. Small businesses, which are the fuel that powers our economic engine, make up 99 percent of all enterprises in the United States and employ almost half of our workforce.

Prior to the COVID-19 pandemic, roughly three-quarters of all small businesses relied on financing in the last 12 months. Nearly 70 percent of startups received less financing than they initially requested, while 28 percent received no financing at all. The fact is, most people don't realize it, but 80 percent of business debt financing comes from investors in our capital markets, not from banks.

The U.S. continues to experience a slump in the number of new businesses, which in 2016 hit a 40-year low. Last year showed a spark in IPOs, which broke that disturbing trend. Until 2020, our economy launched half the number of domestic IPOs than it had 20 years ago.

At the same time, the U.S. doubled the regulatory compliance costs that businesses incur, just one of the myriad reasons why the decline in traditional IPOs is the cost of going public. Costs associated with, "going public", are high because investment bankers, lawyers, and auditors collectively charge millions of dollars to prepare the lengthy registration statement that is required to be filed with the SEC before any shares can be sold.

Additionally, a series of regulatory burdens placed on public companies only adds even more costs to these companies. The SEC estimates the average cost of just achieving initial regulatory compliance for going public in a traditional IPO is $2.5 million, with an annual compliance cost averaging $1.5 million after that. These costs are prohibitive for small and other emerging companies focused on growing their businesses.

As a result, more companies are opting for private fundraising over the costly hassle of entering our public markets. In 2016, private offerings in the U.S. raised nearly 5 times the equity as IPOs. In 1997, 8,884 companies were listed on exchanges in the United States. Since then, the number of companies on the exchanges has decreased by more than half, which results in fewer investment choices for everyday Main Street mom-and-pop investors.

In the U.S., there are 242 unicorns, startups with valuations of more than a billion dollars, that were privately financed as of November 2020. That is called a herd of unicorns. Those aren't unicorns.

Conversely, as more businesses today remain privately funded instead of going public, the number of publicly held companies has declined to levels not seen since the 1980s. The decline in IPOs only hurts everyday American consumers, as I said, because there are fewer opportunities for them.

It is important to note that while the U.S. IPO market has steadily decreased, until last year, foreign markets, specifically China, were growing. China's annual GDP growth remains approximately 6.2 percent despite the recent trade war.

Additionally, in 2020, mainland China was the only major economy to achieve positive economic growth. China's IPO market produced over one-third of the world's IPOs in 2020, reporting 536 out of the 1,363 IPOs across all global markets. Beijing's, "Made in China" 2025 agenda lays out its plan to dominate the high-tech, biotech, and artificial intelligence industries within the next 10 years. Additionally, experts predict more IPO activity on mainland China's 14th 5-year plan, which is designed to boost IPOs in specific sectors through direct financing.

Increased pressure from foreign markets only heightens the necessity for immediate action and reform. Republicans support making our markets more attractive, but make no mistake: China is aggressively pursuing policies that challenge us economically. This includes the IPO space. Republicans and Democrats must work together to continue to make our capital markets the envy of the world.

Given the capital formation issues facing American companies and the decline in IPOs over the last several decades, this committee needs to be focused on legislative and regulatory frameworks that make our public markets more attractive and preserve various paths for companies to pursue going public.

I look forward to hearing from our witnesses today, and I yield back.

Chairman SHERMAN. Thank you very much.

I now recognize the ranking member of the Full Committee, the gentleman from North Carolina, Ranking Member McHenry.

Mr. MCHENRY. Thank you. Look, if any one of my colleagues wanted to discuss ways to make public companies more attractive today, they would be disappointed. Today, committee Democrats will push for more regulation, which ultimately will discourage companies from going public. That is unfortunate.

What we should be discussing instead is Mr. Huizenga's proposal to facilitate small business mergers and acquisitions as an alternative to small business bankruptcy; Mr. Hill's bill to expand investment opportunities for investors who know the subject matter; Mrs. Wagner's proposal to provide investor-friendly disclosure formatting and reduce disclosure costs for public companies; Mr. Emmer's bill to facilitate trading in smaller, early-stage companies to spur capital raises and reward innovation; Mr. Steil's bill, his proposal to reduce regulatory costs and streamline disclosures for small public companies; and Mr. Loudermilk's bill to remove misguided regulation and reduce costs for non-bank financial institutions.

All of those bills I just mentioned would do more to help investors and small businesses than the discussion we are having today.

I yield back.

Chairman SHERMAN. Thank you.

Today, we welcome the testimony of our distinguished witnesses: Stephen Deane, the senior director of legislative and regulatory outreach at the CFA Institute; Andrew Park, a senior policy analyst at Americans for Financial Reform; Usha Rodrigues, professor, and M.E. Kilpatrick Professor of Corporate & Securities Law at the University of Georgia School of Law; and Scott Kupor, a managing partner at Andreessen Horowitz.

Witnesses are reminded that their oral summary of their testimony will be limited to 5 minutes. You will be able to see the timer on your screen which will indicate how much time you have left, and a chime will go off at the end of your time. I would ask that you be mindful of the timer and wrap it up quickly if you hear the chime. And without objection, your full written statements will be made a part of the record.

Mr. Deane, you are now recognized for 5 minutes.

STATEMENT OF STEPHEN DEANE, SENIOR DIRECTOR, LEGISLATIVE AND REGULATORY OUTREACH, CFA INSTITUTE

Mr. DEANE. Chairman Sherman, Ranking Member Huizenga, and members of the subcommittee, my name is Steve Deane, and I am with the CFA Institute. It is an honor to be here.

I would like to focus on SPACs and investor protection. If we look at the track record so far, we see two starkly different worlds. On the one hand, we have big, sophisticated investors such as hedge funds that invest at the IPO stage, and then they exit when the SPAC announces a merger to take a company private.

On the other hand, there are individual investors who buy in the public markets, often at the time of the merger announcement, and hold their shares in the post-merger period.

These two sets of investors face two starkly different results. There are lucrative profits for the sponsors, as well as the hedge funds who exit, but poor returns for ordinary investors who stay on.

The question is, are there any design features of SPACs that could explain this pattern, and I point to three. First, dilution. The initial IPO investors, including hedge funds, buy SPAC units which consist of shares and warrants, but those warrants are detached after about 2 months. So later, in the second phase, when these investors redeem their shares, and most of these hedge funds do, they get their money back, plus interest, but they get to keep their warrants.

One academic paper calls this a, “default-free, underpriced, convertible bond with extra warrants.” In other words, a free lunch. We know there is no such thing as a free lunch. It comes at the expense of the investors who hold their shares in the post-merger period, and that includes retail investors. So, dilution is a handicap and it is one that the record shows that SPACs to date have not overcome.

A second investor concern involves misaligned incentives. For example, the sponsor has a strong financial incentive to make a merger deal, even a bad one that may not be in the interest of the other shareholders. In addition, the SPAC may offer special inducements such as discounts to get still other investors to invest in private deals called PIPEs. The details of these side deals are not always disclosed.

The third area of concern involves forward-looking statements. SPACs enjoy a safe harbor. At least, it has been thought until now that they enjoy a safe harbor from private litigation if they make a forward-looking statement or projections about the future of the proposed merger. That is different from a traditional IPO, which gets no safe harbor, and therefore almost never offers forward-looking statements. This heightened liability in IPOs is an important investor protection, and the question is, why doesn’t this same investor protection apply to SPAC mergers?

So, where do we go from here? First, we have seen an explosion of SPACs, and now they are facing heightened scrutiny, including this hearing. That is a good thing. Public education is an important component to help protect investors. As SPACs evolve, we may see market solutions to address some of these concerns.

But there is also a clear role for Congress and securities regulators to remain vigilant to protect investors. As Congress deliberates on possible actions it may take, we would welcome the focus on investor protection and transparency. I would specifically suggest focusing on dilution, misaligned incentives, undisclosed side deals, and safe harbors to forward-looking statements.

Thank you.

[The prepared statement of Mr. Deane can be found on page 38 of the appendix.]

Chairman SHERMAN. Thank you, Mr. Deane.

Mr. Park, you are now recognized for 5 minutes.

STATEMENT OF ANDREW PARK, SENIOR POLICY ANALYST, AMERICANS FOR FINANCIAL REFORM

Mr. PARK. Thank you. Chairman Sherman, Ranking Member Huizenga, and members of the subcommittee, thank you for inviting me this afternoon to share my views on the different ways that private companies have been choosing to go public outside of the traditional IPO process. My testimony today will focus in particular on the rise of SPACs.

Over $100 billion worth have been issued so far this year, or nearly 10 times the total that we saw in 2018. This exponential growth is concerning because SPACs historically have performed very poorly for retail investors, while the issuers, advisors, and a select group of institutional investors will still profit.

The SPAC surge appears to be driven in part by private companies' desire to exploit the perceived speed, streamlined disclosures, reduced liability, and reduced shareholder rights that are offered by the SPAC process. Although many have just started hearing about SPACs recently, SPACs are really far from new. In fact, they actually date back to the 1980s, when they were actually called blank check companies, and they were often associated with scams, and in the process bilked unsuspecting investors out of millions of dollars.

Fraud was, in fact, so pervasive in these blank check companies that Congress back in 1990 had to pass the Penny Stock Reform Act (PSRA) to address some of these problems. The SEC followed shortly thereafter with Rule 419 that also dictated blank check company rules.

Blank check company issuers, though, decided that they would get around these rules and devised this modern-day SPAC structure, reminding us that properly regulating new assets requires both continuing attention and action, and there are two main ways that SPACs escape from coverage from both the PSRA and also Rule 419.

The first is this arbitrary $4-a-share threshold that defines a penny stock; and the second is the extremely low standard of $5 million in net tangible assets. None of those conditions end up applying to SPACs, because everyone holds more than $5 million in cash, and they are deliberately issued at $10 a share to get around that $4 mark.

SPACs also rely on a safe harbor from being held accountable to forward-looking statements under the Private Securities Litigation Reform Act of 1995. Whereas with an IPO, issuers and underwriters are liable for making false and misleading forward-looking statements, SPACs are not subject to that same standard. That has emboldened many pre-revenue companies in highly speculative industries such as electric vehicles, cryptocurrency, and space exploration to use what we could generously call, "rosy projections."

Take, for example, nine electric vehicle companies that have gone public through a SPAC in 2020. Their combined annual revenue was $139 million that year. But between them, they project to investors that by 2024, they will generate $26 billion in annual revenue. Or let's take a look at a space exploration company, Holicity, which is proposing a merger with Astra Space. They have disclosed to investors, for example, that they have not yet launched any rockets, but by 2025, they project that they will have daily rocket launches.

What is most concerning is that retail investors are buying into this type of hype, and in some instances pouring a significant portion of their savings into certain SPACs when the data continue to show, time and time again, that they perform poorly over the medium and long run. A large part of that underperformance comes from the sizable up-front compensation that goes to the sponsor who receives that 20 percent promote regardless of the quality of the acquisition.

As a result, when you look at the average SPAC that is issued at $10 a share, after you pay the sponsor and you meet the redemptions of the shareholders who want to cash out, that SPAC only ends up with $6.67 in cash after the merger. Or put another way, that would mean that the value of the company would need to rise 50 percent just to get back to that $10, and that leaves many of the retail investors who hold this post-merger SPAC at a significant disadvantage.

We wouldn't want people's 401(k)s to be used at the blackjack table, given how the game is mathematically stacked against them. But unfortunately, investing in SPACs in their current form is not too different. I will end my remarks with these figures that show just how clearly the house always wins.

The average SPAC sponsor between 2019 and 2021 saw returns of 958 percent. The average institutional investor who is doing this arbitrage trade, which I can later elaborate on, averages a 40-percent return. But now, retail investors who chase these SPACs with high hopes are losing. So if we look at between 2010 and 2018, the average one-year return of SPACs following a merger was negative 15.6 percent. Even more recently, Goldman Sachs found that 200 SPACs in April lost around 17 percent compared to a 10 percent return.

Given these dramatically misaligned incentives that characterize these deals and their extremely poor performance, we urge the committee to take action. We urge you to amend the Exchange Act to align the rules that govern forward-looking projections in SPACs with those of IPOs and to broaden the definition of blank check companies to better protect Main Street investors.

I thank you for your time, and I look forward to answering your questions.

[The prepared statement of Mr. Park can be found on page 61 of the appendix.]

Chairman SHERMAN. Thank you.

Professor Rodrigues, you are now recognized for 5 minutes.

STATEMENT OF USHA R. RODRIGUES, PROFESSOR, AND M.E. KILPATRICK PROFESSOR OF CORPORATE & SECURITIES LAW, UNIVERSITY OF GEORGIA SCHOOL OF LAW

Ms. RODRIGUES. Chairman Sherman, Ranking Member Huizenga, and members of the subcommittee, it is an honor to participate in today's hearing. Because my time is limited, I am going to highlight just two aspects of my written testimony. I will use a somewhat offbeat metaphor, and then an analogy that I think might hit home.

First, the metaphor. The subject of this hearing is going public, and I am going to propose to you that you think of the traditional IPO process like a traditional wedding. Most of us have attended many weddings: the couple picks out the date months in advance; there is an announcement; there are elegant invitations; the venue is selected with care, and so are the flowers, the photographer, the caterer, and the dresses. The couple's families will meet and perhaps help with planning the ceremony. It is quite a process.

Well, how is an IPO like a wedding? An IPO also starts out months ahead of time. The CEO, the CFO, and the General Counsel have likely been dreaming for years of the day when they can take their company public. Once they decide they are ready to embark, they interview a series of investment banks and select the right one to lead the offering. The lead underwriting bank then shepherds the company through the process. It works for the company to draft the registration statement, which it files confidentially with the SEC. The SEC comments on the draft, the company responds, and they go back and forth several times. Finally, the company files its first public registration statement.

But that isn't the end of the story. The banks and the company then launch a road show in which they try to explain the company's business to interested investors and convince them to invest in the IPO. The SEC continues to comment, asking for clarification or adjustments in wording. Finally, the SEC signals that it has no more comments, and the bank is comfortable that it can sell the offering and the prospectus is free of material misstatements.

Then, and only then, will the offering price and the IPO commence.

Now, if an IPO is like a traditional wedding, then an SPAC is more like a Vegas wedding. It just doesn't have the same level of preparation and vetting that a traditional IPO does. But here is the point: It is still a legal wedding. Whether it is Vegas or traditional, at the end of the day, you still have a lawfully married couple, and that is just like whether a company goes public via an SPAC or via a traditional IPO. At the end of the day, it is a publicly traded company.

But these are the products of two very different processes. And it is misleading to try to equate the two. That is why I support prohibiting forward-looking statements in the De-SPAC, and extending Section 11 liability, underwriter liability, to include the De-SPAC disclosures. These reforms will help to equalize the process.

Okay, that is my offbeat metaphor. Here is my analogy. As I described in my written testimony, SPACs used to allow a vote in the De-SPAC so that SPAC shareholders got a say in whether or not to make the acquisition. And if enough of them said they wanted their money back, 20 percent to be precise, then the deal wouldn't close. After all, the SPAC needed the money from the trust account to fund the acquisition.

The rules changed, and I don't have time here to get into why, but they did, and now just a majority vote is required, except sometimes a vote isn't required at all. And what actually troubles me isn't the elimination of the vote; it is how meaningless the vote is when it does occur. And that is because SPACs allow shareholders to vote for the acquisition and still redeem their shares.

As a SPAC shareholder, you can basically say, sure, I think we should acquire this company and take it public, but I don't want any part of it; give me my money back.

And that takes me to my analogy. This is like a U.S. citizen voting in an election, say a congressional election, except this citizen is in the process of renouncing their citizenship while they are voting. They vote, but they have no interest in the outcome.

I suggest that this decoupling of voting and economic interest is a real problem that you should consider.

This concludes my remarks. Thank you again. I look forward to your questions.

[The prepared statement of Ms. Rodrigues can be found on page 66 of the appendix.]

Chairman SHERMAN. That is perhaps the most interesting presentation I have heard in a while.

And Mr. Kupor, you are now recognized for 5 minutes.

STATEMENT OF SCOTT KUPOR, MANAGING PARTNER, ANDREESSEN HOROWITZ

Mr. KUPOR. Thank you, Chairman Sherman, Ranking Member Huizenga, and members of the subcommittee. Thank you for the opportunity to talk about this very important topic.

Before I give you some perspectives on potential reforms to consider in order to enhance capital formation and access to investment opportunities for all Americans, I will briefly summarize a few trends that haven't yet been touched on in this setting.

First, I think we shouldn't lose sight of the fact that the raw number of IPOs has declined significantly. From 1980 to 2000, we used to do about 300 IPOs per year. From 2001 to 2016, that number fell to about 108.

Second, companies are staying private longer, roughly double the time period they used to, and therefore we have more mature and obviously higher valuation companies at the time of the IPO.

Now, I think it is a reasonable question to ask, why should we care about any of this? First, the number of publicly listed companies in the U.S. has declined by 50 percent, which reduces competitiveness and overall consumer choice.

Second, we know publicly traded companies drive employment growth and are the key to expanding geographic access to economic opportunity.

And third, and I think very importantly, the vast majority of appreciation of high-worth companies is now accruing to institutions, pension funds, and wealthy individuals who can invest in the private markets, while retail investors are largely relegated to the public markets. This two-tiered market structure has significant implications for income and wealth inequality.

There is some good news, which is we have seen some positive developments. The number of IPOs has been steadily increasing in the last few years, and no doubt, some of this is due to the work that many of you were instrumental in as part of the passage of the JOBS Act. So we appreciate that, and thank you for your efforts.

We also now have choice, which is really important. Traditional IPOs now compete alongside direct listings and SPACs for quality issuers. And choice is good. It drives competition, it reduces expenses, and it enables more companies to seek capital to grow their business.

However, to ensure that choice and competition thrive, and that all investors have access to growth opportunities, and that the U.S. continues to create new jobs and economic growth, and that the U.S. remains the best place for company formation and growth, there are a number of things that I believe legislators and regulators should consider.

First of all, we should consider, how can we make it easier for companies to go public and to do so at earlier stages of maturity? Expanding the current JOBS Act emerging growth company (EGC) eligibility criteria for issuers from 5 years to 10 years, as noted in the Helping Startups Continue to Grow Act, would help smaller-cap companies on-ramp into the public markets; and providing a transition period of one year for EGCs could trigger the large accelerated status when public flow exceeds $700 million for the first time, which would also help.

Second, we have to be mindful of the fact that very low-volume small-cap stocks are especially vulnerable to short activity, and so this body should consider short positions closure similar to what exists for materially long positions to support innovative small capitalization companies.

Another way to enhance liquidity would be to look at the opportunity for EGCs to opt out of unlisted trading privileges and therefore select the venues on which they want to trade their securities and consolidate trading volume.

We ought to ensure that the choices exist for going public and that they engender fair competition, and enhance price discovery and broader retail participation.

With respect to direct listings, one of the very important things for clarification is around the tracing rules and Section 11 liability. There is some uncertainty around this for selling shareholders, and this is potentially preventing direct listings from achieving their full potential.

You have heard a lot already about SPACs, so I won't comment on that, but I think, Chairman Sherman, you noted the most important thing, which is that we should have a level playing field. Whatever this body determines, it should not be the case that there are different regulatory regimes for traditional IPOs relative to SPACs.

While enhancing the public market, I think we also need to look at ways to enhance access to the private markets for non-institutional investors, obviously with appropriate oversight and investor suitability. While the SEC has taken some initial steps towards amending the credit investor definition, I think there are more ways that we should expand that to materially increase the number of individuals who qualify.

We might also consider making it easier for retail investors to access private fund investments. Models such as that proposed by Representative Gonzalez could enhance retail access to private growth companies.

And finally, there is another area of capital formation that hasn't been touched on here, which is around blockchain crypto industries. In many ways, a healthy blockchain ecosystem not only creates economic growth and technological development for the U.S., but it is also an opportunity for anyone who desires to be part of a project and benefit from the success of that endeavor. Unfortunately, to date, the SEC has not provided clear regulatory guidance for how tokens will be treated under existing regulatory rules.

This is important, because we need to differentiate between good-faith technology entrepreneurs and get-rich-quick schemes, and make sure that this is very clear to others.

I appreciate the opportunity to be here, and I look forward to your questions.

[The prepared statement of Mr. Kupor can be found on page 47 of the appendix.]

Chairman SHERMAN. Thank you. I want to thank all of our witnesses for their presentations. I now recognize myself for 5 minutes for questions.

I am going to be interested in all of our witnesses presenting for the record their ideas on how we can reduce the cost of the companies' base because we need more companies to decide to go public for all of the reasons that have been outlined. And when I talk about cost, it is not just the commission that is shown but also underpricing or anything else that prevents the company from benefitting from all the dollars invested.

I want to thank our last witness for recognizing that we ought to have the same liability system, whether you choose the SPAC route or the IPO route. Either we want to encourage companies to speculate about the future so that we at least get some information or some speculation and tell them they are free to do so without strict liability, or we want to tell all investors that you are protected and that any forward-facing statement will be subject to all of the protections of Section 11 liability.

I want to focus on the use of the IPO as a way, in effect, to bribe those with fiduciary duties. A public (inaudible) spends a lot of attention making sure that Members of Congress who owe a fiduciary duty to our constituents and the people aren't taking gifts. And yet, there is also the private sector, where every corporate officer owes a fiduciary duty to the corporation.

We have charitable trusts; we have pension trusts. And it occurs to me that if I was in the investment banking business, I would love to do business with a $100 billion pension trust. And if I were to go into the trustee's office with $100,000 in a briefcase and say, "I will be bringing you similar briefcases from time to time, no quid pro quo, I just like bringing you briefcases full of money," my guess is that I and the trustee would go to jail.

But if instead, I call the trustee and say, "Look, for your own account, you may want to invest in this hot IPO. I won't make it available to any but my best friends, and no quid pro quo, it is just that every month I am going to give you another IPO and you will make about $100,000 from the shares I allocate to you. And, oh, by the way, I would like to, in some other conversation, talk to you about your $100 billion fund and how we can be of service."

Professor Rodrigues, does that work? Is that legal?

Ms. RODRIGUES. It is a practice called IPO spinning, and it is not legal. The allocation of IPO shares from the syndicate to investors is a really opaque one. I was looking on—

Chairman SHERMAN. If I can interrupt, Professor—

Ms. RODRIGUES. Yes, of course.

Chairman SHERMAN. —it is kind of known that the underwriter can make this opportunity available to their best customers.

Ms. RODRIGUES. Yes.

Chairman SHERMAN. And the best customer is the one with a $5 million account. But if you have a person who only has a $50,000 account, but they happen to be the trustee of a big charitable trust, can you treat them as one of your good customers?

Ms. RODRIGUES. I was looking on the Fidelity website, and it says, "Customers who want to participate in an IPO offering are evaluated and ranked based on their assets and the revenue they generate for their brokerage firm." So, it is clearly a system where—

Chairman SHERMAN. Okay, so that is a system whereby it is just what you generate for the firm. Would it be illegal to say, or what you generate for this firm through the accounts you control? I don't think Fidelity does it that way, and I would put it in writing if I did. But would it be illegal for them to say, you generate a lot of money for our firm because you are the trustee for the big trust?

Ms. RODRIGUES. I think it would. It certainly is an ethically questionable practice.

Chairman SHERMAN. I look forward to trying to draft legislation to make sure that not only is it illegal to bring the fiduciary a briefcase with $100,000 in cash, it is also illegal to bring a fiduciary a chance to make $100,000 profit that is not available to the other customers of the brokerage.

And with that, I will call on our next questioner, who, of course, is the ranking member of the subcommittee, Mr. Huizenga.

Mr. HUIZENGA. Thank you, Mr. Chairman.

First of all, I would like to ask unanimous consent to enter into the record an article written by Jennifer Schulp entitled, "IPOs, SPACs, and Direct Listings, Oh My!"

Chairman SHERMAN. Without objection, it is so ordered.

Mr. HUIZENGA. Thank you.

Mr. Kupor, today's hearing is focused on three primary pathways for going public: traditional IPOs; SPACs; and direct listings. Will you please discuss each of these three pathways to go public, and why one may be more attractive or advantageous over another, depending on a company's specific circumstances and needs at the time?

Mr. KUPOR. Yes, sure. Thank you very much for that question. In general, let me take them one by one. The promise of SPACs is that the process typically can be faster for companies because you already obviously have a public vehicle, and there is more certainty around the initial pricing because you pre-negotiate, obviously, through the merger and the De-SPAC agreement, as well as a PIPE, what the valuation is. That has been the promise.

I would say so far, if you look at the data, that has generally been true, which is the timeframe has been faster. I will note, and I mentioned this in my written testimony, that of late, we have seen things slowing down at the SEC, just given the volume of SPACs, and that has created more uncertainty around market timing. We have also seen the PIPE market be very, very different in terms of being much less robust than it was even just a couple of months ago. So, that timing question kind of remains to be seen.

Direct listing today is most relevant for companies that do not have to raise primary capital. Now, there is, as you know, the opportunity for companies to raise primary capital, but to date we have only seen secondary offerings. The direct listing tends to be most attractive for companies where they don't need access to primary capital, and in general, where there is enough what I would call awareness and brand of the company so that they can effectively be able to become public through a lesser marketing process.

And the traditional IPO is, again, mostly today being taken advantage of by companies who need access to primary capital. That is really the main reason. It is obviously a heavier-weight process from a regulatory perspective. It certainly takes typically more time. But it does have that effect.

I think what is important in this discussion, which I don't think we should lose sight of, is that this choice really matters because it is very important, and we are already seeing market responses to these choices being available.

Mr. HUIZENGA. Expand on that. It is my understanding that you have helped bring a number of companies public?

Mr. KUPOR. Yes.

Mr. HUIZENGA. So, talk a little bit about why do some of them want to go public, and why are some of them choosing to not go public? We talked about these unicorns. I always say if you have 240-some-odd unicorns, they are not unicorns; that is a herd. And there is a reason why they are doing that, and we can't seem to come to an agreement on both sides of the aisle as to these massive costs or what it is that is keeping that. But let me ask this last part, if you can touch on that.

What kind of concerns do you have about the SEC or Congress making it more difficult or less attractive for companies to go public via these three pathways?

Mr. KUPOR. I have a lot of concerns, because I think it is really important for us to have more public companies.

To give you just a few specific thoughts, one of the reasons that companies are staying private longer is because it is very difficult to be a small-cap company today in the public markets. You don't have research coverage. You tend not to have sales and training activity happening at the banks. You obviously do have regulatory burdens, but I would say the regulatory burdens are a little bit of an up-front cost often.

But the real question is, once you are a public company, what is it like to be a public company? It can be very lonely to have a very low float, not well-followed stock.

So some of the things, as I mentioned in my testimony, we can do is to think about how do you increase liquidity and volume of activity for small cap stocks in particular? I think that is one really important area.

Second, we do want to have more public companies. One of the beauties of this country has been that the capital markets here are the envy of many across the world. And if you look, quite frankly, at what we have seen even in this horrible crisis of COVID, companies like Moderna—the reason we have vaccines is because companies like Moderna were able to both tap private capital, and then, quite frankly, tap public capital in a way that gave them access to tremendous research and development dollars that has now resulted in what is today a medical miracle, and there is a whole host of companies doing that.

So, the most important thing that I would ask this body to think about is, before we introduce additional regulation, I think I would ask: first, does that regulation help or hinder access to capital markets for companies; and second, does it help or hinder access for retail investors to be able to actually access these opportunities?

Mr. HUIZENGA. In my closing seconds, I know that these are the questions that we have. We need to pursue these and make sure that we remove those barriers, not put more up.

With that, I yield back.

Chairman SHERMAN. Thank you.

I now recognize the Chair of our Full Committee, Chairwoman Waters.

[pause]

Chairman SHERMAN. Chairwoman Waters?

[pause]

Chairman SHERMAN. I don't know if Chairwoman Waters is available.

I am going to go to Mr. Himes, and we will come back to Chairwoman Waters later.

Mr. HIMES. Thank you, Mr. Chairman. Thank you for holding the hearing.

And thank you to our witnesses.

We have been talking a lot about investor protection in the context of Robinhood. There is a dispiriting dialogue on this committee where the Republicans accuse the Democrats of wanting more regulation. When that dispiriting dialogue happens, we forget to focus on something that I think is particularly important in this realm, which is remarkable rent-seeking behavior. By rent-seeking, of course, I mean taking advantage of oligopolistic situations or information asymmetries or dislocations in markets to make money which you wouldn't otherwise make in a competitive scenario.

I do think that an awful lot of investors—as Warren Buffet says, you don't know who is swimming naked until the tide goes out. The tide really hasn't gone out much in the last couple of years, and I do think that investors at some point are going to get a very expensive education in the fact that equity markets don't go to the sky, but I don't think that, absent shining a light on or considering regulatory behavior, we are going to see a decline in the amount of rent-seeking.

It hasn't been mentioned, but for a long time I have been banging the drum on the fact that if you do an IPO between roughly $30 million and $150 million in proceeds, the mint market IPO, you always get to pay a 7 percent gross spread. That has never felt to me like competitive activity.

There is another area that has been mentioned this morning, and I would like to highlight it for a minute or two, maybe starting with Mr. Deane, and that is IPO pricing. I used to do IPOs for many, many years, and we always used to celebrate when you were 10 times oversubscribed and priced the IPO at exactly half or one-third of what the value was on the second day of trading. It always struck me that that was a way to leave an immense amount of value, value that might have otherwise gone to the limited partners at Mr. Kupor's organization or to the company itself.

So, Mr. Deane, talk to me a little bit about pricing behavior and who benefits when IPOs are underpriced. And I will open this up, once you are done, to anybody on the panel.

Is there any long-term fundamental value in having a big IPO pop, long-term fundamental value? Mr. Deane?

Mr. DEANE. Thank you, Mr. Himes. Actually, Commissioner Jackson, Professor Jackson has often made the same points that you have about the 7 percent tax and competitiveness.

I guess first, I would say that on the one hand, IPOs offer tremendous strengths in investor protections, including Section 11 strict liability. On the other hand, they just don't seem to be perfect, and you have identified one of the big issues, which is, are the issuers leaving money on the table for the pop, the extra price that the shares trade at on the first day, and also a seemingly uniform 7-percent cost for the IPO?

It does seem to me that some of these other things we are seeing, like SPACs and direct listings, maybe they are identifying some underlying problems, even if the SPACs themselves have flaws, even if they are not the perfect answers. Maybe we also have to ask, what are they telling us about the market that could be improved?

So again, on the one hand, I think, yes, these are problems—in my opinion, these are problems with IPOs. The issuers are leaving money on the table. On the other hand, I would reiterate that they also come with some great strengths in investor protection.

Mr. HIMES. Thank you, Mr. Deane.

Professor Rodrigues, I saw you nodding away there. Give me 30 seconds, because I do have a question for Mr. Kupor. Give me 30 seconds on the value of a very substantial IPO pop. Who gets that value?

Ms. RODRIGUES. The investors, right? The investors in that initial IPO get a huge bump. They get a huge rise in value on one day.

Mr. HIMES. To go with your metaphor, the investors are the guests at your wedding. Does every guest at that wedding get an equal chance to see that Day-1 doubling in value?

Ms. RODRIGUES. Let's beat this metaphor. So, no.

Mr. HIMES. Let me put it this way, some people weren't invited to the wedding, right?

Ms. RODRIGUES. Yes.

Mr. HIMES. Lots of people weren't invited to the wedding, and I will leave the witness here by saying usually those are the retail investors, right?

Ms. RODRIGUES. Right. So, the syndicate, the banks, get the value of having their customers be happy with them because they have gotten this initial first-day pop. Those are the winners, and then the losers are everybody who has to buy at the real market price.

Mr. HIMES. Which is generally retail investors investing a couple of weeks after you have seen that pop, and an awful lot of institutions have actually made an awful lot of money, correct?

Ms. RODRIGUES. That is exactly right.

Mr. HIMES. Thank you.

Mr. Kupor, I'm sorry I don't have time to go to you. My time has expired, and I yield back.

Chairman SHERMAN. I would point out the company might also be losing if they underprice the shares.

Mrs. Wagner is now recognized for 5 minutes.

Mrs. WAGNER. Thank you, Mr. Chairman.

Mr. Kupor, I will go to you. Would you agree that being a public company comes with additional disclosure and filing requirements that can often deter a private company from going public?

Mr. KUPOR. Yes, I think that is a fair statement.

Mrs. WAGNER. In your experience, and I know your experience is vast in this, from taking private companies public, what are some of the specific overly burdensome regulatory requirements, specifically filings and disclosures, that you believe make going public less attractive to a private company?

Mr. KUPOR. Yes, some of the things that were identified in the JOBS Act, the EGC status of being able to defer some of the Sarbanes-Oxley requirements, obviously, is very helpful and valuable, and those things can be burdensome, particularly for small-cap companies where you are really trading off regulatory dollars versus R&D dollars.

There are other things like say on pay and other disclosure items that I think are challenging as well, particularly for some of these smaller cap companies. But as these companies get much larger, many of those things are much more manageable.

Mrs. WAGNER. There certainly is more work that this committee should be doing to make our public markets more attractive to increase the number of companies going public while also, very importantly, preserving investor protection.

Mr. KUPOR. Absolutely.

Mrs. WAGNER. One way to help increase IPOs is by simplifying the quarterly financial reporting burden on companies. In recent years, quarterly reporting requirements have grown in size and complexity, making it much more difficult for investors to determine, I think, relevant information, often leaving them overwhelmed and unable to make sound investment decisions.

Furthermore, some companies believe that current reporting requirements have become a barrier to registering as a publicly traded company, as noted in a report by the IPO Task Force. The report, which was promoted by the JOBS Act that you mentioned of 2012, found that 92 percent of public company CEOs said that the administrative burden of public reporting was a significant challenge to completing an IPO and becoming a public company.

It is time, past time, to move away from this one-size-fits-all approach to corporate disclosure and focus on transparency through new technologies and the flexibilities that I think new technologies have allowed us. The current disclosure rules were written before the advent of websites and social media and direct connection to investors that comes from the ubiquitous access of even just smart phones.

I believe that you can reform disclosure requirements without depriving investors of any critical information that they may need or that they absolutely deserve. That is why I have introduced the Modernizing Disclosures for Investors Act, which would require the SEC to implement rules simplifying the quarterly reporting regime for SEC registrants. My legislation would allow issuers of securities traded on a national securities exchange to disclose quarterly financial information in a much more simplified manner and reduce some of the administrative costs that are deterring small and mid-sized companies from going public, and I would certainly urge my colleagues, especially here on the Capital Markets Subcommittee, to co-sponsor this legislation.

Mr. Kupor, in the limited time I have left, is it beneficial for businesses to have multiple pathways of going public? And why?

Mr. KUPOR. Yes, it absolutely is, and the good news, as I mentioned in my testimony, is that we are seeing that now. There are some issues that many of the panelists have raised here around SPACs, and I think those are worthy of discussion. But the idea that we now have SPACs, we now have direct listings, and we have traditional IPOs really is helping from a market perspective. So even in some of the comments that were mentioned earlier by some of the Members here, things like IPO pricing has actually improved. If you are concerned about pops, those pops have actually gone down as a result of greater competition. We are getting better price discovery in these mechanisms.

And so to me, the most important thing to preserve is competition and choice, and if we do that alongside, as you mentioned, Mrs. Wagner, investor protection, then I think we have a very good shot at remaining a very important capital market center.

Mrs. WAGNER. Great. Thank you very, very much. I appreciate it.

Mr. Chairman, I yield back.

Chairman SHERMAN. Thank you. I thank the witness for mentioning direct listing, and I am hoping that the questioning will focus more on that.

And I now recognize the Chair of the Full Committee, Chairwoman Waters.

Chairwoman WATERS. Thank you very much, Mr. Chairman.

Mr. Park, in a letter sent to the House Financial Services Committee, the Consumer Federation of America and Americans for Financial Reform noted that initial SPAC sponsors and hedge funds that are granted exclusive access to the early investor pool are granted, "attractive investment returns on an essentially risk-free investment while avoiding the disclosure obligations and liability risk associated with the typical IPO."

The letter noted that these initial investors who sell or redeem their shares before the SPAC merger received, on average, an 11.6-percent rate of return, while the SPAC sponsors themselves, "performed even better, earning a mean return of 32 percent in the 12-month period post-merger."

However, unsurprisingly, retail investors in the rest of the market appear to have a much different experience. Reports show that 90 percent of SPACs that announced this year are lagging the S&P 500 based on when they began trading. According to a Reuters analysis, "The median performance of a SPAC from the day it announces what company it will merge with is 6 percent."

Why is it that, once again, it appears that Wall Street and hedge funds are profiting while retail investors are left bearing the cost? A lot has been said about this already, but what I would really like, instead of answering that question, I would like to know, can you explain the protections and safeguards that are part of the traditional IPO process that are absolutely absent from the SPACs and how this may affect investors, particularly retail investors? What is it that investors have access to with the IPO that they don't have with the SPACs?

Mr. PARK. Thank you for that question, Chairwoman Waters. I would say, first off, that the key critical component that is missing is information. When investors are buying into these SPACs at the initial offering, they don't have any insight as to the financials, nor really necessarily what the business is going to be. So what they are doing is they are putting their faith in the sponsor to be able to find a good deal for them, or ultimately a good company with which to merge.

Now, the problem here is that when it comes to the process where the SPAC has finally identified a company to merge with, there wouldn't be a vote in place. But what we find is that a lot of the initial investors are more interested in voting for the merger and then selling their shares because they know that they can still profit. They can do so because when you originally buy into a SPAC, as Mr. Deane was saying in his testimony, you get both the shares and you get these warrants. So, if you sell the shares and you still vote for the merger, you can still hold onto these warrants. What happens with the warrants is that if the stock were to go above $11.50, you can still make money, even though you don't still own the shares. But at the same time, you still voted for the merger.

That conflict right there seems to be very odd. And keep in mind, too, with the compensation structure of these SPACs, as I was stating in my testimony, the sponsor, upon completing a deal, gets 20 percent. They are not evaluating necessarily on whether it is a good deal but whether it gets completed. They collect that, right?

And there are also these other sets of investors that come in later called the PIPE investors. They have a different set of securities that they are investing in, and they have a different set of interests.

So all throughout the whole SPAC process, everyone has their own set of incentives where they can make money.

Chairwoman WATERS. Okay. Let me just ask you before my time is up, Mr. Sherman has legislation dealing with precisely what we are discussing, making sure that more information is available, et cetera. Have you seen the legislation, and do you think it is what we need? Do we need to make it tougher? Do we need to add to it? Have you examined that legislation of Mr. Sherman's?

Mr. PARK. Yes, I have, Madam Chairwoman.

Chairwoman WATERS. What do you think?

Mr. PARK. It is certainly a step in the right direction. We are really going after these forward-looking projections that are being abused. That is the core component of the difference between an IPO and a SPAC. And on top of that, I will add the fact that there are reasons why Rule 419, which dictates blank check companies, was put into place, again, to protect investors. And we are asking the committee to also consider aligning SPACs with blank check company rules.

Chairwoman WATERS. Thank you, and I thank all of our witnesses who are here today. I yield back the balance of my time.

Chairman SHERMAN. Thank you.

I now recognize Mr. Hill.

Mr. HILL. Thank you, Mr. Chairman, and I appreciate you holding this hearing. It is, of course, I think, no surprise to any of the Members that with interest rates at negative returns due to artificially keeping our interest rates too low and fueling a major fiscal injection into our economy, and the GDP at the growth rate that it is projected to be this year, and our bit companies announcing outstanding earnings, I think it is no surprise that over the last 5 months, we have concentrated on some of the excesses that we have seen out in the capital markets and people taking advantage of this unprecedented expansion in the capital markets due to, I think, the monetary policy.

So with that, I do share Mr. Huizenga's goal that we need to be thinking long term, which is, how do we bring down that marginal cost of going public and staying public? Of course, we want that going public to be done in a fair and transparent way, but the real issue is that ongoing cost of being public and continuing to stay public, and try to lower that as much as we can consistent with our obligations to the investing public.

So, I appreciate Ranking Member Huizenga raising that point. I think, long run, we need to get that ecosystem of both private company capital formation and public capital formation really looked at closely so that we encourage the U.S. to be the preeminent capital market.

One thing I wanted to concentrate on in this hearing today is a bill that I have introduced with my friend, Mr. Schweikert of Arizona. I have introduced this bill during my time in Congress, and it has gotten a good report in the past in previous Congresses, and it speaks to expanding the access to investors by expanding the definition of an accredited investor to include professional expertise. We introduced that in the 114th Congress, and it was passed favorably by the committee with strong bipartisan support, and received a 347–8 vote on the House Floor. It also received strong support in the committee during the 115th Congress, and a voice vote on the House Floor. But with the change in the Majority in the 116th Congress, this bill did not receive Floor consideration, and I hope, Mr. Chairman, we can do that.

Mr. Kupor, I believe you have had a chance to review the legislation. You and I have talked about the importance of an accredited investor definition before. I wonder if you would reflect on what the Commission has done, and do you think the bill that Mr. Schweikert and I are proposing would aid investors that have the professional qualifications and knowledge to be a bigger participant in that accredited investor rule in a private placement?

Mr. KUPOR. Thank you, Mr. Hill. Yes, I have reviewed it, and I agree with your general proposition, which is in addition to figuring out how we have more companies going public, we also need to figure out how we actually increase private access participation from more investors, and I do think expanding the definition of accredited investors would be very helpful.

One of the things that also could be considered is that in the crowdfunding legislation that was part of the JOBS Act, this Congress decided that there were certain dollar limits, for example, that they were comfortable with, even unaccredited investors investing in that market. So, another potential way to expand that access to investors in the private markets would be to adopt that language and give people, for example, a set number of dollars that even unaccredited investors could invest in the private markets.

And then finally, I think we have discussed this as well, the other way to help increase private market access for unaccredited or even accredited investors under a new definition would be to look at expanding fund-level investment opportunities by giving people the benefit of professionally managed funds and revisiting, for example, the 3(c)(1) limitations on the number of accredited investors that are currently limited to 100 in those funds. Those I think would expand access, as well.

Mr. HILL. That is helpful, because I think we want to do both. I think we want to make sure that our public investors, through 401(k)s and through their IRAs and through their company pension plans have more opportunities, as you have outlined, to invest in public companies. The number of public companies has been cut in half over my business career. But we also want to safely give them opportunity to participate in a private market if, in fact, as you argue, companies are staying private longer.

Give me one thing that would lower that marginal cost of being public so that a small or mid-cap company might be inclined not to wait until it is huge to go public? What would be the top thing for you?

Mr. KUPOR. To me, I think the framework that this Congress laid out on the EGCs is the right framework. So if you could extend the time period under which those issuers could take advantage of the lighter regulatory environment for EGCs that exists today, I think that would be very meaningful.

Mr. HILL. Good. Thank you so much.

I yield back, Mr. Chairman.

Chairman SHERMAN. Thank you.

I now recognize Mr. Foster for 5 minutes.

Mr. FOSTER. Thank you, Mr. Chairman. First, just two quick comments on the thing that we have been struggling with on this committee for quite some years, which is, who is going to pay for the research on a small-cap firm at the edge of going public? There is an asymmetry because wealthy private equity investors have the wherewithal to look into details. If they are talking about investing in a potential unicorn, they can look and ask if the intellectual property is sound and defensible in court. That is never going to be cheap or easy or transparent, but it is a real cost, and someone ought to do it at the point that the issue goes public, because the retail investor is not going to have the wherewithal to do that kind of due diligence.

And a second general comment on it, I think it is very often pointed out that maybe one of the drivers of wealth inequality is the asymmetric access. I think it may actually be the other way around, that when you have an increasing concentration of wealth at the top, then those are the people who can realistically make private equity-type investments, which are the high-risk, high-reward investments. So the problem is at least feeding on itself, and we should look at it from both sides of that coin.

Okay. I really appreciate the argument about the benefits of competition between IPOs, direct listings, and SPACs. That has to be part of a good solution to this. But the question I have is, do we know enough at this point to define what a safe, sound, and economically efficient SPAC looks like? In an effort to at least carve out a subset of SPACs that are really reasonable things to invest in, can we define those? This huge boom in SPAC listings has given us a lot of data. So, do we know enough?

Does anyone want to grab that and try to say what are the essential things that we could do, and is it a wise thing to try to split off part of the SPAC market into well-regulated, responsibly-run entities?

Let's start with weddings. How do you make weddings less likely to end in divorce?

Ms. RODRIGUES. I am studying SPACs right now. I am studying the current crop of SPACs right now. I will have better answers when that study is concluded. I will say that I think all of the witnesses are in agreement that we need to equalize the regulations so there isn't this regulatory arbitrage. It shouldn't be that it is easier, that the liability is different, or the disclosure level is different in one versus the other.

So once that is done, I think a lot more disclosure—I will tell you, I am looking at these disclosures around the mergers right now, and they are incredibly complex. I can't really understand them, and this is what I am doing every day. They are opaque, and I am not exactly sure whose money is coming in and what their interests are. So, standardizing disclosure.

And then, the final thing that I think would make SPACs safer is to make it a real vote, to have there be a real vote from the market so that if 50 percent—and this was the intention at the outset of the form—of the SPAC shareholders want their money back, then it is not a good acquisition and it shouldn't go forward. But if more than 50 percent are willing to stay in, that is a market test.

Again, I am looking at the empirics, but that is where I am right now.

Mr. FOSTER. Any other comments or suggestions?

Mr. KUPOR. Mr. Foster, if I could comment on your earlier comment, you mentioned two things that I think were very important. One was you mentioned who will pay for research for these small-cap companies, because it is very critical, and I do think fundamentally this goes back to, is there an economic incentive for this through making sure that these stocks trade and they have appropriate volume and liquidity. So, some of the suggestions that I brought up around UTB suspension, and also looking at the global research settlement and making sure that there aren't impediments to research covers that may still be stemming from that.

And then, if I could just also comment on the second thing you mentioned, which is wealthy individuals being able to access private markets, I 100 percent agree with you that is a real issue, and I think that is why, again, this body should consider how you could improve retail access to the private markets in addition to all of the good work you are doing around IPOs. So, thank you for bringing this up.

Mr. FOSTER. Does anyone else have a suggestion?

Mr. DEANE. I would just also speak—when you ask about how we can identify better SPACs, they are evolving. I talked earlier about the dilution, the misaligned incentives.

I see the time is up. I would just say the current designs that they have are not locked in stone, and there could be changes. But I see my time is up.

Mr. FOSTER. Thank you, and I was just suggesting that maybe we can carve out a set of responsibly run SPACs and let the market, let the Wild West try to develop more efficient models.

My time is up, and I yield back.

Chairman SHERMAN. I believe next in seniority order is Mr. Davidson.

Mr. DAVIDSON. I thank Chairman Sherman for this hearing. I really appreciate our witnesses highlighting this important topic, and I have enjoyed the discussion thus far.

Ms. Rodrigues, in your testimony you stated that you do not believe there is anything fundamentally wrong with the current IPO process. But in Mr. Kupor's testimony, he eloquently pointed out that small IPOs, companies with less than $50 million in annual revenue at the time of their IPO, have declined from more than 50 percent of all IPOs in the 1980 to 2000 timeframe, to about 25 percent of IPOs over the past 15 years. Additionally, he points out that companies are trying to stay private much longer. The median time to IPO from founding hovered around 6½ years from 1980 to 2000, but now companies are staying private for 10 years or more.

Ms. Rodrigues, when you look at these facts, how can you say that there is nothing fundamentally wrong with the IPO process?

Ms. RODRIGUES. Thank you for that question. I will say, one, I want to be more precise. I think there is nothing wrong with the basic IPO process from a regulatory perspective. I think that the move to direct listings and SPACs is, in part, a function of companies' dissatisfaction with phenomenon like underpricing and the fact that there is a lot of uncertainty surrounding that traditional system, wanting to get more control over it, which they can get from a direct listing or from a SPAC.

I would echo what Mr. Kupor said about how it is pretty unattractive to be a small-cap publicly traded company, that there isn't that coverage, there isn't the trading volume. So, that is one explanation.

Another explanation is it is pretty darn easy to be private. There has been so much money sloshing around private equity firms. Venture capital firms are throwing money at these private companies—

Mr. DAVIDSON. Thank you for that reference to the private market. I think that would be a great hearing, as well.

When you talk about public markets, there are really important things. Mr. Deane highlighted some good topics on dilution. My colleague, Mr. Hill, who has a bill that I am a co-sponsor of, highlighted one of the barriers to participation in our markets with accredited investor rules. Frankly, Mr. Himes did a nice job talking about reference price, which you alluded to here, all a big deal in terms of affecting value for not just the companies that launch but the people who invest in them, and so broadly, access to capital.

But when you look at the things that are broken, the SPAC market and the volatility in it, is coming in after the IPO market. If you look back a few years ago, the initial corn offering market was in a kind of meltdown, and you saw some fraud.

Mr. Kupor, I appreciate you for highlighting that issue, because it is heavily dominated in the crypto space. For the structure of our market, the SEC failed to provide regulatory clarity, and that has kept your average investor from being able to hold these in retirement accounts. What has that meant for people, and what needs to happen in that space?

Mr. KUPOR. Mr. Davidson, as you mentioned, I think this is another example where I think we just have very significant disparity between, let's call it institutional or high-net-worth individuals versus traditional retail investors, which is for the former category people can afford to spend a lot of money on legal counsel and understand exactly what is the nature of these tokens, are they securities, are they not, what the SEC is likely to do. But for ordinary folks without that clarity from the SEC, it really does mean that they are missing out on what at least we do believe is a really important growth opportunity.

Mr. DAVIDSON. Yes, thanks for that. For example, because of that lack of regulatory clarity, there is no Bitcoin exchange-traded fund (ETF), though many have tried and are lingering in never-never land with some hope that there will be some clarity. Maybe with new Chairman Gensler, we will get there. But you can get a SPAC ETF. You can still buy those.

All of these highlight voids in the fundamental IPO market, and I really think that the market is trying to tell us the IPO market is not healthy, it is not fundamentally sound, it is broken, and everyone is trying to find a path around that.

Lastly, I want to thank Ranking Member McHenry for his bill on Regulation Crowdfunding (Reg CF). I think just the promise that has offered for crowdfunding should be looked at as a model, though we could expand to provide broader access and more democratic access to capital.

The last thing—and I am running low on time—is direct listings. I think Coinbase's direct listing highlights that it can be a viable model and all important areas, and I thank everyone for helping us get to this point in the hearing, and I yield back.

Chairman SHERMAN. Okay. We have five more questioners. We will be done in less than 30 minutes, unless there is a general consensus to do a second round of 2½ minutes per Member. So if you have a view on that, please text me.

Mr. Vargas is now recognized for 5 minutes.

Mr. VARGAS. Thank you very much, Mr. Chairman, for holding this hearing. And I especially want to thank the witnesses today. I think the most important question that came up today was, what about weddings and marriages?

I am going to give you the answer right now, very clearly. It doesn't matter if it is a wedding in Vegas or a traditional wedding. If you want to make the marriage work, if you love your spouse, you don't cheat on them. I have been married for 30 years; it works great, okay? There. That one has been asked and answered.

So now, we move to this. The way that traditionally we hold a hearing is that whatever party is in power has two or three or four witnesses, and then the party in the Minority has one witness. Normally, they don't agree on things. That is why you have the disparity, which is fine.

But I think we may have found something that everyone agrees on today, and that is why I want to pursue this line of questioning, and that is the issue of liability. I think Mr. Kupor said we should have the same liability system for all of these.

Section 11, as I understand it, is a strict liability regime. Issuers are made strictly liable for registration statements that contain an untrue statement of a material fact, or that they omit one. So, you don't have to prove causation or reliance on the misstatements. It is a strict liability statute and regime.

Now, did I understand correctly, Mr. Kupor, that you agree that an IPO should have the same—that the playing field should be the same for a SPAC and for an IPO, or am I misstating what you said?

Mr. KUPOR. No, Mr. Vargas. Yes, I agree that this Congress should determine—I am not taking a position on what the appropriate liability regime should be, but I absolutely agree with your position that we should have a level playing field and we should not have regulatory arbitrage that determines which path makes most sense for companies.

Mr. VARGAS. To me, that seems like a very big deal. I am going to ask Professor Rodrigues, that seems to me a huge issue with these forward-looking statements, do you agree?

Ms. RODRIGUES. Yes, absolutely.

Mr. VARGAS. Could you expound on that?

Ms. RODRIGUES. Sure. So, information is valuable. That is why issuers disclose it on their own, and that is why we require disclosure under the securities laws. If you are interested in a company, you are interested in what happened in the past, but you are probably as or more interested in what should happen in the future, what the CEO and the CFO think the prospects of the business are. That is why Congress, in 1995, said, okay, under the Private Securities Litigation Reform Act, you have a safe harbor and we can protect you if you want to say, hey, here is what we think is going to happen down the road.

But that is not for IPOs, because IPOs are a special world where the company is first coming out into the public markets, and so we have really strict liability standards. We want to make sure that everything there is accurate, that there isn't any material misstatement.

Mr. VARGAS. And do SPACs have that today?

Ms. RODRIGUES. They do, because when they go public they are just an empty shell. What you really care about is when they find that private target and they are acquiring it. That acquisition is effectively an IPO. But in that, the Vegas wedding IPO, then they get to say whatever they want about the company's prospects in a way that a traditional IPO can't, and that is just not fair, right? There is a different standard depending on which way you take to—

Mr. VARGAS. I agree with that.

Does anyone disagree with that?

Mr. Park, do you disagree with that?

Mr. PARK. No, I don't. In fact, I think this whole notion of forward-looking statements and the accuracy of that is very important, and the way that we know that is because if we look back most recently to COVID, actually, the strength and the certainty of these forward-looking statements are very important to make sure that not only do investors have protections, but also other business owners who rely on what some of these other businesses are doing.

For example, the SEC, back in April 2020, had to give guidance to a lot of executives on how to handle a very unprecedented and uncertain time as it pertains to how COVID affects their business models, and that shows how strong the protections are for public companies right now.

If you also think about this from another point of view, if I am a travel agency and I need to look at airlines and hotels and what they are doing, I need to trust their forward-looking statements as well.

Mr. VARGAS. Yes. My time has expired, but I am glad that we may have agreed on something here.

Thank you. I yield back.

Chairman SHERMAN. Thank you. And I would add one more thing for a happy marriage: Do not undervalue your spouse, or underprice in this world.

The gentleman from Ohio, Mr. Gonzalez, is now recognized for 5 minutes.

Mr. GONZALEZ OF OHIO. Thank you, Mr. Chairman, for holding today's hearing, and thank you to our witnesses for being with us today, and thank you to Mr. Vargas for preaching a little bit; I enjoyed that.

In any event, over the last year we have seen significant changes in the way that retail investors of all stripes are engaged in our capital market system, and personally, I am encouraged to see more and more retail investors invested in the market in an effort to better their lives and build a more prosperous future for their families.

Of course, that is not without risk. That is how markets work. And in this case I do think it is important that we take a step back and recognize that whether we are talking about the crypto or NFT markets or SPACs, the proliferation of riskier investments has been driven by a zero-interest-rate world, which has resulted in a fully valued stock market and investors moving further and further out on the risk curve. I don't think we have mentioned that, but I do think it is important to keep that in mind as we debate what is happening in our markets.

So rather than doing what I fear my colleagues on the other side are doing, which is trying to turn off options at times for retail investors to put their capital to work and to make it harder for companies to raise capital, I do think we need to recognize the uniqueness of the moment and try to find ways to improve the efficiency and the strength of our capital markets for all participants.

Mr. Kupor, in your testimony you talk about the two-tiered capital market structure where, because more companies are willing to go public later, a disproportionate amount of value is created in the private markets, which structurally lock out retail investors. I completely agree. You also correctly point out that having multiple avenues to go public is a good thing from a competitive standpoint.

And we haven't talked much about direct listings, and I want to hear from you from the perspective of the entrepreneur or the founder. When it comes to a direct listing, what is the benefit specifically of a company looking at that as a vehicle to go public? And if you could also touch on the projections that are made in that process, because I see projections when I look at the YouTube videos and things like that, but I would love for you to just sound off on that, if you could.

Mr. KUPOR. Sure. Thank you, Mr. Gonzalez.

So, yes, with respect to direct listings, as mentioned before, typically the companies that are choosing this route are ones that don't have a need for primary capital. So they are able, again, to avoid the dilution, quite frankly, that you would have in the IPO process, and that is very positive.

The second benefit to direct listings is they utilize what I would call more of an auction mechanism to actually try to derive the opening price for the stock. We see a little bit of advancement here in the traditional IPO markets. There are some banks trying to do a modified auction process, but the kind of process that goes into a direct listing is still a much more robust process. Therefore, for people who are concerned about potential underpricing or things of that sort, there is probably a closer market price and a better way to discern that market price that happens there.

So, it has been very positive. As I said, the reality is we have had very few. We have had about six of them in the technology market, so I think there is a lot of work to be done there. But it also has the positive effect, as you mentioned, from a competitive perspective. It has forced traditional underwriters and IPOs to kind of tighten their pricing windows, which I think has been positive, and it has forced people to think about things like lockups, for example, which can create distortions based on supply and demand in the market.

I think making sure direct listings stay as a viable option will also actually address some of the challenges that many of you have mentioned around traditional IPOs.

Mr. GONZALEZ OF OHIO. Thank you.

Mr. Deane, one thing that you talked a lot about on the SPAC side with respect to disclosures and subsequently incentive alignment—and I think that is right in many ways. I am personally somebody who wants to be able to take risk. I just want those things disclosed so I can understand them. And more or less, I do think you can figure out what the promote structure is in a SPAC if you go through the listings. Yes, it is hard, but I think you can do it.

One thing you didn't touch on, which sort of surprised me, is with respect to the syndication of the risk capital at the pre-IPO stage, if you will. So in essence, if you are purchasing pre-merger shares in a SPAC, you are really just buying a sponsor. But is it possible today for someone to know who owns the sponsor, or can the sponsor syndicate the risk capital such that you don't actually know?

Mr. DEANE. To be honest, I am not certain what your question is about. You are asking who actually stands behind the sponsor?

Mr. GONZALEZ OF OHIO. Yes. The sponsor has to put up risk capital. Can the sponsor syndicate that, sell it off, and not disclose it?

Mr. DEANE. In the pre-IPO, I would question that. But to be honest, I would like to look at it further and get back to you.

Mr. GONZALEZ OF OHIO. Sure.

Mr. Kupor, do you know how to answer that?

Mr. KUPOR. I believe that is correct.

Mr. GONZALEZ OF OHIO. So, the answer is yes. I think that is another area where I think from a disclosure standpoint we probably need to do a little bit better work.

I have run out of time, but thanks again for the hearing. With that, I yield back, and thanks for the marriage advice.

Chairman SHERMAN. Thank you.

Good news for our witnesses. Our friends on the other side of the aisle did not want an abbreviated second round, so we will be done in around 20 or 25 minutes. That puts a special onus on the remaining questioners to ask brilliant and incisive questions, which is why I now recognize Mr. San Nicolas.

Mr. SAN NICOLAS. Thank you, Mr. Chairman, for the introduction. That is very kind of you.

I wanted to address my question to Professor Rodrigues. As I am listening to this whole conversation about SPACs, I am brought back to the old days when I was in the investment industry and we had to learn about the different types of management companies, and I wanted to see if you could really help us to understand the difference between a SPAC as we are discussing it today, and a closed end equity fund that would typically be somewhat similar in its function of pulling together investors and making specific investments or acquisitions.

Ms. RODRIGUES. Well, I don't know that I can. I think a closed end equity—if you could describe a closed end equity fund a little more to me, then I can probably take it from there. But thank you for the question very much.

Mr. SAN NICOLAS. I just wanted to put it out there. Maybe Mr. Deane can elaborate, perhaps, on what the differences are between a closed end equity fund and a SPAC.

Mr. DEANE. Again, I am not—as I understand it, there are closed end mutual funds. I am not quite sure. But if that is what you are asking, they would own assets. They would buy—they would invest in different things. It would be closed end, but it would still be—other than that, it would be like a mutual fund, and it would have diversity. It would probably have a diversified portfolio, and you could look at it and see what those assets are.

Now, in a SPAC, it is different because first, at the very beginning of the IPO, the SPAC is just saying, we are out there, give us some money, and we are going to go find a great deal, trust us. There are no assets other than the money that comes in.

And a second point, they do find a merger market, but at that point it is just one company, a private company that they are taking public. It is not a diversified portfolio. It is just a risk on one company.

That is really the best I can do to respond.

Mr. SAN NICOLAS. When a SPAC is being formed, do the investors in the SPAC know what company is being targeted for acquisition?

Mr. DEANE. No, Congressman, they do not. A SPAC might say, we are going to look at EV, electric vehicles, or we are going to do something in the tech space or biotechnology. So, you might have an idea of what sector it is. But if the question is do they identify a specific company that they plan to take public, the answer is no.

Mr. SAN NICOLAS. So why would an investor invest in a SPAC prior to its IPO if they have no idea what they are investing in?

Mr. DEANE. That is a great question.

Mr. SAN NICOLAS. The reason I am asking is that there are really only one of two answers. Either, one, they do know what they are going to invest in, and then we are talking about some serious potential insider trading; or they don't know what they are going to invest in, but they are investing because of the management team of the company, but then we are talking about open-ended or closed-ended management companies that really should be under the regulation of the Investment Company Act of 1940.

So, I am sitting back and I am looking at SPACs, and it doesn't really make any sense to me as to why they would be treated as a typical IPO, a typical company that is being formed under the equity markets. They really sound like they are forming under the status of management companies and trying to skirt around the Investment Company Act of 1940; or two, they actually know what they want to invest in, in advance, and then we are talking about insider trading and a bunch of investors knowing what they are going to go after and kind of structuring the entire acquisition in a manner that is going to guarantee that all the players are going to make a certain amount of margin at the expense of retail investors.

Professor Rodrigues, do you have anything that you perhaps would like to add to that analysis?

Ms. RODRIGUES. Yes, that was very helpful. Thank you to Mr. Deane and to you.

The idea, in theory, is that it is a bet on management, that the management either has this experience in private equity that makes it able to identify some attractive target or it has public company operating experience that can help shepherd the company once it is identified.

I will say that in the study I am doing right now, sometimes there are multiple targets that wind up being acquired. It isn't just one company. It is two or even three that are sometimes related and sometimes not.

Mr. SAN NICOLAS. And just to close, because my time has expired, Mr. Chairman, perhaps we need to regulate SPACs as management companies and not as equity IPOs.

Thank you, Mr. Chairman. I yield back.

Chairman SHERMAN. The Chair will advise Members that if I cannot see your face on screen, I cannot call on you when your turn arrives. But Mr. Emmer's face is definitely on screen and he is now recognized.

Mr. EMMER. Thank you, Mr. Chairman.

Participation in the IPO process has significantly slowed over several years. The number of IPOs declined more than 63 percent in the 1990s to the 2000s, and then it stayed flat up until 2020.

What is interesting is that at the same time, the United States has doubled the regulatory compliance costs a business has to take on for going public in a traditional IPO. It costs, on average, $2.5 million for a company to achieve initial regulatory compliance for going public, and an additional $1.5 million annually thereafter. These are the SEC estimates.

This is just not feasible for our small and emerging growth companies. These businesses are turning to more streamlined approaches to access capital like SPACs, direct listings, or even staying private. An overly burdensome IPO process hurts American consumers by eliminating their access to the markets and ensuring that only institutional investors can invest in these innovative emerging growth companies. It is critical that our capital market structure meets the needs of American companies regardless of their size or type.

I am excited that we are going to reintroduce my bill, the Main Street Growth Act, which passed out of the House in the 115th Congress, and passed out of this committee unanimously thanks to my colleagues on the other side of the aisle, many of whom are present with us today. This bill will allow the SEC to provide for the creation of venture exchanges. These specialized securities exchanges offer streamlined regulation and strong investor protections which will help small and emerging growth companies gain access to capital, create jobs, and help the economy rebound.

Mr. Kupor, in your testimony you note that fewer small companies than ever are going public. But the good news for capital formation is that there are now multiple choices for companies that are considering going public—traditional IPOs, direct listings, and SPACs. Given the current landscape and the importance of having new companies join the marketplace, can the creation of venture exchanges help incentivize more emerging growth companies to go public?

Mr. KUPOR. Thank you, Mr. Emmer. I appreciate that. You and I have discussed this a little bit before.

The concept of a venture exchange, I think is a very good concept, the basic idea being how can we address from a regulatory perspective, and then, importantly, from an after-market perspective things like liquidity and volume of trading that impacts small-cap stocks. So, the concept makes a lot of sense to me. I think the devil is in the details, as you and I have discussed.

We want to make sure that we don't create kind of adverse selection risks associated with companies that might choose to list on a venture exchange relative to the traditional market, and again these are issues that you and I have talked about before. Some of the experience, for example, in the A markets in the U.K. have exposed some of those challenges. So making sure that the venture exchanges don't create that and that there is a seamless opportunity for companies to effectively graduate over time from a venture exchange into a more traditional national market exchange, as we have today, I think would be important to ensure high-quality issuances in those markets.

Mr. EMMER. Just following up on that, can you elaborate a little bit more and speak to the importance of facilitating a competitive marketplace where small and medium-sized companies can be attractive to investors, since that marketplace is currently dominated by larger-cap companies?

Mr. KUPOR. Yes, it is really important, and I think the issue goes back to something one of your colleagues mentioned, which is that we have taken a bit of a one-size-fits-all approach to regulating companies. Many things that have worked well for large companies just don't work well for small companies, so we really need to do that.

And look, to me, competition is great. I mentioned before that we are already seeing changes in how underwriters are doing pricings in traditional IPOs as a result of direct listings and SPACs being viable alternatives. We are seeing reforms around how people think about lockups, which also, as I mentioned, create strange trading dynamics in these companies. And you would expect that also may impact pricing, quite frankly, and the fee structure, which I know many people have talked about on this committee.

So, I think the last thing we want to do is restrict choice. Clearly, we should make sure that things are regulatory-compliant and are available to others. But if we do something that kind of constricts the choice for issuers, I think we will lose on a lot of these great opportunities.

Mr. EMMER. I appreciate that.

Mr. Chairman, I yield back the balance of my time.

Chairman SHERMAN. Thank you.

I now recognize the new Vice Chair of our subcommittee, who brings tremendous business and financial experience to that role, for his first questions as Vice Chair, Mr. Casten.

Mr. CASTEN. Thank you so much, Mr. Chairman. I am looking forward to the responsibilities you will be assigning me.

It strikes me that on this subcommittee, we talk about trends in capital markets as if the investors were static and they only reflect changes in companies' access to capital. We all know that is not true. In the last 3 decades, we have seen transformative changes in the institutional sector, the pension funds, the endowments, which used to have all of their capital in Treasuries and utility stocks and have now created these whole investor classes, alternative investment classes and real estate investment trusts (REITs) and private equity and venture, and that is awesome. It has completely changed the market. It has created opportunities where companies, like the company I used to run, that were really too small to go after private markets, still had access to capital, and that is a good thing.

It has also created an entirely new class of actors in our financial markets. They used to be owners of wealth and people who needed wealth, and now we have custodians of wealth in the middle, and some of them have done a great job. Some of them haven't, but it has changed the dynamics. There is nothing wrong with that.

I sort of view SPACs and PIPEs as things that live in that continuum, right? Because every company that has a single, large, sophisticated investor would love to still have the access to capital with the less sophisticated investor. It makes your life easier as a manager. And I think the challenge of regulation is always trying to figure out how to ensure that access to capital survives, while at the same time, not taking advantage of unsophisticated investors.

So my first question for you, Mr. Park, is you mentioned that the challenge with SPACs is that they are putting their trust in a sponsor rather than the company. Isn't that essentially the same thing that happens when investors invest in a private equity fund? Is there any fundamental difference there?

Mr. PARK. Representative Casten, the major difference between the SPAC and a private equity fund is that, again, with the private equity fund there is going to be a debt investment where the investor has some security that they have, versus in a SPAC they are the junior most if there is other debt type of investor there.

I should also point out that there are some significant differences between how SPACs work and also some of these private equity funds. Again, part of the business model for a lot of these SPACs is that you need a lot of marketing and a lot of hype around them in order to attract investors. That is why you see the SEC warning a number of investors, don't just buy a SPAC just because they hire a celebrity to go and promote them, right? That is a major concern there.

Mr. CASTEN. Sure, and I take your point. I am really just talking about the equity investors in both, that if you view it as along a continuum, the equity investor is taking a bet on the sponsor in both cases. I take your point, and I don't mean to criticize. I just want to run through some other questions.

Mr. Deane, you mentioned in your testimony that there is pressure to deploy capital in a SPAC before the window closes. Is that fundamentally different from a private equity fund that is nearing the end of its lockup period, that has committed capital that is still undeployed?

Mr. DEANE. I would say it is the same, except that maybe a private equity (PE) firm might have more years. Maybe it will have 7 years, or 5 years to do it. The SPAC is usually either 18 months or 2 years.

The other difference, if I could, is that a PE firm will often have a diversity of targets, a diverse portfolio, whereas the SPAC is usually, if not always, one firm, one target.

Mr. CASTEN. Okay. And I want to be clear that I am in no way meaning my questions to be leading and saying one way or the other. But we have all seen the statistics that the overwhelming majority of returns in the alternative asset class base is driven by a tiny number of firms, and there are actually a lot of people who are thought of as sophisticated investors, who are losing their shirt on that side.

I guess I will start with you, Mr. Deane, because I still have you on the screen. But capital markets are going to continue to evolve. They will evolve in response to what we do from a regulatory perspective. And if the issues are the compensation structure and the incentives, let's make sure we think about where those guardrails should be. If the issue is that there is a specific class of investment that we want to prohibit, okay, then let's do that. I just want to make sure that in thinking about the compensation structure of SPACs, the lockup period, the deployment, I want to make sure we are focusing on the right issues.

So if you were looking at the broader space of money going into somewhat less conventional structures, are there guardrails that cross that whole continuum we should be thinking about, or is this just a SPAC issue?

And I see I am out of time, so perhaps we will have to take that offline, but I would appreciate any of your thoughts in writing after the hearing is over on that question.

Mr. DEANE. Saved by the bell. But I would be happy to respond afterwards.

Mr. CASTEN. Thank you.

Chairman SHERMAN. We look forward to your written response to that question, and we all look forward to the questions of Mr. Steil, who is now recognized for 5 minutes.

Mr. STEIL. Thank you. I appreciate you holding this hearing, Mr. Chairman.

Mr. Kupor, as you know, most venture startups are emerging growth companies. Can you walk us through your analysis of some of the benefits of EGC status?

Mr. KUPOR. Yes. Thank you, Mr. Steil. There are several things.

Number one, which we have now extended more broadly, is the idea of confidential filings and the idea of test-the-waters are very, very important, because this really gives the companies an opportunity to talk to investors before they have to kind of make a final determination, quite frankly, of what the right path is, and it really is beneficial.

Number two is, as we have talked about before, the idea of reduced regulatory burdens, the ability to have different Sarbanes-Oxley-related requirements and other things that are generally geared towards smaller companies. So, effectively, think of it as an on-ramp to becoming a public company. If we make that on-ramp a little bit easier, we are more likely to see public companies go out.

Mr. STEIL. And maybe you could comment about bringing more companies into the public markets, how that EGC structure assists companies in accessing capital? Can you comment on that?

Mr. KUPOR. Yes. At the end of the day, what it means is that if you are an investor, it just means that there is more money that the company is going to have access to on their balance sheet that can go towards research and development or other important initiatives they are doing, versus that amount of money being diverted towards regulatory expenses. It has been very beneficial—particularly, you see this in the biotech market, which has been very robust over the last several years. That tends to be a bit of a smaller-cap market, at least relative to the IT markets, and I think those companies have substantially benefitted from the ability to deploy capital in the most promising areas versus on regulatory structure.

Mr. STEIL. We are talking about how companies enter. How about companies that are already in EGC status, and particularly those that have either already lapsed through the 5 years or that are approaching that lapse, what are the implications of losing EGC status for some of those key companies?

Mr. KUPOR. Yes. I think it is really the same. If we could extend that time period from 5 years to 10 years, or whatever this body thinks is appropriate, I think it has the same beneficial impact. Think of it as you have a fixed pot of money on your balance sheet, and the question is, where are you deploying those resources? The more we can divert those towards productive research and development-related expenses, I think that is beneficial for the economy, and it is beneficial for those issuers, as well.

Mr. STEIL. So in your view, if we extend the EGC status, there are going to be benefits not only to the companies but really to the R&D ecosystem, to employees, and all the way down that entire pipeline for those EGC companies and their stakeholders?

Mr. KUPOR. Yes, I do believe that, Mr. Steil.

Mr. STEIL. I appreciate it. And I appreciate you joining us today.

And I appreciate you, Mr. Chairman, for holding today's hearing. With that, I will yield back.

Chairman SHERMAN. Thank you.

We now turn to the distinguished gentleman from Missouri, Mr. Cleaver, who is also the Chair of our Housing, Community Development, and Insurance Subcommittee, for 5 minutes.

Mr. CLEAVER. Thank you, Mr. Chairman.

I just have one question. I think most of the issues that I was concerned about have been raised by the members of the intelligentsia of your committee.

What I wanted to just say is that I am amazed by the notoriety of our celebrity culture in this country. It is just absolutely amazing. Shaq played basketball, and now he is in the middle of giving financial advice to folks. He made a lot of money, so maybe he learned a lot about money.

But back in March, the SEC issued an investor alert regarding celebrity involvement in SPACs. In the notice, the SEC warned individuals never to invest in a SPAC based solely on a celebrity's involvement.

I don't know if that will stop anybody from doing it, but, Mr. Park, would you agree that this trend reinforces the fact that SPACs generally represent a very speculative investment?

Mr. PARK. Absolutely, Congressman Cleaver, and that is a great point that you raise. What I find really noteworthy about how SPAC sponsors are relying on celebrities to promote themselves is that they are implicitly saying that by doing so, they think that they can attract retail investors to invest in their SPACs just merely by the association alone rather than on their business model, their financial statements, or really looking at it in any kind of substantive way.

What is kind of notable about this too is that hiring celebrities really isn't a new strategy. We have seen celebrities being used time and time again to promote different types of financial products, whether it is reverse mortgages, annuities, and lately different cryptocurrencies too, right? So, I think that is very noteworthy.

What I would also point out is that sometimes the issuers can also have a bit of a celebrity status of their own, and that can also lead to some poor investments that way.

I think that for SPACs, the perfect type of investment that goes wrong is that a company is very heavily hyped, you have a compelling narrative around the founder, and it also really appeals to our desires for a product or a company that will really improve the world. But the problem is that sometimes we can find that it is fraud. The example that comes to mind for that is Theranos, which kind of meets all of the criteria of that, and unfortunately just bilked a bunch of different investors, some of whom were more sophisticated than your average retail investor.

Mr. CLEAVER. Thank you very much. This is an all-day conversation, at least for me, because I am just amazed at what goes on. I am not sure that the statement issued by the SEC is going to do anything in and of itself. We are almost worshipful when it comes to celebrities in this country.

Anyway, thank you very much, Mr. Park.

And I yield back, Mr. Chairman.

Chairman SHERMAN. I want to thank all of my colleagues for participating in this hearing, particularly those who were here at the very end. And I want to thank our witnesses for their testimony.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

With that, the hearing is adjourned. Thank you.

[Whereupon, at 1:53 p.m., the hearing was adjourned.]

A P P E N D I X

May 24, 2021

CFA Institute

Testimony before the
Investor Protection, Entrepreneurship, and Capital Markets Subcommittee
U.S. House Committee on Financial Services

"Going Public: SPACs, Direct Listings, Public Offerings, and the Need for Investor Protections"

Stephen Deane, CFA
Senior Director of Legislative and Regulatory Outreach
CFA Institute

May 24, 2021

Chairman Sherman, Ranking Member Huizenga and Members of the Subcommittee:

On behalf of CFA Institute, let me thank you for the invitation to testify at this hearing. I am Senior Director of Legislative and Regulatory Outreach for the Americas at CFA Institute. My work focuses on capital market policies. I also serve as a volunteer member of the Markets Advisory Council of the Council of Institutional Investors. Previously, I served for more than nine years at the U.S. Securities and Exchange Commission, including in the Office of the Investor Advocate (since its inception) and as the Commission's staff liaison to the Investor Advisory Committee. It is an honor to appear before you today.

CFA Institute is a not-for-profit, nonpartisan global association of investment professionals that sets the standard for professional excellence and credentials. The organization is a champion of ethical behavior in investment markets and a respected source of knowledge in the global financial community. Our aim is to create an environment where investors' interests come first, markets function at their best, and economies grow. Our Mission Statement is, "To lead the investment profession globally by promoting the highest standards of ethics, education, and professional excellence for the ultimate benefit of society."

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1401 New York Ave. NW
Suite 330
Washington, DC
20005-2269 USA

+1 (202) 908 4520 tel
+1 (202) 908 4538 fax
info@cfainstitute.org
www.cfainstitute.org

SPACs: Two Starkly Different Worlds

SPACs present two starkly different worlds. Two different narratives. Two different transactions – the initial public offering (IPO) and the subsequent merger in lieu of an IPO. Two different sets of investors – big, sophisticated investors on one side, and individual investors on the other. And two starkly different sets of investment outcomes – excellent for the big investors who exit at the time of the merger, and poor returns or losses for the ordinary investors who stay on.

One narrative of SPACs—the optimistic one—mixes hype and hopes in touting perceived benefits of SPACs over traditional IPOs. This narrative portrays SPACs as the poor man's private equity, allowing ordinary folks to get in on the ground floor of profitable companies. If they don't like the merger, they can get their money back.[1] SPACs also bring private companies into the sunlight of public markets without the perceived drawbacks of the traditional IPO.

The second narrative points to troubling features of SPACs: conflicts of interest, dilution, lucrative profits for big investors, and a track record of dismal returns for ordinary investors. These features threaten to feed into a third, all-too-familiar narrative—that Wall Street is rigged.

Winners and Losers: A Pattern of Starkly Divergent Investment Returns

Investment returns offer an unforgiving reality test for any investment product, including SPACs. Unfortunately, SPACs have displayed a clear pattern of winners and losers. Big investors – the SPAC sponsor, the hedge funds and others who invest in the IPO, and investors in the PIPE – generally do very well. Retail investors—who often buy their shares at the time of the merger announcement and hold them into the post-merger period—generally do poorly.

Two recent studies document this pattern of divergent investment returns. The first study ("the Klausner et al study") analyzed the 47 SPACs that completed mergers between from January 2019 to June 2020.[2] The second study ("the Ritter et al Study") examined the 114 SPAC IPOs from January 2010 to May 2018.[3]

The Klausner et al study finds that sponsors have fared well, even in cases where the post-merger company has not. Specifically, sponsors enjoyed a mean return of 393% for both three and six

[1] This is close to a money-back guarantee, though there are some differences. Investors are only entitled to their pro rata share of the trust account, which may be less than the market price they paid for their shares on the market. *See* SEC, What You Need to Know About SPACs – Investor Bulletin (Dec. 10, 2020), "(SEC 2020"), available at https://www.sec.gov/oiea/investor-alerts-and-bulletins/what-you-need-know-about-spacs-investor-bulletin.

[2] Klausner, Michael D. and Ohlrogge, Michael and Ruan, Emily, A Sober Look at SPACs, ("Klausner et al"), (October 28, 2020). Yale Journal on Regulation, Forthcoming, Stanford Law and Economics Olin Working Paper No. 559, NYU Law and Economics Research Paper No. 20-48, European Corporate Governance Institute – Finance Working Paper No. 746/2021, Available at SSRN: https://ssrn.com/abstract=3720919 or http://dx.doi.org/10.2139/ssrn.3720919

[3] Gahng, Minmo and Ritter, Jay R. and Zhang, Donghang, SPACs, ("Ritter et al"), (January 29, 2021). Available at SSRN: https://ssrn.com/abstract=3775847 or http://dx.doi.org/10.2139/ssrn.3775847.

CFA Institute

1401 New York Ave. NW
Suite 330
Washington, DC
20005-2269 USA

+1 (202) 908 4520 tel
+1 (202) 908 4538 fax
info@cfainstitute.org
www.cfainstitute.org

months after the merger, and 187% after 12 months. (Median returns after 12 months were a more modest, but still lucrative, 32%.)[4] The Ritter et al study noted, however, that sponsors' actual profits may be less than they appear. That is because sponsors give away some of their compensation, in the form of shares and warrants, to certain other investors as inducements either to invest new capital or refrain from redeeming their shares.[5]

Klausner et al also found that IPO investors—who invest when the SPAC first launches its IPO and, in most cases, redeem their shares at the time of the merger announcement—earned mean annualized returns of 11.6%.[6] The Ritter study– using a different time period and different weightings—found an average annualized return of 9.3%. These are excellent returns for an investment which, as explained below, involves minimal risk.

These returns stand in stark contrast, however, to those of the post-merger public company. This is important, because the post-merger returns represent what retail investors will earn by investing around the time of the merger and holding on to the stock.

The Klausner study found that the sample's 12-month mean return after the merger was -34.9%.[7] (The median return in that time period was an even worse -65.3%). The SPAC cohort also underperformed benchmarks involving an IPO index and the Russell 2000. The study also analyzed returns going back to 2010. For every year since 2010, SPAC post-merger one-year returns underperformed the Russell 2000 by 10% or worse. Tellingly, the study also found the poor returns were highly correlated with the level of dilution.

The returns were also negative, but not quite that poor, according to the Ritter et al study. Specifically, it found returns of either -15.6% or -4.0%, depending on how they were measured.[8] In sum, these findings present a consistent track record of profits for certain types of investors and losses for others.

Questionable Design Features of SPACs

Are there systematic design features of SPACs that explain this strikingly divergent record of returns, which draw a sharp line between SPAC winners and losers? The two studies point to three particular features of SPACs: dilution, misaligned incentives, and an uneven regulatory playing field that permits forward-looking statements at the time of the merger.

[4] *See* Klausner et al, *supra* note 2, at 39.
[5] Sponsors forfeit an average of 34% of their common share promotes and 42% of their private placement warrants, according to the study. See Ritter et al, *supra* note 3, at 6.
[6] *See* Klausner et al, *supra* note 2, at 18.
[7] *Id.* 34.
[8] The difference in returns is based on how the researchers weight the shares. The less negative number (-4%) only counts the money that public SPAC investors leave in after redemptions. In other words, this number reflects the fact that investors redeem most of their shares in deals that produce the lowest returns. *See* Ritter et al, *supra* note 3, at 5.

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1401 New York Ave. NW
Suite 330
Washington, DC
20005-2269 USA

+1 (202) 908 4520 tel
+1 (202) 908 4538 fax
info@cfainstitute.org
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Before elaborating on these features, it may be helpful to review the basics of how a SPAC works. A SPAC – short for Special Purpose Acquisition Company – is a publicly listed company set up for a single purpose: to find a private operating company, merge with that company, and thereby take it public, thus bypassing the traditional IPO process. SPACs typically have 18-24 months to complete that merger or else dissolve and give shareholders their money back.

Dilution

The SPAC sponsor arranges its IPO, manages the search for a merger target, and negotiates with the target on merger terms. As compensation, the SPAC receives 20% of the post-merger shares for a nominal price. This is called the sponsor's "promote," and it represents dilution of the future returns of the post-merger public company.

The very first investors in the IPO often include hedge fund regulars known as the "SPAC Mafia." These initial investors purchase units, which are almost always priced at $10 each. These units consist of shares, warrants and, in some cases, rights.[9]

Warrants give the holder the right, but not the obligation, to buy shares (or a fraction of a share) at a certain price (for SPACs, $11.50 per share) from the post-merger company. After about two months (usually 52 days after the IPO), the warrants and rights detach from the shares and can be traded separately.[10] After this time, an investor buying shares on the public market will receive no warrants or rights. The initial bundling and subsequent unbundling of warrants and shares is a critical feature to which we will return.

The SPAC places the proceeds of the IPO in a trust. There the money remains for months, while the sponsor searches for a merger target. The SPAC will use this money to complete the merger. In this pre-merger period, the SPAC has no operating business. It has no products or services to sell.

At the time of the merger announcement, investors—big and little—can ask for their money back. The greater the redemptions, however, the more the trust is depleted. The SPAC will need this money to complete the merger and provide the merger target with capital—just as the merger target would receive capital from IPO proceeds if it had chosen that avenue to become a public company.

To replenish the trust (at least partially), SPAC sponsors often make private deals with certain investors—who could be institutional investors, private equity, or other professional investment firms— in transactions known as PIPEs (Private Investments in Public Equity). To induce these

[9] The rights can be exchanged for a fraction of a share (such as one-tenth of a share) at no cost, provided that the SPAC merger is completed. *See* Klausner et al, *supra* note 2, at 7.

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1401 New York Ave. NW
Suite 330
Washington, DC
20005-2269 USA

+1 (202) 908 4520 tel
+1 (202) 908 4538 fax
info@cfainstitute.org
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investors to invest in the PIPE, the SPAC sponsor often sweetens the terms with side deals, such as a discounted price. These side deals represent a second source of dilution to the SPAC.

The merger process is called the "de-SPAC." It results in a newly merged company. In this manner, the previously private company becomes a public reporting company without having gone through the traditional IPO. This newly public company is an operating company, with products or services to sell.

In practice, nearly all of the initial IPO investors choose to dispose of their shares at the time of the merger announcement.[11] They can do so in either of two ways. If the current share price exceeds their initial purchase price (typically $10), they will sell their shares on the open market. If the market price is less than the initial purchase price, they will instead redeem their shares to the SPAC, which will take money from the trust to pay them (plus modest interest that the money has earned while in the trust).

Critically, however, when initial IPO investors redeem or sell their shares, they get to keep their warrants. This is about as close to a free lunch as one can get in the investing world. Because their money has been placed in a trust, the investment has been close to risk-free. It's true that, by tying their money up for months in the trust, the investment may entail opportunity costs. Nonetheless, Ritter et all liken this arrangement to a "*default-free* underpriced convertible bond with extra warrants."[12]

It should also be noted that the initial IPO investors are allowed to vote for or against the merger, regardless of whether they retain or dispose of their shares. They will have an economic incentive to vote in favor of the deal – because they retain their warrants – even if they believe it is a bad deal.

In sum, SPACs entail several significant sources of dilution, including 1) the sponsor's 20 percent promote; 2) the warrants that the initial IPO investors retain (even if they dispose of their shares) and 3) discounts or side payments given to the PIPE investors. All of these sources of dilution represent future claims on the returns of the post-merger company. They represent a handicap that the company must overcome before it can return profits to ordinary shareholders.

Both of the studies cited above find that the dilution is highly correlated with subsequent poor returns of post-merger companies to date.[13] It is possible that a strong company can overcome these handicaps and reward its investors. In practice, however, the post-merger track record of

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[11] Among large institutions known as 13f filers, the study puts the mean and median SPAC divestment rates at 90% and 98%, respectively. As for the SPAC Mafia, more than half of these hedge funds totally divest before the merger. (Institutions with at least $100 million in specified equity securities are required to file 13f disclosures with the SEC.) *See* Klausner et al, *supra* note 2, at 17.

[12] *See* Ritter et al, *supra* note 3, at 34. (Emphasis in the original.)

[13] Correlation, however, is not causation. As Ritter et al note, it is unclear whether dilution causes poor returns, or instead whether inferior SPACs require more dilution to induce investments. *See* Ritter et al, *supra* note 3, at 4 and Klausner et al, *supra* note 2, at 37.

CFA Institute

1401 New York Ave. NW
Suite 330
Washington, DC
20005-2269 USA

+1 (202) 908 4520 tel
+1 (202) 908 4538 fax
info@cfainstitute.org
www.cfainstitute.org

SPACs – dating back to 2010 – shows how hard that is to accomplish. Most SPACs have been unable to overcome these hurdles.

Could this time be different? No one can predict the future, and it is always possible that future returns will break the old pattern. It is also possible that SPACs could evolve new features to reduce dilution.[14] The evidence to date, however, points to the need for legislators and regulators to be vigilant in protecting investors and for investors themselves to exercise informed judgment in their investment decisions.

Misaligned Incentives

SPACs also present some misaligned incentives. For example, the sponsor has a strong financial interest to complete the merger – even if it is a bad deal for ordinary shareholders. If the sponsor makes no deal at all, the SPAC must return all the shareholders' money and dissolve the SPAC. In that case, the sponsor will lose its entire investment in the SPAC, which can total millions of dollars. It will receive no compensation whatsoever for its work of the past year or two. Its 20 percent promote will be worthless, along with any warrants or rights it had purchased.

As the deadline to produce a merger approaches, the sponsor will face increasing pressure 1) to find a merger target and 2) to negotiate the terms of the merger deal. A bad deal may nonetheless yield lucrative returns for the sponsor—even as it leads to poor returns for the regular shareholders in the post-merger company. And the pressures on SPAC sponsors can only be expected to grow more intense in the months ahead. Hundreds of SPACs are now competing to find and negotiate deals with private companies—even while competing with private equity firms, which are also awash in cash.[15] The competition may far exceed the limited pool of viable merger targets that will make suitable public companies; i.e., companies that 1) have systems, controls and resources in place to meet their obligations as public reporting companies and 2) can maintain or grow their business, and hence their stock price, as a post-merger publicly listed company.

The initial IPO investors also have incentives that are misaligned with those of public investors who buy their shares later on the public market. The IPO investors have an economic incentive to vote in favor of a merger, even if it is a bad deal. If there is no merger, the IPO investors' warrants and rights will become worthless. And, as noted above, these investors are free to dispose of their shares even while voting in favor of the merger and retaining their warrants and rights.

[14] Indeed, warrants have fallen more recently. *See* Ritter et al, *supra* note 3, at 36. Also, some SPACs have adopted features that are significantly more investor-friendly. So far, however, these improvements are the exception that prove the rule.
[15] *See* SEC 2020, *supra* note 1, ("***With an increasing number of SPACs seeking to acquire operating businesses, it is important to consider whether attractive initial business combinations will become scarcer.***"). (Emphasis in original.)

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1401 New York Ave. NW
Suite 330
Washington, DC
20005-2269 USA

+1 (202) 908 4520 tel
+1 (202) 908 4538 fax
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What about the incentives of the private investors in the PIPE at the time of the merger announcement? They have a mix of incentives, some aligned and some potentially misaligned with those of ordinary shareholders. These are typically sophisticated investors, and they gain access to confidential information about the merger that is not available to the public. (They typically agree not disclose or trade on the information, so as not to run afoul of Regulation FD.) Thus, if a prestigious private investor chooses to invest in the PIPE, the investment can signal to public investors that the deal has merit. In essence, retail investors may believe that they are riding the coattails of the due diligence conducted by the private investors. And since the private investors retain their shares after the merger, their incentives are aligned with the post-merger retail shareholders.

On the other hand, any side deals offered to the private investors in the PIPE can cause their incentives to diverge from those of public shareholders. These inducements represent a source of dilution that comes at the eventual expense of public shareholders. In addition, if the PIPE investors receive discounts as inducements, they will have a different yardstick than public investors to measure the success of the investment. For example, a private investment at, say, $8 per share can turn a profit sooner than a public investment made at the prevailing market price of $10 or more per share. In sum, the incentives of PIPE investors overlap but may also partially diverge with those of public investors.

Safe Harbor for Forward-Looking Statements

In a singular regulatory advantage over IPOs, SPACs have enjoyed a safe harbor from private liability to make forward-looking statements about the proposed merger (provided the statement is accompanied by meaningful cautionary statements).[16]

Yet the two parties making the forward-looking projections—the SPAC sponsor and the target company—both have incentives to promote the merger. The sponsor has a strong financial incentive to complete the merger, as we have seen, and the merger target has a similar incentive: the transaction will enable the private company to become a public company and receive the capital that the SPAC has raised.

In an IPO, in contrast, the issuer and the underwriter enjoy no safe harbor from private litigation for making any forward-looking statements. As a result, IPOs generally avoid forward-looking statements. This is an important protection for investors and market integrity, because it eliminates the risk of rosy and unrealistic forward-looking statements.

The disparate regulatory treatment of forward-looking statements makes for an unlevel playing. And yet the SPAC merger and IPO are functionally equivalent. Whether via a SPAC merger or IPO, the private company becomes a public one; i.e., it becomes subject to public reporting

[16] In a recent statement, however, John Coates, Acting Director of the SEC Division of Corporation Finance, raised questions as to the extent that SPACs should rely on this safe harbor. *See* SEC, John Coates, Public Statement, "SPACs, IPOs and Liability Risk under the Securities Laws," (April 8, 2021), available at https://www.sec.gov/news/public-statement/spacs-ipos-liability-risk-under-securities-laws.

CFA Institute

1401 New York Ave. NW
Suite 330
Washington, DC
20005-2269 USA

+1 (202) 908 4520 tel
+1 (202) 908 4538 fax
info@cfainstitute.org
www.cfainstitute.org

requirements and is listed on a stock exchange. Moreover, this is the first time that the investing public learns about the hitherto private company in filings to the SEC.

It should also be noted that our federal securities laws subject the IPO issuer and underwriter to strong legal liabilities for material misstatements and omissions in the registration statement and the prospectus. The issuer faces strict liability; the underwriter is subject to similar liability – unless it can make an affirmative defense that it performed due diligence. This gives the underwriter a strong incentive to conduct its own independent review of the accuracy and veracity of the IPO registration statement and prospectus. There do not appear to be the same third-party due diligence incentives in the case of SPAC mergers (or direct listings).

At one level, this may sound like a rather arcane discussion of federal securities laws. But the frenzy surrounding SPACs over the past year or so shows how important these investor protections are in the real world.

The Path Going Forward

Though SPACs have been around for years, they took off in popularity beginning in March 2020. They are still evolving, and they may ameliorate concerning features such as high levels of dilution.[17]

SPACs now face scrutiny by Congress – including this hearing – as well as by the SEC and the media. That is a good thing. The SEC, for example, has published two investor bulletins explaining how SPACs work and considerations that the public should keep in mind. One bulletin explains how the incentives of sponsors and certain other investors may "diverge from your interests." The other bulletin specifically cautions against relying on celebrity endorsements of SPACs.[18]

CFA Institute also has raised questions about the investor protection issues involving SPACs.[19] In addition, we have announced that we are forming a working group to examine and possibly make recommendations regarding the surge in SPACs and the implications for investor protection, corporate governance, and market integrity.[20]

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[17] *See supra* note 14.
[18] SEC, Celebrity Involvement with SPACs – Investor Alert, (March 10, 2021), at https://www.sec.gov/oiea/investor-alerts-and-bulletins/celebrity-involvement-spacs-investor-alert, ("***It is never a good idea to invest in a SPAC just because someone famous sponsors or invests in it or says it is a good investment.***"). (Emphasis in original.)
[19] See, e.g., Margaret Franklin, CFA, President and CEO of CFA Institute, "5 things to watch out for before you invest in SPACs," (April 14, 2021), available at https://www.marketwatch.com/story/5-things-to-watch-out-for-before-you-invest-in-spacs-11618349032; Stephen Deane, CFA, Barron's, "SPACs May Feed the Public's Worst Fears About Wall Street," (April 22, 2021), available at https://www.barrons.com/articles/WP-BAR-0000043424.
[20] *See* CFA Institute Announces the Launch of SPAC Working Group, (May 5, 2021), available at https://www.cfainstitute.org/about/press-releases/2021/cfa-institute-announces-launch-of-SPAC-working-group.

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1401 New York Ave, NW
Suite 330
Washington, DC
20005-2269 USA

+1 (202) 908 4520 tel
+1 (202) 908 4538 fax
info@cfainstitute.org
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Investor education is a necessary tool in addressing a wide range of novel investment products and financial innovations, including SPACs. Public education alone, however, is not enough. Congress and securities regulators must remain vigilant to protect investors and the integrity of securities markets.

As Congress deliberates on whether and, if so, how to take action on SPACs, we welcome the focus on measures to protect investors and enhance transparency. This submission has sought to articulate several investor protection concerns regarding SPACs. Specifically, these involve 1) dilution; 2) misaligned incentives that may work against the interests of certain SPAC investors, including retail investors; 3) the lack of disclosure of side deals with PIPE investors or others; and 4) the unlevel regulatory playing field and the risks of biased information that flow from a safe harbor for forward-looking statements related to SPAC mergers.

Thank you for holding this hearing and, more generally, in addressing these investor protection issues.

AH CAPITAL MANAGEMENT, L.L.C.
2865 Sand Hill Road
Menlo Park, California 94025

Testimony of Scott Kupor, Managing Partner, Andreessen Horowitz, U.S. House of Representatives, Financial Services Committee May 24, 2021

Chairwoman Waters, Ranking Member McHenry, and members of the Financial Services Committee, thank you very much for the opportunity to submit written testimony regarding capital formation and the state of the U.S. IPO market.

By way of background, I am the Managing Partner for Andreessen Horowitz, a $16.5 billion multi-stage venture capital firm focused on IT-related investments. Some of the companies in which we have invested and with which you may be familiar include AirBnB, Coinbase, Github, Roblox, Instagram and Lyft.

I also serve on various investment committees, including for the St. Jude Children's Cancer Hospital and the Stanford Medical Center, and teach entrepreneurship and venture capital at the Stanford Graduate School of Business. I previously served as the Chairman of the Board of Directors for the National Venture Capital Association, during which time I had the privilege of meeting many of you and your colleagues. Prior to joining Andreessen Horowitz, I held several executive positions in a publicly-traded software company and was previous to that an investment banker.

There are a number of trends concerning IPOs and capital formation to note:

- First, the raw number of IPOs has declined significantly: From 1980-2000, the US averaged roughly 300 IPOs per year; from 2001-2016, the average fell to 108 per year. With the benefit of increasing IPOs in the last few years, we are starting to see better growth: in 2020, there were close to 500 IPOs in the U.S., double the rate of the prior year, 103 of those being venture-backed companies.
- Second, the characteristics of IPO candidates have changed: fewer small companies are making it to the public markets.
    - "Small" IPOs – companies with less than $50m in annual revenue at the time of IPO – have declined from more than 50% of all IPOs in the 1980-2000 timeframe to about 25% of IPOs from 2001-2016;
    - Companies are staying private much longer – the median time to IPO from founding hovered around 6.5 years from 1980-2000; companies are now staying private for 10 or more years from founding;
    - As a result of companies staying private longer, the average size of IPOs has also grown significantly: in 2020, the average IPO raised $353 million, with 18% of all IPOs raising more than $500m each; and
    - Special Purpose Acquisition Vehicles ("SPACS") represented 50% of all IPOs in 2020, a five-fold increase relative to 2019. In the first quarter of 2021 alone, SPACs raised $87.9 billion, more than was raised in the entirety of 2020, an admittedly banner year for SPACs.
- Third, the cumulative effect of these changes is a hollowing out of the broader US capital markets and a decline in corporate competition: the number of publicly listed companies

in the US declined by 50% over the last 20 years, while other developed countries have experienced a 50% *increase* over the same time period.

A number of implications flow from these trends:

- First is jobs. Publicly-traded companies drive employment growth – companies that go public increase employment by 45% relative to private companies. Jobs in competitive industries of course remain key to the goal of sustained and broad economic growth;
- Second is expanding access to economic opportunity: The US needs more public companies creating economic opportunity in areas of the country that are undergoing structural unemployment challenges resulting from a modernizing economy; and
- Third, we are at-risk of creating a two-tiered capital markets structure in the US: one in which the majority of the appreciation accrues to those institutions, pension funds, and wealthy individuals who can invest in the *private* markets and a second for the vast majority of individual Americans who comprise the retail investor base in the *public* markets.
  - A simple example illustrates this wealth shifting effect from *public* market investors to *private* investors. Microsoft went public in 1986 at a $350 million market cap; today, Microsoft's market cap exceeds $1.8 trillion. Contrast that with Facebook, which debuted in the public markets around a $100 billion market cap. While Facebook has performed well in the public markets, the returns to public market investors are about 8.5x. For <u>public</u> investors in Facebook to achieve returns comparable to those of Microsoft shareholders, Facebook would need to reach a market cap of $500 trillion, a number that well exceeds the total global market cap of all listed stocks.
  - While un-accredited Americans do have some access to private markets via the investments that some public mutual funds have made in private companies, the amount of this exposure is very limited. The value of mutual fund investments in *private* tech companies was estimated at just north of $7 billion in 2016, or about .05% of total US mutual fund assets.

While the reasons for how we arrived at this destination are beyond the scope of this hearing, the trends remain clear.

Before offering some suggestions about how we might improve capital formation, I'd like to review the current state of the IPO market. Despite, the negative trends noted above in terms of overall volume and the later-stage nature of IPOs, the good news is that we have seen areas of innovation and progress in the market over the past few years.

Importantly as well, the positive implications of the 2012 JOBS Act cannot be understated. We have seen improved capital formation as a result of this legislation and the U.S. capital markets remain the deepest and broadest markets for the very best issuers. The combination of access to a robust private market coupled with the easing of the on-ramp created by the JOBS Act has enabled companies such as Moderna to be able to invest in life-changing technologies as we've seen with the recent COVID vaccines. I would be remiss if I didn't acknowledge the wisdom of Congress in passing this very important legislation.

Direct Listings:
Although there has been much talk of direct listing potentially overtaking the traditional IPO, we have seen very few of them in the venture-backed space. To date, only six companies have chosen this path over three years, representing well less than 1% of the total capital markets debuts over the same time period. They have occupied significant attention, however, because 3 of the direct listings are in the top 5 opening trade volumes in the history of the traditional IPO/Direct Listing market.

Given the paucity of direct listings, it is hard to draw too many conclusions from the limited data set. However, below we provide some data on what has been observed to date.

Unlike in an IPO where the banks purchase primary shares directly from the company and resell them to public market investors, in a direct listing there is an opening auction by which the exchanges (New York Stock Exchange (NYSE) or Nasdaq) or their designees ("market makers" in the NYSE case) solicit "bids" (the price and volume at which a buyer wants to transact) and "offers" (the price and volume at which a seller wants to transact). The auction process continues until a sufficient number of orders are "matched" – buyers and sellers are willing to transact at an agreed-upon price and volume to open the stock.

Matching for the completed direct listings vary from a low of 2% to a high of 8% - meaning that percentage of the total shares outstanding have traded in the opening auction. A simple average would get you to around 5%. In contrast, traditional IPOs in the tech space have average around 2% trading volume on the opening trade. This may be one of the reasons why the "IPO Pops" for direct listings are more muted than we have seen recently for more traditional tech IPOs.

For the direct listings completed to date, the stocks have traded in the first day in the range of 15-23% of the total shares outstanding. So, the total first-day volume is about 3-5 times the number of shares that are exchanged in the opening auction. Not all of those shares are additional secondary shares that come into the market. Rather, much of that trading volume reflects the re-trading of shares that were initially exchanged in the opening price auction. We estimate that about one-third of the total shares that trade on opening day of a direct listing are newly-introduced into the market, whereas two-thirds of the trading represents re-trading of those shares.

Traditional IPOs in the tech space have traded closer to 12% of total shares outstanding on the first day of trading – well below what we have seen in direct listings. One explanation for that is, as noted above, direct listings have done a better job of getting initial share volume into the market (~5% on the opening trade vs 2% in traditional IPOs). Second, by better matching supply and demand, direct listings have generally mitigated the magnitude of IPO Pops, thus engendering better overall price discovery.

Most IPOs have lockups that prevent additional secondary shares coming into the market, sometimes for as long as 6-months. Because direct listings generally don't have lockups (Palantir being the only exception), they enable more secondary shares to be offered to the market post-initial trade, thus reducing price movements caused by supply/demand imbalances in a traditional IPO.

Thus, while the results are still early, we do seem to see better price discovery and reduced after-market volatility from the direct listing process.

SPACs:

As noted above, the most significant change in the IPO markets in recent years is the dramatic increase in the number of SPACs raised – constituting 50% of the IPO market in 2020, with the first quarter of 2021 eclipsing the full 2020 number. In April 2021, however, the SPAC new issue volume dropped to 13 deals, a decline of roughly 90% from the March 2021 volume.

There are many theories speculating about the causes of the rapid decline in SPAC issuances, among which are:

- SEC warnings to issuers about potential accounting restatements stemming from option grants issued to promoters;
- SEC warnings to retail investors to be cautious about "celebrity-endorsed" SPAC offerings;
- Overall volatility in the public equity markets and, in particular, contraction in trading multiples for high-growth stocks;
- Delays caused by backlogs and thus longer SEC reviews of de-SPAC offering documents, resulting in existing holders of SPAC shares having less capital to invest in new issuances; and
- Overall poor after-market performance of de-SPAC'd entities.

Proponents of SPACs argue that SPACs offer shorter timelines for companies to become public and with greater certainty of completion (and less pricing risk) than are characteristic of traditional IPOs. As to the former, Nasdaq has published data showing that for the roughly 72 de-SPAC transactions that had been completed as of February 2021, the time to market averaged 4 months versus approximately 6 months for traditional IPOs. The de-SPAC process is essentially the process that occurs after a SPAC has agreed to terms with an acquisition target where the two entities are fully merged.

Performance has been more un-even. According to Nasdaq – again looking at the 72 de-SPAC'd transactions through February 2021 – only 64% have outperformed the S&P 500. Reuters has recently reported that 90% of SPACs that have announced transactions in 2021 are lagging the S&P 500.

A recent study by Professors Michael Klausner and Michael Ohlrogge provides the most comprehensive view to date of the underlying financial behavior of SPAC investors and the after-market performance of SPACs through June 2020.

Among the findings are:

- SPAC dilution amounts to roughly 50% of the cash ultimately delivered to the companies brought public. These costs are much higher than those for IPOs, even accounting for IPO Pops;
- SPAC shares tend to drop by one third of their value or more within a year following a merger, leaving investors who hold shares post de-SPAC most vulnerable to price declines; and
- SPAC investors typically differ from de-SPAC investors. The former are often institutional shareholders who can earn rates of return as high as 11% for "loaning" money to the SPAC in search of its target. However, most SPAC shareholders exit at the time of the de-SPAC, leaving a new set of de-SPAC investors to hold the shares.

Traditional underwritten IPOs:
With the exception of 2020 and the first quarter of 2021, traditional IPOs remain the predominant method of going public.

Much has been written about the concept of what is referred to as the "IPO Pop." In essence the IPO Pop is the increase in the price of the opening trade of an IPO relative to the IPO price. Concerns have been raised around what this reveals about the price discovery process for IPOs and whether retail investors are disadvantaged relative to certain institutional investors that have access to purchase shares at the IPO process.

We have published some research on this topic elsewhere, which I will summarize briefly below.

First, as the below chart shows, IPO pops are not a new phenomenon. In fact, if you exclude the Dot Com Bubble of 1999-2000, they have been steady for nearly thirty years.

Time Period	IPO Pop*
1980-1989	6.1%
1990-1998	13.3%
1999-2000	51.6%
2001-2019	13.7%

[*IPO Pop = mean increase in stock price from IPO price to 1st-day close.
Source: https://site.warrington.ufl.edu/ritter/files/IPOs2019_Underpricing.pdf]

Second, the size of the IPO Pop is mostly a function of the demand for a given stock. Gauging demand for an IPO can be difficult, but a rough proxy for the relative magnitude of the institutional demand is whether a company's final offering price is above, within or below its initial filing range (IFR).

Time Period	% Below IFR	% Within IFR	% Above IFR
1980-1989	30%	52%	13%
1990-1998	27%	49%	24%
1999-2000	18%	38%	44%
2001-2019	33%	45%	22%

[Source: https://site.warrington.ufl.edu/ritter/files/IPOs2019_Underpricing.pdf]

When we combine the data from the two charts, we can discern some conclusions.

Time Period	IPO Pop	% Above IFR
1999-2000	51.6%	44%
2001-2019	13.7%	22%
1990-1998	13.3%	24%
1980-1989	6.1%	13%

[Source: https://site.warrington.ufl.edu/ritter/files/IPOs2019_Underpricing.pdf]

Interestingly, the proxy for demand – the percentage of IPOs that priced above the initial filing range – seems directionally correlated with the size of the IPO pop. If you plot the individual years between 1990-2019, you see a fairly strong correlation (r-square = 58%) between percentage of IPOs pricing above the high end of the file range and the average first-day return.

What appears to be happening is that bankers increase the final offering price relative to the initial filing range more frequently when they assess greater institutional demand during the roadshow, and, at the same time, the buyside likely gets lower than their desired allocations in a "hot" IPO. The combination of these two factors would create stronger after-market performance as the marginal buyers increase their ownership (and as the momentum investors chase the price performance); thus, a higher IPO pop.

Third, the supply of IPO shares being offered by the company, otherwise referred to as the float (the quotient of the number of shares sales in the offering divided by the total shares outstanding for the company) has changed over time.

The below chart shows median % IPO floats over various time periods: median floats were pretty consistent from 1980-1998, but fell significantly during the Dot Com Bubble,

Time Period	Median % IPO Float
1980-1989	40%
1990-1998	45%
1999-2000	25%

[Source: http://www.econ.yale.edu/~shiller/behfin/2002-04-11/loughran-ritter.pdf]

And how does this change in floats manifest itself in the magnitude of IPO Pops?

Time Period	Low Float IPO Pop	High Float IPO Pop
1980-1989	1.8%	1.9%
1990-1998	10%	6.3%
1999-2000	37.5%	9.9%

[Source: http://www.econ.yale.edu/~shiller/behfin/2002-04-11/loughran-ritter.pdf]

With the exception of the 1980-1989 time period (where we know that IPO pops overall where the lowest), the size of the IPO pop is correlated with the float: lower floats (meaning that there are fewer shares available to trade, aka low supply) yield higher first-day pops.

As noted above, the demand side of the equation – whether IPOs are priced above their initial filing range – also influences the size of the IPO float. The below charts illustrates that interplay between supply (float) and demand (pricing above the initial filing range).

Time Period	Low Float % of Companies Pricing Above the Range	High Float % of Companies Pricing Above the Range
1980-1989	14%	11%
1990-1998	28%	18%
1999-2000	48%	30%

[Source: http://www.econ.yale.edu/~shiller/behfin/2002-04-11/loughran-ritter.pdf]

In 2020, we have seen even smaller floats. At approximately 15%, the median float is well below historical norms; not surprisingly, this is one reason why we see much higher IPO Pops in recent IPOs relative to historical norms. Constrained supply drives the after-market prices higher.

And why are floats so much lower? One likely contributor is the fact that venture-backed companies in particular are staying private much longer (nearly double the 6-7 year time frame that we saw through the early 2000's). As a result, they are much more mature at the time of IPO (median revenue is about 10x what is what in the Dot Com bubble) and thus much higher valued. So, even assuming they wanted to raise the same amount of nominal dollars at the IPO as in the past, a higher valuation means they can do so by issuing many fewer shares.

<u>How can we improve the overall state of the IPO markets, economic growth and retail access to capital?</u>

As has been noted, the good news for capital formation is that there are now multiple choices for companies that are considering going public: traditional IPOs, direct listings and SPACs. We hope this competition among listing options can drive down costs and reduce friction in the public offering process, thus encouraging more companies into the public markets. In fact, we are already seeing some positive improvements in the market as a result of competition.

For example, lockups agreements, which distort short-term trading in the markets by artificially reducing the amount of tradeable float, are starting to be modified to enable more staged "dribbles" of stock at various time frames and price points versus the all-or-nothing 6-month lockups that have existed for most traditional IPOs. In addition, some underwriters are enhancing their price discovery mechanisms for traditional IPOs to reduce IPO Pops and dampen first-day trading volatility.

However, even with this competition, we still face a situation where too few companies go public and, when they do so, they go public at much later stages of maturation. As a result, job growth attendant with public companies is impacted and retail investors' access to high-growth stock appreciation is limited.

There are, however, a number of things that legislators and regulators could consider that would help ensure flexibility while achieving the economic growth and retail investor access goals.

Opportunities to make it easier for issuers to become public companies (and at earlier stages of maturity):

> **Expand Emerging Growth Company (EGC) Status -** One of the most successful aspects of the Jumpstart our Business Startups (JOBS) Act was the creation of the EGC designation for growth companies accessing the public markets. EGC designation smooths the transition to the public markets for innovative growth companies, making an IPO relatively more attractive.
>
> Two improvements to the eligibility criteria for EGCs would create greater certainty around regulatory status for companies considering whether to go public:

- Extend the timeframe for EGC eligibility from five years to ten years for certain exemptions and disclosure requirements. Existing legislation, the *Helping Startups Continue to Grow Act* sponsored by Representative Bryan Steil (R-IN), would make these improvements for small capitalization companies.
- Provide a transition period of one year for EGCs who trigger large accelerated filer status when their public float exceeds $700 million for the first time.

Require Short Position Disclosure - A short position disclosure regime similar to that which exists for material long positions would support innovative small-capitalization companies by requiring that investors disclose material short positions they hold. There currently exists an information vacuum which encourages certain investors to promote misleading information and inaccurate data that can drive a company's stock price down while hiding the true source and financial interest behind those efforts. Small capitalization companies are particularly vulnerable to these so-called "short and distort" campaigns as they often have shallow liquidity and limited research coverage, meaning their share price can move quickly based upon investor sentiment.

Allow EGCs to choose trading venues - With the proliferation of new trading venues that have been created over the last twenty years, fragmentation of shares trading across venues has become an increasing challenge for smaller companies with less liquidity. Fragmentation leaves smaller companies more vulnerable to short-term volatility that can further erode liquidity and dry up research coverage. Providing EGCs the opportunity to opt out of unlisted trading privileges (UTP) and select the venues that can trade their securities will improve trading volume for these companies and improve capital formation in the public markets.

Review regulatory barriers to research coverage for EGCs - A lack of consistent research coverage has become one of the most significant disincentives for smaller companies trying to decide whether to become publicly listed. Research coverage for small-capitalization companies in particular has dropped dramatically. Research coverage is particularly important for companies with thinly traded stocks, as name recognition is often low, trading can be volatile, and the universe of investor interest is limited. Engaging a study to examine ways that policy can reduce the barriers to research coverage for EGCs would be helpful to improving overall liquidity.

Review potential barriers to diversified mutual fund ownership of EGCs – Diversified mutual funds are typically restricted to owning no more than 10% of the float of publicly-listed companies. Given that mutual funds have grown significantly in size, they often find it difficult to acquire meaningful positions in smaller-cap companies owing to these concentration limits. To encourage greater institutional participation, Congress and the SEC should consider, potentially for a limited period of time relative to a new issue, increasing the concentration limits for diversified mutual funds. Allowing mutual funds to hold slightly larger positions in newly issued stocks would increase the economic incentives for them – material appreciation in a stock could have a meaningful impact on the overall fund performance.

Opportunities to encourage issuer choice of paths by which to come public to engender fair competition, enhanced price discovery and broader retail participation:

Clarify the tracing rules with respect to direct listings – Because direct listings to date have been largely completed with secondary shares, Section 11 liability for selling shareholders for potential misstatements in the offering documents remains unclear. The "tracing" rules in a traditional IPO typically require that a plaintiff be able to trace the share purchased in the after-market to the registration statement for those shares. In a direct listing, many shares are typically sold under Rule 144 and thus not registered until a traditional offering document (only the shares outside of 144 are typically registered). Because of this uncertainty around potential liability for selling shareholders (including in pending litigation underway currently), direct listings may not achieve their full potential. Clarification around the liability regime would be helpful to clear-up the current tracing rule ambiguity.

Ensure appropriate disclosures and liability regimes around SPACs – Currently, in connection with the de-SPAC process, many SPACs provide 5-year forward forecasts that are used in connection with the marketing process for the pending acquisition. Some have argued that the Private Securities Litigation Reform Act (PSLRA) safe harbor applies to such disclosures, in effect providing a shield against private securities actions for sponsors in connection with the de-SPAC process. The SEC's Director of the Division of Corporate Finance recently provided some guidance raising questions about the extent of PSLRA coverage. However, clear guidance from Congress or the SEC about this would go a long way to ensuring that traditional IPOs are not disadvantaged relative to SPACs in a competitive marketplace. In addition, clarity on this topic would ensure that retail investors (who are typically different from the institutional investors who purchase the initial SPAC shares and often exit the company pre de-SPAC) are provided with all material information around the acquisition and with appropriate legal protections for any material misstatements.

In addition, Congress and the SEC should consider conducting further studies on the issues highlighted by the research of Professors Klausner and Ohlrogge to better understand the trading dynamics of SPACs, the redemption behavior of institutional investors and the ultimate dilution borne by shareholders post de-SPAC. Such an inquiry could lead to enhanced disclosures to retail investors in particular about the nature of the shareholder base they may be joining in connection with the de-SPAC.

Congress and the SEC should also consider conducting further studies on the "promote" economics in SPAC transactions and consider whether additional disclosure is required to ensure that all investors understand potential conflicts that may arise between sponsors and non-sponsor shareholders. In some cases, promotes may be "shared" with PIPE investors, which could meaningfully impact the return opportunities for sponsors and PIPE investors relative to retail investors who buy shares in the open market.

It is worth noting that, even in the absence of new regulatory guidance, the SPAC markets are already "self-correcting" in response to institutional investor feedback. For example, PIPE investors are increasingly requiring that sponsor's remain holders of their shares for longer periods of time post de-SPAC, and the size and nature of sponsor promotes are also being impacted.

Ensure appropriate SEC resources to increase the throughput of public offerings – Given the increased options for companies to go public, we have heard that the SEC staff has been overwhelmed by the volume of offerings in its review pipeline. As a result, turnaround times for companies to be declared effective and thus access the public markets have become longer and less predictable. When timing risks are uncertain, on balance, companies may pursue other avenues (e.g., acquisitions) or may chose the shortest possible go-public path, independent of the relative merits of other options. To ensure maximum flexibility for issuers, Congress should consider whether the SEC has adequate resources to manage a growing pipeline of companies seeking to go public.

Opportunities to enhance access to <u>private</u> markets for non-institutional investors

As noted above, as companies stay private for longer periods of time, more of the appreciation opportunities inherent in high-growth companies is reserved for institutional investors and wealthy individuals who have access to private market investments. Thus, while looking for ways to make it easier for companies to go public earlier is important, we should also look to ways to expand access to retail investors in the private markets. Importantly, however, we should not lose sight of investor suitability and overall investor protections, even as we seek to expand broader retail access.

Amend the Accredited Investor definition to expand its ranks – The SEC has taken an initial step toward this by creating effectively a "knowledge" safe harbor to include more individuals in the definition, but Congress and the SEC should look at ways to materially increase the number of individuals who would qualify under a revised definition. One shorthand for this may be to incorporate the Crowdfunding rules mechanism, which provides for absolute dollar amounts that may be invested by individuals regardless of accredited investor status. To ensure investor protection, any amendments to the rules could be restricted to private funds that would provide investors the benefits of diversification and professional fund management (vs providing a broad exemption for individual company investments).

Amend the 3(c)(1) restrictions on the number of Accredited Investors for private funds – Most private funds today are limited under Rule 3(c)(1) to accepting no more than 100 accredited investors. As a result, nearly all of the capital raised by these funds comes from qualified clients or qualified institutional purchasers. In addition to expanding access to the accredited investor definition, Congress and the SEC should consider whether to amend the 100-person limit to enable broader individual access to private funds. In addition, to ensure investor protection, consider amending the rules to create a dollar limit (versus a number of persons limit). For example, one could limit accredited investors to no more than 10-20% of a total fund's assets under management to ensure that there is also strong institutional support behind the private fund manager.

Amend the RIA restrictions on incentive-based compensation – Under current rules, registered investment advisers (RIAs) are prohibited from charging incentive-based fees for accredited investors. As a result, access to private funds for these investors are limited. Coupled with the regulatory changes noted above and with appropriate disclosures, Congress and the SEC should consider amending these rules to permit incentive-based compensation as a way to increase accredited investor access to private funds.

Enhance access to private investments via mutual funds – Today, closed-end funds are limited to holding no more than 15% of their total assets in private offerings, unless they restrict fund access to accredited investors only. Models, such as those proposed by Representative Anthony Gonzalez (R-OH) in the *Increasing Investors Opportunities Act*, which would eliminate this limitation, could also enhance retail access to private, high-growth opportunities.

Enhance access to private, secondary market transactions – Today, un-accredited individual investors are permitted under the Crowdfunding rules to invest in early-stage seed companies, but are prohibited from investing in later-stage, pre-IPO companies. This makes little sense when you consider the differential risks of loss associated with those two very different stages of investments. To expand retail access to private market opportunities, Congress and the SEC should consider amending these rules to permit access to later-stage, pre-IPO companies. This of course needs to be accompanied by enhanced regulatory disclosures, but supporting venues who seek to enter this business opportunity through reformed regulation would expand access to high-growth opportunities.

Opportunities to enhance access to capital formation and individual participation in investment opportunities via effective blockchain regulation.

We believe that blockchain holds the promise to be the next transformative industry, provided the policy environment allows entrepreneurs to fully experiment with the technology in the U.S. The current discussions around blockchain have many similarities to the regulatory policy conversations that occurred during the rise of previous generations of new industries, such as biotechnology and the commercialization of the Internet. In each of these cases, doubts amongst policymakers proliferated and policy proposals were considered that could have prevented American leadership before the full promise of the technology was realized. Fortunately, cooler heads prevailed, and as a result, the U.S. has been the unquestioned global leader in technological innovation since World War II.

The commercialization of blockchain technology is in its infancy, but a glimpse into the current efforts of blockchain entrepreneurs offers a clear illustration of its potential. As we speak, blockchain entrepreneurs are working to apply the technology to solve critical societal challenges like access to financial services for the unbanked and underbanked, expanding economic opportunity, fighting climate change, and providing a market-based solution to technology and financial services industry concentration. These individuals are undertaking the risky endeavor of entrepreneurship to explore how the power of open protocols can fundamentally redesign how individuals and businesses use the internet.

The benefit of blockchain development is that the ultimate users and community members associated with the various projects can receive tokens during the infancy of a project as a reward for their participation. This democratization of access to tokens means that, if the projects are ultimately successful and thus the value of the token accretes alongside the utility value derived from the project, these market participants can benefit from that appreciation. Thus, in many ways, a healthy blockchain ecosystem not only creates economic growth and technological developments in the U.S., but it also is an opportunity for anyone who desires to be part of a project to also benefit from the success of that endeavor.

Unfortunately, the SEC has not provided clear regulatory guidelines for how tokens will be treated under existing regulatory rules. Rather, the SEC has focused predominantly on bringing enforcement actions against bad actors. While this is laudable, it has failed to provide clarity for the many determined good actors who seek to develop blockchain projects that are both successful and regulatorily compliant. This inability to differentiate between good faith technology entrepreneurs and get-rich-quick schemes makes the SEC's job of policing this activity even harder.

To ensure U.S. leadership in this very important area of technology development, Congress and the SEC should create an effective blockchain regulatory regime. The bipartisan *Token Taxonomy Act* provides a base of work for policymakers to do so. In addition, the *Eliminate Barriers to Innovation Act of 2021* is also constructive in this regard. Establishing a clear regulatory framework for blockchain technology is a difficult task, as with any emerging technology field, but it is a priority shared by many policymakers on both sides of the aisle and most industry participants. We urge policymakers to do what previous generations of regulators were able to accomplish when faced with similar challenges in innovative technologies: construct a regulatory regime that allows the technology to develop in a safe and sustainable manner.

<u>Summary</u>

I thank you for your time and for the opportunity to discuss the very important topic of capital formation in the U.S. As I think we all recognize, ensuring that the U.S. continue to create new jobs that result from new company formation is critical not only to our economic future, but also to our national security and sovereignty.

While I have tried to offer a number of suggestions to achieve this outcome, these are by no means exhaustive. I look forward to the opportunity to work with the Committee to the extent it determines to continue its work in this area.

AFR Americans for Financial Reform

Written Testimony before the House Financial Services Committee of
Andrew Park
Senior Policy Analyst
Americans for Financial Reform

"Going Public: SPACs, Direct Listings, Public Offerings, and the Need for Investor Protections"

May 24, 2021 12:00PM

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

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

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

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

In the typical SPAC structure, the initial investors buy into units of a SPAC. Each unit consists of one share priced at $10 and a warrant, a derivative similar to a call option that entitles the holder to buy additional shares (or fractions thereof) at $11.50. Minimal substantive disclosures are required at the IPO stage other than a vague description of the types of industries in which the proceeds may be used to acquire a company. Initial investors who receive the warrants for free are typically large players like hedge funds. Retail investors typically come in after that and purchase regular shares or those warrants for a price in the secondary market.

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[1] SPACInsider. https://spacinsider.com/stats/

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

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

Notably, upon consummation of a merger (de-SPACing) the sponsor usually receives (or vests in) 20% of the SPAC's shares as compensation (the "promote") for free, which means that issuing SPACs exceeds the costs of a "traditional" IPO. It is not lost on us that hedge fund Pershing Square's Bill Ackman has called SPACs more of a "compensation scheme."[3]

The SPAC surge appears to be driven in part by private companies' desire to exploit the perceived speed, greater negotiating power to get a higher price for themselves than in the private markets, streamlined disclosures, reduced liability, and reduced shareholder rights offered by the SPAC process. Given these features, it is not surprising that highly speculative companies (e.g., those related to crypto currencies, like eToro and Bakkt) are looking to access the public markets via SPAC mergers.

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

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

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

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

[3] Celarier, Michelle. Institutional Investor. Egregious Founder Shares. Free Money for Hedge Funds. A Cluster***k of Competing Interests. Welcome to the Great 2020 SPAC Boom. Sep 21, 2020. https://www.institutionalinvestor.com/article/b1ngx7vttq33kh/Egregious-Founder-Shares-Free-Money-for-Hedge-Funds-A-Cluster-k-of-Competing-Interests-Welcome-to-the-Great-2020-SPAC-Boom

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

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

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

Safe harbor from forward-looking statements

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

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

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

The House Always Wins

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

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

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

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

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

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

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

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

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

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

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

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

[14] Klausner et al.

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

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

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

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

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

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

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

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

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

Testimony before the Investor Protection, Entrepreneurship, and Capital Markets Subcommittee of the U.S. House Committee on Financial Services

"Going Public: SPACs, Direct Listings, Public Offerings, and the Need for Investor Protections"

Usha R. Rodrigues
University Professor
M.E Kilpatrick Professor of Corporate & Securities Law
University of Georgia School of Law

May 24, 2021

Chairman Sherman, Ranking Member Huizenga and Members of the Subcommittee, it is an honor to participate in today's hearing on Going Public. My name is Usha R. Rodrigues and I am a professor at the University of Georgia School of Law, where I teach and write in the areas of corporate law, corporate governance, and securities regulation. Prior to joining the faculty at UGA, I worked as a corporate lawyer in a Silicon Valley-based law firm.

I have written extensively about the public and private markets, and co-authored an early paper on special purpose acquisition companies (SPACs). In fact, my co-author Michael Stegemoller and I are currently conducting ongoing, active research into SPACs. My remarks today will be grounded in our research, but I want to emphasize that that research is incomplete and ongoing. In this testimony I will provide some context for the public offering process, and then turn to addressing some of the specific proposals for the potential reform of SPACs.

SPACs bill themselves as cheaper, faster, more certain alternatives to IPOs.[1] Let me be clear: I do not believe there is anything fundamentally wrong with the current IPO process. It does not need "fixing." Admittedly, it is a slow and painful process. But given the vital importance of protecting the public capital markets, this deliberate process is entirely appropriate.

A public offering marks the debut of a company on the public markets. This debut represents a significant milestone in a corporation's life. An operating corporation begins as a private entity, sheltered from public scrutiny. Any capital raises occur in the private markets. U.S. securities laws allow a much more laissez faire approach in the private markets—aside from anti-fraud protections, we mostly expect private investors to "fend for themselves"[2] relying on wealth as a proxy for sophistication.[3] As I explain to my law students, this is why they cannot invest in hedge funds, venture capital funds, or a hot Silicon Valley startup.

The public markets, in contrast, allow ordinary citizens to invest. They represent a vast new source of capital for companies—and expose average investors to risks that only wealthy and institutional investors faced when the company was privately held. Entry into the public markets thus brings tremendous scrutiny to a newly public company. It must satisfy a host of periodic disclosure requirements; its financial reporting is scrutinized by analysts; its board must be independent. Its officers must certify as to the strength and reliability of its internal controls.[4] The process of readying a company for the "big leagues" of the public markets is admittedly a slow and difficult one. It *should* be. After all, the end result is that the company is public—that average individuals, who lack the wealth and sophistication of private investors, can invest in them. Public companies *need* to be vetted. They *need* to be tested.

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[1] *See generally* Michael Klausner, Michael Ohlrogge & Emily Ruan, *A Sober Look at SPACs*, Eur. Corporate Governance Inst., Finance Working Paper No. 746/2021 (2021).
[2] SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953).
[3] *See* Usha Rodrigues, *Securities Law's Dirty Little Secret*, 81 FORDHAM L. REV. 101, 129 (2013); *See generally* Jonathan D. Glater, *Private Offerings and Public Ends: Reconsidering the Regime for Classification of Investors Under the Securities Act of 1933*, 48 CONN. L. REV. 355 (2015).
[4] Amy Deen Westbook & David A. Westbrook, *Unicorns, Guardians, and the Concentration of the U.S. Equity Markets*, 96 NEB. L. REV. 688, 704–12 (2018).

With this background context, I turn to the reform proposals of the Americans for Financial Reform and the Consumer Federation of America (Proposals) and the Discussion Draft. Two of the Proposals apply the IPO regulations and requirements to the de-SPAC transactions, and it is with these that I begin.

Exclude SPACs from the PSLRA's Forward-Looking-Statements Safe Harbor

The Discussion Draft and one of the proposals of the Americans for Financial Reform and the Consumer Federation of America is to "Tamp Down Pre-Merger Hype" by amending Section 27A of the 1933 Act and Section 21E of the Securities Exchange Act to exclude SPAC disclosures from the safe harbor for forward-looking statements provided by the Private Securities Litigation Reform Act of 1995 (PSLRA).[5] I support this proposal.

U.S. securities laws treat the going-public process as a period fraught with the possibility of investor hysteria. Ever since the passage of the 1933 Act, a key concern has been that the public will be whipped up into a frenzy and will overbid for new offerings untested in the public markets. Communication in the time before a private firm's debut is thus highly regulated.[6] U.S. securities laws divide the offering process into distinct time periods with specific rules regarding communication in each.[7] Before the filing of the first public registration statement on Form S-1, the company is in the "quiet period."[8] So-called "gun-jumping" rules prohibit the issuer or underwriter from saying much about the firm's prospects in general and about the offering in particular.[9] The exact beginning of the quiet period can be difficult to identify, but once a company is in it, it must be careful not to "jump the gun," because offers to buy or sell are strictly prohibited during this time.[10]

Beyond explicit offers, the issuer may not say anything to advertise the offering or "condition the market."[11] The business is highly circumscribed in terms of what it can say about the business and its prospects, and the government will scrutinize the manner of communication, the content of the message (casting a negative eye on statements touting the firm's future prospects), and the method of distribution. Violations trigger liability under Section 12, with a right of rescission or damages.[12]

These laws exist for good reason—investor interest in a private company debuting on the public markets for the first time is intense. Despite all of the actions taken by the SEC to try to tamp down investor excitement, the prices of IPO shares typically jump (or "pop") in the first day

[5] Letter from Americans for Financial Reform and Consumer Federation of America to Chairwoman Maxine Waters, House Financial Services Committee, and Ranking Member Patrick McHenry, House Financial Services Committee (Feb. 16, 2021).
[6] LATHAM & WATKINS LLP, US IPO GUIDE 3 (2020), https://www.lw.com/thoughtLeadership/lw-us-ipo-guide.
[7] *Id.* at 4.
[8] *Id.* at 15.
[9] *Id.*
[10] *Id.*
[11] *Id.* at 78.
[12] *Id.*

of trading.[13] For example, Airbnb's IPO priced at $68 a share and soared in first-day trading to close at $144, an increase of 113%.[14] DoorDash's IPO similarly surged 86% on opening day.[15] While these are particularly noteworthy examples, a consistent pattern of underpricing remains.

Congress enacted the PSLRA's safe harbor for forward-looking statements in 1995 to acknowledge that investors hunger for financial projections and other information about a company's prospects.[16] This information is extremely valuable—but it is also speculative. In 1995, Congress made the calculus that the benefits of forward-looking information outweighed the risks—for companies that had already been through the rigorous vetting of the IPO process.

These considerations are relevant because the de-SPAC transaction is effectively an IPO. Allowing forward-looking statements in a de-SPAC allows a transaction functionally equivalent to an IPO to skirt a key prohibition in a traditional IPO. Because the acquisition is effectively an IPO, it should be treated as such. There is no good policy reason for this disparate treatment.

I would anticipate that such a regulatory move would have a chilling effect on new SPACs, because it would take away one of their chief attractions over a traditional IPO. Indeed, John Coates, Acting Director of the SEC's Division of Corporation Finance, released a statement titled "SPACs, IPOs and Liability Risk under the Securities Laws," in which he questioned whether the PSLRA's safe harbor even applied to de-SPAC transactions.[17] The press attributed a slowdown in SPAC listings, at least in part, to this statement.[18]

Ensure Section 11 Underwriter Liability

Because the de-SPAC is the functional equivalent of an IPO, I likewise support the proposal to extend Section 11 liability to SPAC sponsors and underwriters. Investment banks play an important role in a traditional IPO. They put their reputation on the line, as well as taking on

[13] Patrick M. Corrigan, *The Seller's Curse and the Underwriter's Pricing Pivot: A Behavioral Theory of Pricing*, 11 VA. L. & BUS. REV. 335, 348–51 (2019).
[14] *See* Andrew Ross Sorkin et al., *Airbnb's Stunning I.P.O.*, N.Y. TIMES (Dec. 11, 2020), https://www.nytimes.com/2020/12/11/business/dealbook/airbnb-ipo-chesky.html (reporting how Airbnb's shares were set to begin trading at $139 after its IPO had priced them at $68).
[15] *Id.*
[16] Susanna Kim Ripken, *Predictions, Projections, and Precautions: Conveying Cautionary Warnings in Corporate Forward-Looking Statements*, 2005 U. ILL. L. REV. 929, 932 (2005) ("Historically, the SEC objected to the dissemination of forward-looking statements, fearing that unsophisticated investors would rely too heavily on this type of speculative information. In order to promote the disclosure of future-oriented information, however, Congress in 1995 enacted the Safe Harbor for Forward-Looking Statements (the "Safe Harbor") as part of the Private Securities Litigation Reform Act (the "Reform Act"). The Safe Harbor was designed to give corporations the freedom to make projections and discuss the future potential of company operations without fear of liability should managers fail to predict the future accurately.")
[17] Public Statement, John Coates, SPACs, IPOs and Liability Risk Under the Securities Laws (Apr. 8, 2021), https://www.sec.gov/news/public-statement/spacs-ipos-liability-risk-under-securities-laws.
[18] *See, e.g.*, Dave Michaels, Amright Ramkumar & Alexander Osipovich, *SPAC Hot Streak Put on Ice by Regulatory Warnings* (Apr. 16, 2021, 5:38 PM), https://www.wsj.com/articles/spac-hot-streak-put-on-ice-by-regulatory-warnings-11618565403.

at least theoretical economic risks in a firm commitment offering.[19] Furthermore, by putting the "deep pockets" of the investment bank on the hook in a traditional IPO, U.S. securities laws in essence deputize the investment bank to police the offering documents and ensure their accuracy.[20] The banks do this through an extensive due diligence process as the registration statement is revised again and again. The banks thus serve as an important check, performing a gatekeeping role. They will not price an offering unless—and until—they are convinced it will sell and that none of the statements in the prospectus subject them to Section 11 liability.[21]

Banks should be subject to the same kind of liability in the de-SPAC transaction—because it is the functional equivalent of an IPO. Instead, banks currently face no Section 11 liability in the de-SPAC transaction. Moreover, the banks often agree to delay a portion of their compensation unless and until the de-SPAC occurs.[22] Thus, far from being a gatekeeper, the underwriter is incentivized to make sure that an acquisition—*any* acquisition—closes and that the target goes public. This subversion of the typical role of the underwriter is another example of regulatory arbitrage—there is no principled justification for it.

Again, the effect of this reform likely would be to decrease the number of de-SPAC transactions and the number of SPAC IPOs. Investment banks, facing strict liability for misstatements in the de-SPAC disclosures, would likely vet them much more thoroughly, therefore theoretically slowing down the process (although the de-SPAC can stretch over many months). Moreover, they might demand more compensation upfront, to account for the decreased likelihood of an eventual acquisition.

In terms of the Proposals, I am more skeptical of extending Section 11 liability to include SPACs' financial advisors. The Securities Act defines "underwriter" as "any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such underwriting."[23] I believe this definition to be capacious enough to include financial advisors who functionally serve as underwriters, as the Act contemplates.

While I have supported two of the Proposals as described above, I have more hesitation about two of the other Proposals.

Apply the Definition of a "Blank Check Company" to Include SPACs

Rule 419 defines a "blank check" company as one that is both issuing penny stock and "is 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

[19] This risk is mostly theoretical because, while the bank commits to buy all the company's shares in a firm commitment offering, it will ensure through the roadshow and book-building process that it can sell all of the shares before it commits to price the offering.
[20] Usha R. Rodrigues, *Financial Contracting with the Crowd*, 69 EMORY L. J. 397, 407 (2019).
[21] JONATHAN R. MACY, CORPORATE GOVERNANCE: PROMISES KEPT, PROMISES BROKEN 127–29 (2008).
[22] *See* Usha Rodrigues & Mike Stegemoller, *Exit, Vice, and Reputation: The Evolution of SPACs*, 37 DEL. J. CORP. 849, 914 (2013); Klausner, Ohlrogge & Ruan, *supra* note 1, at 43-45.
[23] 15 U.S.C. § 77b(11).

companies, or other entity or person."[24] SPACs avoid penny-stock status by having a market value of over $5 million and trading at over $4 per share.[25]

Were the definition of a blank-check company expanded to include SPACs, thus subjecting them to Rule 419, the SPAC form would likely cease to exist. Rule 419 requires that both the proceeds and the securities offered in the IPO be held in escrow until an acquisition is completed.[26] Thus, this requirement would eliminate any secondary market in SPACs. SPACs' whole raison d'etre is to allow for public trading of pre-acquisition shares.[27] I believe the application of Rule 419 would make them economically unviable. It may be that Congress determines that there is no merit at all to SPACs as a route to the public markets. I am not willing to go so far. I believe other reforms might refine the form, as I describe below.

Enhanced Disclosures at the SPAC Offering and Merger Stages

Both the proposed Sponsor Promote & Compensation Act and the Proposals advocate more disclosure at the offering and merger stages. This section will address each in turn and describe why I believe disclosure to be insufficient.

Disclosures in Offering Documents

The Proposal requires clear disclosure of fees and payments to the sponsor, underwriter, and other parties, as well as the potential dilutive impact of warrants. These disclosures are important information and, as the Proposal points out, "should be made more explicit to investors, especially retail investors who often purchase SPAC shares in the secondary market." The SPAC goes public largely as a shell. Much of the information that is of interest, especially to retail investors, will be contained not in the offering documents, but instead in the periodic filings—the annual and quarterly reports, and 8-Ks that the company must disclose under the 1934 Act—that update the market on how the SPAC is faring in its hunt for a target.[28] As someone who has looked at hundreds of these forms, I cannot overemphasize the need for standardization in these disclosures. But such disclosure must of necessity not be simply in the offering documents—which are something of a dead letter once the offering is complete—but instead apply to the current and continuously updated periodic filings. Investors who purchase on the secondary market, sometimes over a year after the IPO, need to understand any related-party transactions, the dilutive effects of warrants, and other crucial matters, even more than do purchasers in the initial offering.

Disclosures Relating to the de-SPAC/Merger Transaction

The de-SPAC disclosures must be more standardized and transparent. My co-author and I are actively reviewing these disclosures as part of our ongoing research. They are byzantine in their complexity. We are left unsure as to the interests of the sponsor and its related entities, the identity and interests of the PIPE investors, and the principals of the target. Some subsequent

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[24] 17 C.F.R. § 230.419(a)(2)(i).
[25] *See* 17 C.F.R. § 240.3a51-1 (definition of a "penny stock").
[26] 17 C.F.R. § 230.419(b)(1)(i).
[27] Rodrigues & Stegmoller, *supra* note 21, at 876-77 (2013).
[28] *See* Klausner, Ohlrogge & Ruan, *supra* note 1, at 43–45.

investments came from trusts whose beneficial owners are the sponsors. Entities and affiliations are not always consistently identified. Disclosures are not cumulative, so it is difficult to keep track of the full financial picture. In short, these disclosures are a mess. And they are, crucially, a mess just when the SPAC enters its arguably most important period: the last period, when investors face a choice as to whether to exit and get their money back or instead risk ownership of an untested public company. These disclosures are in dire need of clarity and standardization if shareholders are to understand the economics of any proposed transaction. But improved disclosure, while necessary, is not sufficient to protect retail investors.

Disclosure Is Not Enough: Voting Reform Is Needed

The incentives of the major SPAC players tilt inexorably towards closing a deal—any deal. Sponsors devote their own money and time to a SPAC, and will receive compensation if and only if they complete an acquisition.[29] Similarly, underwriters—the gatekeepers in the traditional IPO model—defer a portion of their compensation, which they will only receive if a deal closes.[30] And they have only a limited period of time to claim that compensation after the fact—generally 18 to 24 months following the IPO—or they will have to return the money in the trust account to shareholders.[31] If that happens, the sponsors lose everything, and the investment banks lose out on the deferred portion of their underwriting fee.

Thus, the merger is a time of great peril for shareholder, sponsor, and underwriter alike. My co-author and I documented in 2014 this powerful last-period pressure.[32] Both our past and current research suggest that SPACs disproportionately complete acquisitions in the last few days before they expire.[33] Press reports have detailed examples where even these bad deals can result in paydays for SPAC sponsors.[34] The *Wall Street Journal* described a case where, although a post-acquisition SPAC's shares were down about 30%, its sponsor's initial $20 million investment was valued at about $140 million.[35]

Early SPACs provided valuable counterweights to these last-period pressures. First, they required a majority vote on a proposed acquisition.[36] Second, if more than 20% of shares were redeemed, the transaction would not close.[37] The reasons for these two separate protective measures are clear. The first was a standard vote on the deal, a familiar measure because the shareholders of targets generally receive a vote on an acquisition.[38]

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[29] *Id.* at 6–11.
[30] Usha Rodrigues & Mike Stegemoller, *What All-Cash Companies Tell Us about IPOs and Acquisitions*, 29 J. CORP. FIN. 111, 112 (2014).
[31] *See* Rodrigues & Stegmoller, *supra* note 21, at 886–90.
[32] *See* Rodrigues & Stegmoller, *supra* note 29, at 119.
[33] *See id.*
[34] Amrith Ramkumar, *SPAC Insiders Can Make Millions Even When the Company They Take Public Struggles*, WALL ST. J. (Apr. 25, 2021, 4:51 PM), https://www.wsj.com/articles/spac-insiders-can-make-millions-even-when-the-company-they-take-public-struggles-11619343000?mod=article_inline.
[35] *Id.*
[36] Rodrigues & Stegmoller, *supra* note 24, at 856.
[37] *See* Milan Lakicevic & Milos Vulanovic, *A Story on SPACs*, 39 MANAGERIAL FIN. 384, 388 (2011).
[38] *See* Rodrigues & Stegemoller, *supra* note 21, at 856.

The second vote, called the conversion threshold, was rooted instead in principles of basic economics. If the purpose of the trust account was to fund the ultimate acquisition, then the target and the SPAC needed the certainty of having enough money to close. The 20% conversion threshold, a deal term borne of economic necessity, became effectively a second supermajority requirement.[39]

Note that both of these mechanisms are safeguards that counterbalance managerial pressure to close a deal—even a bad deal for shareholders. Early SPAC sponsors had to convince at least a majority of the SPAC shareholders that the public target was worth at least what the SPAC was offering. During the financial crisis, these robust investor protections became a liability, as hedge funds piled into SPACs—either as a safe haven or as a target for "greenmailing,"[40] withholding votes or threatening redemption as a way to extort side benefits.

In response, SPACs evolved—with the consent of the SEC—to largely eliminate the conversion threshold.[41] SPACs now require only a majority vote—and in some cases, they use tender offers to avoid a vote entirely. The SEC justified the elimination of the conversion threshold and, sometimes, even of the vote itself by focusing on the protection offered through letting shareholders "vote with their feet" in a tender offer.[42] That is, the SEC reasoned that shareholders do not need a vote for protection because they can always get their money back. That, in their reasoning, should be protection enough.

This reasoning had a fatal flaw: SPACs typically allow their shareholders to vote for the proposed transaction and still redeem their shares. In essence, then, the "vote" is merely pro forma, decoupled from any economic interest. A shareholder can vote for an acquisition in which she has no desire or intent to participate.

In approving the elimination of the vote, the SEC reasoned that any shareholders unhappy with the transaction could exit.[43] But, as I will explain below, the conversion threshold protected not just the exiting shareholders, but also those shareholders who were left behind. The current system allows savvy shareholders to approve a transaction even as they head for the exit—leaving the most vulnerable investors holding the bag.

Professors Henry Hu and Bernard Black criticized the hypothetical possibility of decoupled voting and economic interest as "empty voting."[44] The ability of shareholders to vote yes and nevertheless jump ship in a de-SPAC is a species of empty voting. It is deeply troubling because, in mergers especially, voting interests typically accompany economic interests.

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[39] *See id.* at 856.
[40] *See* Noam Noked, *"Greenmail" Makes a Comeback*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE (Jan. 22, 2014), https://corpgov.law.harvard.edu/2014/01/22/greenmail-makes-a-comeback/.
[41] Rodrigues & Stegemoller, *supra* note 21, at 856.
[42] Self-Regulatory Organizations; New York Stock Exchange LLC; Notice of Filing of Proposed Rule Change Amending Its Listing Standards for Special Purpose Acquisition Companies, Release No. 34-79676, 81 Fed. Reg. 96150 (Dec. 29, 2016), *available at* https://www.sec.gov/rules/sro/nyse/2016/34-79676.pdf at 4.
[43] *Id.*
[44] Henry T. C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811 (2005).

This point bears emphasis, and an example will make it more concrete. Target shareholders in a typical merger have what are called dissenters' or appraisal rights, which protect them from a low-ball offer.[45] If they vote against a proposed acquisition, then they can go to court and ask the court to determine the fair value of the deal. And if the court says the fair value of the deal is more than the merger consideration, they receive the difference.

In a famous case, T. Rowe Price owned shares in Dell and wanted to claim dissenters' rights when Silver Lake Partners and Michael Dell took the company private. The offer was $13.75 per share.[46] The Court agreed with T. Rowe Price; its appraisal price was $17.62 a share, or 28% above the Silver Lake buyout price. But it turned out that T. Rowe Price had neglected actually to vote against the merger before it went to court.[47] The Court held that in order to exercise its economic rights to reject the deal, T. Rowe Price needed to have voted to reject the deal.[48] Thus, T. Rowe Price lost out on $194 million in dissenters' rights.[49]

This story emphasizes the importance that the law traditionally places on aligning shareholders' votes with their economic claims—on aligning a proxy vote with a shareholder's wallet. I believe that, in assenting to the elimination of the vote via tender offers and in allowing SPACs to decouple voting and economic interest, the regulators at the SEC made a mistake. The original SPAC mechanism of a vote and redemption right protected not only the investors who opted out of the proposed business combination, but *also those who remained*. As originally conceived, the SPAC's managers had to convince the market of the proposed deal's merits. If a certain percentage of the shareholders were unconvinced and wanted to cash out, then the deal failed. Bad deals could be frustrated. Thus, the sophisticated players who could comprehend those byzantine de-SPAC disclosures protected the retail investors who could not.

With these voting protections gone, skeptics can cash out, leaving only the convinced or the unwary—thus eliminating the market test of the transaction that SPAC originators touted as a key safeguard. In one study of recent SPACs, at the median 73% of the IPO proceeds are redeemed.[50] I believe that if more than 50% of the shareholders ask for their money back, the deal should not go forward.

The safeguard of a market check is all the more important because the evidence shows that SPACs, at least in the early years of our sample, can be quite thinly traded. A considerable percentage of SPACs in our initial stage of review have been threatened with delisting for having fewer than 300 shareholders. In such a context, where the concern is with the retail shareholders left behind after hedge funds and other institutional players have redeemed their shares, simple disclosure cannot be sufficient protection. The retail investors need the protection of the

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[45] Jonathan Kalodimos & Clark Lundberg, *Shareholder Rights in Mergers and Acquisitions: Are Appraisal Rights Being Abused?*, 22 FIN. RESEARCH LETTERS 53, 53 (2017)..
[46] In re Appraisal of Dell, Inc., 2016 WL 3186538, at *11 (Del. Ch. 2016).
[47] In re Appraisal of Dell Inc., 2016 WL 3030909, at *31 (Del.Ch., 2016).
[48] *Id.*
[49] *Id.*
[50] Klausner, Ohlrogge & Ruan, *supra* note 1, at 14.

sophisticated investors—and they are more likely to have that protection if economic and voting interests are aligned.

Conclusion

To sum up, although it can be improved, I do not believe the IPO process needs fundamental "fixing." Graduating a private company to the public markets is a major step in a corporation's life. The federal securities laws acknowledge that with a host of regulations and restrictions. Among them are a ban of forward-looking statements and the assignment of Section 11 liability, which deputizes the investment bank to police the offering documents for material misstatements. Treating the de-SPAC, which is the functional equivalent of an IPO, differently from an IPO weakens investor protections without a good policy reason. And while more robust and standardized disclosure is necessary, it is not sufficient. I believe that if less than a majority of the public stockholders are willing to put their money on the table for a de-SPAC, then the transaction should fail.

Thank you, Chairman Sherman and Ranking Member Huizenga, for inviting me to participate in today's hearing. I look forward to your questions.

RealClear Policy

IPOs, SPACs, and Direct Listings, Oh My!

By Jennifer J. Schulp
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Ding, dong, the IPO is dead? Although sung more often as a funeral dirge than a celebratory ditty, this refrain has echoed often over the past twenty years. But last year, something was different: U.S. exchanges experienced the largest increase in public listings since the late 1990s. While the hot stock market undoubtedly played a role in the uptick, alternatives to traditional initial public offerings (IPOs) have been making it easier for companies to take the plunge. As NYSE President Stacey Cunningham put it, for public listings, "[t]here's been more innovation in the last two years than in the last two decades."

Yet, as is often the case, this innovation has been the subject of scrutiny. On May 24, 2021, the House Financial Services Subcommittee on Investor Protection, Entrepreneurship and Capital Markets is holding a hearing entitled, "Going Public: SPACs, Direct Listings, Public Offerings, and the Need for Investor Protections." Plainly, the hearing's title contemplates the need for more "investor protection," also known as regulation. While investors should have accurate information about their investments, additional regulatory requirements can quickly do more harm than good, especially where investors benefit from more paths to public listing.

It's been clear for years that the traditional IPO process fails as a "one-size-fits-all" approach, with many companies choosing to remain private rather than run the IPO gauntlet. In a traditional IPO, a company taps the public market to raise capital. For a hefty fee, investment bankers underwrite the offering, promote the company, and figure out the price at which to sell the shares. The review by the Securities and Exchange Commission takes about four to six months, but companies often spend a year or more preparing. And company insiders are usually not permitted to sell their shares until six months after the IPO. In addition to the direct costs in fees and time, many companies see money left on the table, as the stock's price often is intentionally set below what the market is expected to bear.

Direct listings, by contrast, appeal to companies who want to save on investment banking fees, have their price set by the market, and let their insiders sell shares. A number of tech companies have taken this route since 2018, including Spotify and Coinbase. Direct listings offer a startup's out-of-the-garage-era employees and angel investors the opportunity to reap a greater return on their relatively high-risk investments.

Until recently, a company could only list already existing shares to be traded, meaning that a direct listing was only an option for a company that did not need of new capital. But newly approved rules permitting companies to raise capital through a direct listing may make this path to public trading more attractive to a wider group.

Special purpose acquisition vehicles (SPACs) are another IPO alternative that has become increasingly popular. A SPAC is formed to raise money to complete a merger with a private company, and the private company assumes the SPAC's place as a publicly traded company. While the SPAC itself goes through

A merger also affords private companies more flexibility to talk about their business, particularly their expectations for the future, than an IPO. In this way, a SPAC merger can be an attractive option for private companies who have yet to turn a profit, but have high hopes and capital raising needs pinned on technological advancement or other innovations.

All of these options are not just good for companies; they are good for investors too. Where more and more firms have looked to the regulatory landscape and chosen to remain private for longer, reversing this trend would benefit the broader American economy, not just financial-industry insiders. Direct listings and SPACs may encourage companies to go public that otherwise have spent their high growth years private, out of reach of most retail investors.

Of course, there's no guarantee that all of the companies that join the publicly traded ranks will be successful — that's true regardless of the route taken. But even if potential returns are no more robust, encouraging more companies to join the public markets gives investors more choice.

Instead of setting sights on further regulating innovation in public listings, the focus should be on understanding why many companies have preferred to stay private rather than go through a traditional IPO. Making the traditional IPO a more attractive option can only benefit investors and businesses, who should not have to follow the one yellow brick road to the public markets.

Jennifer J. Schulp is the director of financial regulation studies at the Cato Institute's Center for Monetary and Financial Alternatives