PROFESSOR ANDREW F. TUCH

COMMENTS ON PROPOSED RULES FOR SPECIAL PURPOSE ACQUISITION COMPANIES, SHELL COMPANIES, AND PROJECTIONS (MARCH 2022)

RE: FILE NO. S7-13-22

June 13, 2022

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

Via Electronic Mail (rule-comments@sec.gov)

Dear Ms. Countryman

I submit this comment letter in response to the Securities and Exchange Commission's Release Nos. 33-11048; 34-94546; IC-34549; File Number S7-13-22 (the "Release"), which proposes rules (the "Proposed Rules") regarding Special Purpose Acquisition Companies (SPACs), Shell Companies, and Projections.[1] In light of the limited timeframe for providing comments, I focus on aspects of Parts II and III of the Release

By way of background, I am a law professor who has researched and written in the areas of securities regulation and corporate law. In recent years, my writing has focused on SPACs, de-SPACs, going-private transactions, and the liability exposure of financial advisors, including underwriters and M&A advisors.[2] The views expressed in this letter are solely my own, and the institutional affiliation provided below is given for identification purposes only.

[1] See SEC, Release Nos. 13-11048; 34-94546; IC-34549; File No. S7-13-22 (March 2022) ("Release").

[2] See, e.g., Andrew F. Tuch & Joel Seligman, *The Further Erosion of Investor Protection: Expanded Exemptions, SPAC Mergers and Direct Listings*, IOWA L. REV. (current draft attached and soon available on ssrn); Andrew F. Tuch, *M&A Advisor Liability: A Wrong Without a Remedy?*, 45 DEL. J. CORP. L. 177 (2021); Andrew F. Tuch, *Managing Management Buyouts: A US-UK Comparative Analysis*, in RESEARCH HANDBOOK ON COMPARATIVE CORPORATE GOVERNANCE 477 (A. Afsharipour & M. Gelter eds., 2021); Andrew F. Tuch, *Fiduciary Principles in Banking Law*, in THE OXFORD HANDBOOK OF FIDUCIARY LAW (E. J. Criddle, P. B. Miller & R. H. Sitkoff eds., 2019); Andrew F. Tuch, *The Remaking of Wall Street*, 7 HARV. BUS. L. REV. 315 (2017); Andrew F. Tuch, *Banker Loyalty in Mergers and Acquisitions*, 94 TEXAS L. REV. 1079 (2016).

I. PROPOSED NEW SUBPART 1600 OF REGULATION S-K

A. Proposed Rules Modeled on Rules Applicable to Going-Private Transactions

Many key reforms in the proposed new Subpart 1600 are modeled on provisions in 17 CFR 240.13e-3 ("Rule 13e-3") that apply to certain going-private transactions.

Proposed Item 1605 would require disclosure of the background, material terms, and effects of a de-SPAC transaction. Proposed Item 1605 is modeled, in part, on Item 1004(a)(2) and Item 1013(b) of Regulation M-A, which apply to going-private transactions under Rule 13e-3.[3]

Proposed Item 1606 would require SPACs to state whether they reasonably believe the de-SPAC and any related financing transaction are fair to the SPAC's unaffiliated security holders and to discuss the material factors upon which such belief is based. Proposed Item 1606 is modeled on Item 1013 of Regulation M-A, which applies to going-private transactions under Rule 13e-3.

Proposed Item 1607 would require SPACs to state whether the SPAC or SPAC sponsor has received any report, opinion or appraisal from an outside party relating to the transaction and summarize that third party opinion, among other matters. Proposed Item 1607 is modeled on Item 1014 of Regulation M-A, which applies to going-private transactions under Rule 13e-3.

The Proposed Rules would also amend Exchange Act Rules 14a-6 and 14c-2, as well as the instructions to Forms S-4 and F-4, to require a minimum 20-day dissemination period for disclosure documents filed in connection with de-SPAC transactions. These amendments are also modeled on provisions in Rule 13e-3.[4]

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[3] Release, at 47 n. 88.

[4] *See* 17 CFR § 140.13e-3(f).

In footnotes to the Release, the Commission briefly justifies its recourse to Rule 13e-3, stating:

> In our view, these rules [applicable to going-privates subject to Rule 13e-3] are appropriate models for the proposed specialized disclosure requirements for de-SPAC transactions, in that … the same potential for self-interested transactions exists in de-SPAC transactions as in going-private transactions.[5]

Elsewhere in the Release, the commission explains

> In our view, the disclosure requirements in Rule 13e-3 provide an appropriate model for the proposed requirements with respect to de-SPAC transactions, in that the conflicts of interests and misaligned incentives inherent in going-private transactions are similar to those often present in de-SPAC transactions.[6]

B. An Analogy with Going-Private Transactions

To begin, I agree that de-SPACs are analogous to going-private transactions subject to Rule 13-3 in the conflicts of interests they may create. As Professor Joel Seligman and I argued in *The Further Erosion of Investor Protection: Expanded Exemptions, SPAC Mergers and Direct Listings*,[7] key participants in both types of transactions have opportunities and incentives to engage in self-dealing, to the detriment of unaffiliated security holders. For de-SPACs, these securities holders are public SPAC shareholders unaffiliated with the sponsor; for going-private transactions subject to Rule 13-3, these security holders are public shareholders in the target unaffiliated with the acquirer.[8] In both transaction types,

[5] Release, at 47 n. 88.

[6] Release, at 52 n. 96.

[7] Tuch & Seligman, *supra* note 2.

[8] *Id*. at 53 (footnotes omitted) ("We can also analogize the regulation of SPAC mergers with that of going-private transactions under federal securities law. The quintessential going-private transaction is the management buyout (MBO), a transaction that, like SPAC mergers, creates conflicts of interest for transaction participants, including corporate fiduciaries. In MBOs, managers of a firm participate in buying the firm, a position that pits managers' self-interest against their fiduciary duties of loyalty. Federal securities law responds to these transactions by requiring enhanced disclosure. Rule 13e-3 compels an issuer and affiliates engaged in a going-private transaction to

countervailing forces also limit the effects of conflicts of interests: in going-private transactions, the requirement for target shareholders' approval disciplines conflicted target managers; in de-SPACs, the right of SPAC shareholders to redeem their shares may deter sponsors and directors from proposing value-decreasing deals, since widespread redemptions may leave a SPAC with insufficient cash to proceed with a de-SPAC transaction. An analogy exists, inviting recourse to Rule 13e-3 in proposing reforms to de-SPACs.

While I therefore applaud the Commission's use of Rule 13e-3 as a model for reforms, the extent of borrowing of provisions from Rule 13e-3 and the limited justification for doing so create problems. First, I question whether de-SPACs, *as defined in proposed Item 1601*, give rise to "the same" or "similar" potential for self-dealing as going-private transactions subject to Rule 13e-3 sufficient to justify the application of provisions modeled so closely on Rule 13e-3. Second, I question whether de-SPACs ought to be subject to such extensive rules modeled on going-private transactions subject to Rule 13e-3 when, under the Proposed Rules, de-SPACS would also be subject to enhanced Section 11 liability. This latter concern goes to the cumulative deterrent effect of enhanced Section 11 liability and provisions modeled on Rule 13e-3. Third, and relatedly, I draw attention to conflicts and uncertainties in empirical evidence, an understanding of which should limit regulation designed to steer private companies toward traditional IPOs and away from SPAC mergers. Finally, I have particular concerns about proposed Item 1606, which will encourage if not practically require the use of fairness opinions in de-SPACs.

C. Definitional Issues

Consider first how de-SPACs, as defined in proposed Item 1601, and going-private transactions subject to Rule 13e-3 compare in exposing unaffiliated security holders to the risk of conflict. By definition, going-private transactions subject to Rule 13e-3 create severe conflicts of interest for corporate fiduciaries. The provision applies to a "Rule 13e-3 transaction," defined, in part, as any transaction or series of transactions involving one or

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file with the SEC and to publicly disseminate a Schedule 13E-3, which requires disclosure of the transaction's purposes and a written justification of its structure. The target company and its affiliates must attest that they reasonably believe the transaction is fair to shareholders and must explain why this is so.").

more of certain enumerated transactions. The enumerated transactions are transactions between a target and an "affiliate." They include a tender offer of any equity security made by the issuer of such class of securities by an affiliate of such issuer.[9] So defined, going-private transactions subject to Rule 13e-3 involve a structural conflict since the same individuals owing fiduciary duties, often a target company's managers, are on both sides of the transaction. In the quintessential going-private transaction subject to Rule 13e-3,

> [M]anagers of a firm—who are corporate officers and often also directors—participate in buying the firm. Managers participate in the sense of having ongoing roles in the surviving firm, usually as owners and managers. [Such a transaction] therefore puts participating managers on both the buy- and sell-sides of a transaction, a position that pits managers' self-interest against their fiduciary duties of loyalty, creating conflicts of interest. Potentially exacerbating these conflicts, the private equity firms that sponsor these deals (by partnering with managers) usually enlist support from managers early in the deal process, a practice that may undermine arm's-length bargaining over the terms of sale and deter competing bids.[10]

In de-SPACs, corporate fiduciaries (SPAC sponsors and SPAC directors) typically face conflicts of interest. These conflicts are the result of compensation arrangements under which SPAC sponsors and SPAC directors receive SPAC shares that have value only if the SPAC undertakes a de-SPAC. Since sponsors and directors receive these shares for nominal consideration, they may profit from a value-decreasing de-SPAC, giving them incentives to undertake a de-SPAC even if it harms unaffiliated security holders.[11] As is now well known,

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[9] 17 CFR 140.13e-3 (a)(3)(i)(B).

[10] Deborah A. DeMott, *Directors' Duties in Management Buyouts and Leveraged Recapitalizations*, 49 OHIO ST. L. J. 517 (1988); Matthew D. Cain & Steven M. Davidoff, *Form Over Substance: The Value of Corporate Process and Management Buy-Outs*, 36 DEL. J. CORP. L. 849 (2011); Iman Anabtawi, *Predatory Management Buyouts*, 49 U.C. DAVIS L. REV. 1285 (2016); Andrew F. Tuch, *Managing Management Buyouts: A US-UK Comparative Analysis*, in RESEARCH HANDBOOK ON COMPARATIVE CORPORATE GOVERNANCE 477, 478 (A. Afsharipour & M. Gelter eds., 2021).

[11] *See* Release, at 32-33. As to the conflicts these compensation arrangements produce for SPAC sponsors and SPAC directors, see In re MultiPlan Corp. Stockholders Litigation, C.A. No. 2021-0300-LWW (Del. Ch. Jan. 3, 2022) at 43-47 (regarding sponsor incentives) and 48-50 (regarding board incentives).

the compensation arrangements for SPAC IPO underwriters may also exacerbate their incentives to ensure that a SPAC undertakes a de-SPAC within the required investment window.

Whether de-SPACs give rise to the same or a similar risk of conflicts as going-privates subject to Rule 13e-3 is important since the Release provides this empirical claim to justify its decision to subject de-SPACs to onerous provisions modeled on those applicable to certain going-private transactions.[12] But even accepting this claim, a key problem arises with the Proposed Rules. Going-private transactions subject to Rule 13e-3 are defined in terms that assure a severe conflict of interest exists (that the same party is on both sides of the transaction) while proposed Item 1601 fails to define de-SPACs to assure that any conflict arises. Under proposed Item 1601(b), a *special purpose acquisition company* means, generally speaking, a company with a business plan to undertake a SPAC IPO and either complete a de-SPAC within a specified time frame or return the remaining funds from the SPAC IPO to shareholders. The definition does not assure the existence of a conflict of interest; for instance, no mention is made of sponsors' or directors' compensation. As defined, a company with such a business plan is not comparable to a going-private transaction subject to Rule 13e-3 since corporate fiduciaries do not necessarily have conflicts of interest. Similarly, a *de-SPAC transaction* is not defined in proposed Item 1601(a) in terms that assure the existence of a conflict of interest; generally speaking, it is the business combination of a special purpose acquisition company and one or more target companies. Nor do the Proposed Rules define SPAC *sponsor* or *target company* (in proposed items 1601(c) and 1601(d) respectively) in terms that suggest a close analogy with going-private transactions subject to Rule 13e-3.

Provisions modeled on Rule 13e-3 are therefore insensitive to the possibility that the terms of de-SPACs will change to minimize SPAC sponsors' and directors' opportunities and incentives for self-dealing. Under the Proposed Rules, SPACs will be subject to rules modeled on Rule 13e-3 regardless of the conflicts of interest they pose. It is not far-fetched to think that material changes will occur in SPAC sponsors' or SPAC directors' compensation

[12] *See supra* notes 5 and 6 and accompanying text.

or that the terms of SPACs will otherwise evolve to diminish conflicts between the interests of corporate fiduciaries and those of unaffiliated security holders. Indeed, litigation alleging fiduciary breach by SPAC sponsors and SPAC directors in de-SPACs is already creating incentives for reform of market practices. (Consider, for instance, a SPAC board comprised of a majority of directors who are independent of the SPAC sponsor and are not compensated with "founder" shares). It follows that rules in Subpart 1600 modeled on Rule 13e-3 may be, or become, over-broad; they are justified by reference to going-private transactions that necessarily raise severe conflicts of interest but may themselves apply to transactions that raise no such concerns. Moreover, even if de-SPAC transactions currently create the same or similar potential for self-dealing as going-private transactions subject to Rule 13e-3, as the Release claims,[13] I recommend that it more narrowly tailor the class of de-SPACs to which the most onerous rules modeled on Rule 13e-3 apply. Since the definitions in proposed Item 1601 have various purposes, it would be more sensible to narrow the range of de-SPACs to which the most onerous rules apply than to redefine terms in proposed Item 1601.

The most onerous proposed rules modeled on Rule 13e-3 are proposed Item 1606 (concerning the fairness of de-SPACs and related financing transactions) and proposed Item 1607 (concerning reports, opinions, appraisals and negotiations). These should not apply to de-SPACs generally but only to those de-SPACs that raise risks of severe conflicts of interest.

This concern about the application of provisions modeled on Rule 13e-3 to all de-SPACs, as defined in proposed Item 1601, is all the more serious since Rule 13e-3 does not apply to all going-private transactions. In applying Rule 13e-3, issues arise as to who is an "affiliate" and who is "engaged in" a relevant transaction, creating room for deal planners to structure going-privates to minimize the risk of conflict and avoid the application of Rule 13e-3. According to commentators:

> [T]here are instances in which Rule 13e-3 may be avoided even where management is involved in the [going-private] deal. This may be true, for

[13] *See supra* notes 5 and 6 and accompanying text.

example, where there are no, or only preliminary or non-binding arrangements with management at the time of signing such that the parties can argue that no seller affiliate was engaged in the transaction at the relevant time.[14]

Notably, because it applies to going-private transactions that raise risks of severe conflict, Rule 13e-3 provides incentives for deal planners to structure transactions to avoid these risks and thereby avoid the application of Rule 13e-3, such as by not compromising the incentives of corporate fiduciaries at the relevant time. If de-SPACs are to be subject to rules largely modeled on Rule 13e-3, on the basis that de-SPACs give rise to the same (or similar) risk of conflict, the Proposed Rules should ensure that only de-SPACs creating similarly severe risks will fall within their ambit. That requires restricting the de-SPACs to which the most onerous rules modeled on Rule 13e-3 are subject, in particular, Items 1606 and 1607.

D. Cumulative Deterrent Effect of Proposed Rules

The second question is whether the Proposed Rules would subject de-SPACs to heavier regulatory burdens than those applicable to either going-private transactions subject to Rule 13e-3 or traditional IPOs. I suggest they do since, in addition to subjecting de-SPACs to rules modeled on Rule 13e-3, the Proposed Rules would subject the SPAC transaction participants to enhanced Section 11 liability under the Securities Act of 1933. This matters because Section 11, the most potent liability provision in the federal securities regulatory arsenal, strongly deters misconduct by corporate directors, performing a similar function to rules targeting conflicts of interest, including provisions under Rule 13e-3.[15]

The threat of Section 11 liability distinguishes de-SPACs from going-private transactions subject to Rule 13e-3. Transaction participants in going-private transactions subject to Rule 13-e rarely face the prospect of Section 11 liability, a fact that underscores the importance of Rule 13e-3 for these transactions. De-SPACs may also face tougher regulation under state corporate law than going-private transactions subject to Rule 13e-3, although courts have had

[14] FRANCI J. BLASSBERG, THE BEST OF THE DEBEVOISE & PLIMPTON PRIVATE EQUITY REPORT 72 (2006).

[15] As to Section 11, see 9 LOUIS LOSS, JOEL SELIGMAN & TROY PAREDES, SECURITIES REGULATION 322-60 (5th ed., 2018).

few opportunities to articulate any differences. In *In Re Multiplan Corp. Stockholders Litigation*,[16] the Delaware Court of Chancery suggests that the conduct of corporate fiduciaries will be assessed under the rigorous entire-fairness standard, whereas corporate fiduciaries' conduct in going-private transactions typically enjoy BJR protection due to the use of cleansing mechanisms, including the use of fully informed and uncoerced votes of disinterested stockholders.[17] It is unclear from *MultiPlan* whether the use of cleansing mechanisms by corporate fiduciaries in de-SPACs will provide BJR protection to corporate fiduciaries. If they do not, Delaware fiduciary law will have greater deterrent effect on transaction participants in de-SPACs than it does on corporate fiduciaries in going-private transactions subject to Rule 13e-3. Even leaving aside state fiduciary law, federal securities law would more strongly deter misconduct, including self-dealing, occurring in de-SPACs than in going-private transactions subject to Rule 13e-3, a result of the application of Section 11 under the Proposed Rules. This heavier regulatory burden on de-SPACs is not justified by analysis in the Release or by other evidence of which I am aware.

In addition to subjecting de-SPACs to stricter regulation than going-private transactions subject to Rule 13e-3, the Proposed Rules would subject them to stricter regulation than traditional IPOs, this despite the SEC's expressed objective to "align more closely the treatment of private operating companies entering the public markets through de-SPAC transactions with that of companies conduct traditional [IPOs]" and "to provide investors with disclosures and liability protections comparable to those that would be present if the private operating company were to conduct a traditional firm commitment [IPO]."[18] Traditional firm commitment IPOs are not subject to the requirements of Rule 13e-3, even though founders and promoters in IPOs have interests in conflict with those of IPO investors.

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[16] No. 2021-0300-LWW, Del. Ch. Ct, Jan. 3, 2022.

[17] Corwin v KKR Holdings LLC, 125 A.3d 304 (Del.2015). *For a more detailed explanation, see* Andrew F. Tuch, *Managing Management Buyouts: A US-UK Comparative Analysis*, in RESEARCH HANDBOOK ON COMPARATIVE CORPORATE GOVERNANCE 477, 483-85, 490 (A. Afsharipour & M. Gelter eds., 2021); Iman Anabtawi, *Predatory Management Buyouts*, 49 U.C. DAVIS L. REV. 1285, 1308 (2016); Matthew D. Cain & Steven M. Davidoff, *Form Over Substance: The Value of Corporate Process and Management Buy-Outs*, 36 DEL. J. CORP. L. 849, 895-97 (2011).

[18] Release, at 66.

It is this conflict of interest that scholars and others point to in justifying gatekeeper liability.[19] For example, in determining the IPO offer price, founders' interests are in tensions with those of IPO investors. Although I regard Section 11 liability as justified in the context of de-SPACs,[20] the imposition of such liability must be accounted for in determining the extent to which de-SPACs are subject to rules modeled on Rule 13e-3.

In short, the Proposed Rules would subject de-SPACs to more onerous regulation than either going-private transactions subject to Rule 13e-3 or traditional IPOs. A way to address this is to apply Items 1606 and 1607 more selectively, to those de-SPACs raising heightened risks of self-dealing by SPAC fiduciaries, or perhaps not to apply these particular provisions at all. Reforms should provide transaction participants with incentives to structure de-SPACs to minimize the risk of conflict. Reforms should also account for the threat of liability that transaction participants face under Section 11. For example, proposed Items 1606 and 1607 might be applied only to SPACs that lack cleansing mechanisms such independent boards or board committees to review and approve transactions.

E. Empirical Evidence on the net costs of De-SPACs

The available empirical evidence about de-SPACs has important points of agreement and disagreement. The available evidence does not suggest that de-SPACs have created net collective harm; in fact, even the most critical evidence of de-SPACs reveals the opposite. The evidence is uncertain on whether de-SPACs are more or less expensive *from target companies' perspective* than traditional IPOs. The evidence is also uncertain as to the extent of any benefits that de-SPACs offer target companies over traditional IPOs. If de-SPACs are more expensive for target companies than traditional IPOs, as some scholars claim, we can infer that target companies have nevertheless undertaken these transactions because they offer significant benefits not provided by traditional IPOs. My assessment of the evidence suggests that the Commission should not impose reforms that reveal a regulatory preference for traditional IPOs over de-SPACs, or vice versa, or for rules that would channel private

[19] Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 614-21 (1984); Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L.J. 239, 288–89 (1984); Andrew F. Tuch, *Multiple Gatekeepers*, 96 VA. L. REV. 1583, 1594 (2010).
[20] For reasons developed in detail in Tuch & Seligman, *supra* note 2, 46-54.

companies intending to "go public" away from one type of transaction to the other. Reforms having this effect lack a clear basis in either the SEC's analysis or scholarly research.

However, the Proposed Rules reveal a regulatory preference for traditional IPOs over de-SPACs. It is not apparent that they weigh the cumulative effect of Section 11 liability and provisions modeled on Rule 13e-3 with the result that they subject de-SPACs to more onerous regulation than either going-private transactions subject to Rule 13e-3 or traditional IPOs. To be sure, unaffiliated security holders need greater protection, but regulators must be careful not to tilt the regulatory balance so firmly against de-SPACs.

A solution is to limit the extent to which provisions modeled on Rule 13e-3 apply to de-SPACs.

For convenience, I refer to a synthesis of the empirical evidence that Professor Joel Seligman and I offer in *The Further Erosion of Investor Protection: Expanded Exemptions, SPAC Mergers and Direct Listings* (omitting references):[21]

> [S]cholarly views diverge on which of the remaining transaction participants [SPACs or target operating companies] bear the high costs of raising funds via a SPAC merger: target shareholders or non-redeeming SPAC, a group that includes retail investors. The answer will depend on the terms of the agreement the merger parties strike and, in particular, whether targets negotiating mergers account for the heavily dilutive effect of founder shares, warrants, and rights, a consequence of which is that SPACs hold less cash per share than their $10 nominal share value suggests. Klausner et al. suggest that, in negotiating with SPACs, targets protect their interest by accounting for SPAC's dilutive structure. Pointing to the substantial price declines SPACs experience after a merger and to their finding of a strong correlation between those declines and the extent of dilution, Klausner et al. infer that "SPAC shareholders bear the costs … embedded in the SPAC structure," although "they extract some [modest] surplus from the deal, so their net losses are partially mitigated." Non-redeeming SPAC shareholders

[21] Tuch & Seligman, *supra* note 2, at 48-54.

"unwittingly subsidize" target companies, with the result that, from a target's perspective, going public via a SPAC "has been cheap—cheaper than an IPO."

The evidence presented by Klausner et al. that SPAC shareholders—rather than target companies—bear the brunt of the expense is equivocal. Considering *immediate* post-merger prices, rather than the longer-term post-merger prices on which Klausner et al. base their inferences, and taking an alternative perspective to valuing IPO costs, Klausner et al. report the opposite result, that "SPACs would seem to be very expensive for target companies." But Klausner et al. are skeptical of this alternative approach, suggesting instead that SPAC post-merger prices may be slow to adjust. Rather than rely on a SPAC's immediate post-merger price, Klausner et al. point to evidence that SPAC prices decline in the weeks and months post-merger, which they interpret as consistent with the view that SPAC investors are bearing the cost of SPAC mergers. Again, however, this interpretation hinges on the view that SPAC prices are not highly informationally efficient but rather adjust slowly, a plausible but contestable claim.

Gahng and coauthors prefer the alternative approach, regarding the costs at the time of merger as falling on target shareholders rather than SPAC shareholders. Gahng and coauthors therefore pose the difficult question of why target companies would engage in SPAC mergers rather than less costly conventional IPOs. Klausner et al. need not answer that question, as they suggest that, *from a target's perspective*, SPAC mergers are cheaper than traditional IPOs, making the appeal of SPACs more obvious, especially considering the higher regulatory burdens traditional IPOs carry. But Klausner et al. must explain why SPAC shareholders would have agreed to bear these costs, a question they cannot answer definitively. Under both interpretations, however, the bottom line is that SPAC mergers have been significantly more costly than traditional IPOs, largely due to their highly dilutive structure. Nonredeeming SPAC shareholders have also fared poorly, with SPAC shares generally declining in price post-merger.

> In addition to disputing the relative cost of SPAC mergers and traditional IPOs, scholars contest the extent to which SPAC mergers provide unique benefits. Scholars speculate that SPAC mergers offer advantages for firms with information that is difficult to convey to investors or firms that investors have difficulty valuing. SPAC deals are thought to be speedier to execute, have more certain deal terms, and benefit from sponsors giving advice and certification to private companies. If these benefits exist, they might well explain why so many companies have preferred SPAC mergers when, on Gahng et al.'s view, SPAC mergers are more expensive than traditional IPOs for target companies. However, Klausner et al. doubt whether SPAC mergers are executed more quickly or result in more certain deal terms. They accept that sponsors may provide value in selecting and advising targets and that PIPE investors may certify the transaction and thus aid in price discovery. But Klausner et al. suggest that these benefits are available at less cost by integrating certain features of SPACs into traditional IPOs.
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> The point, however, is that dispute exists as to the relative costs of SPAC mergers and traditional IPOs and to the existence and size of any benefits SPAC mergers provide. Moreover, even critics of de-SPACs find that during their study period de-SPACs created social value, meaning that these transactions provide, on average, a net collective gain among all parties involved. This suggests that with changed terms, de-SPACs might also be value-increasing for non-redeeming SPAC shareholders, although that would mean lower returns for SPAC sponsors, IPO investors, and underwriters. The evidence therefore fails to establish that traditional IPOs strictly dominate SPAC mergers by providing greater welfare, or vice versa, suggesting that reforms should avoid seeking to channel private companies away from one type of transaction to the other.

Rather than targeting areas requiring reform, the Proposed Rules, in cumulative effect, display a preference for traditional IPOs, an approach unsupported by the available empirical evidence.

F. **Concerns about proposed Item 1606**[22]

Proposed Item 1606 would require SPACs to state whether they reasonably believe the de-SPAC and any related financing transaction are fair or unfair to the SPAC's unaffiliated security holders and to discuss the material factors upon which such belief is based. Although framed as a disclosure provision, the proposed rule requires a SPAC's board to make a reasonable determination as to fairness, a requirement that, if adopted, would likely lead boards to engage financial advisors to provide fairness opinions, to aid in their decision-making. Indeed, numerous commentators have pointed to fairness opinions as a way for a SPAC's board to substantiate the reasonableness of its belief as to a transaction's fairness to unaffiliated security holders.[23]

However, fairness opinions that would be responsive to proposed Item 1606 confront major obstacles. Financial advisors giving these opinions would need to opine on the fairness of a de-SPAC *to unaffiliated security holders*. Such an opinion would be far from routine. As the Commission highlights in the Release, the structure of SPACs dilutes the financial interests of unaffiliated security holders primarily due to the grant of founder shares to sponsors for nominal consideration. By convention, parties to a de-SPAC refer to an "implied" enterprise value based on an assumed $10 price per SPAC share. However, due to dilution, the value of each SPAC share at the time of the de-SPAC on a net cash basis is significantly lower than $10.[24] Confirming the importance of net cash per share, econometric research has established that the value of SPAC shares has tended to fall over the 12 months

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[22] Research underlying these comments in Section F is based on joint work with Harald Halbhuber for a project tentatively titled "Fairness Opinions in SPAC Mergers." Comments are my own.

[23] *See, e.g.*, Sullivan & Cromwell LLP, SEC Proposes Sweeping Changes Regulating SPAC Formation and De-SPAC Transactions, March 31, 2022, at 1 ("[A]lthough the proposed rules would not require a SPAC to obtain a fairness opinion from a financial advisor, a SPAC may seek a fairness opinion to substantiate its "reasonable belief" as to the fairness of the transaction"); Sidley, Expansive New SEC Rule Proposals Seek to Rewrite the SPAC Playbook, April 1, 2022 ("SPACs should particularly note the proposed fairness disclosure requirement and consider whether to obtain fairness opinions for pending and future de-SPAC transactions."); Wachtell, Lipton, Rosen & Katz, SEC Proposes New Rules for SPACs and De-SPAC Transactions, April 1, 2022 (SEC proposed rules "could influence whether SPACs and their boards seek fairness opinions, which are not provided in a majority of de-SPAC transactions currently").

[24] *See* Michael Klausner, et al., *A Sober Look at SPACs*, 39 YALE J. REG. 228 (2021); Minmo Gahng et al., *SPACs* 25, 43 (Working Paper, Jan. 29, 2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3775847.

following a merger toward that lower level.[25] This dilution makes it possible if not inevitable that the interests of unaffiliated SPAC investors will diverge from those of the SPAC, underscoring the importance of a fairness opinion opining on the fairness of a de-SPAC *to unaffiliated security holders*.

A de-SPAC may nevertheless be fair to unaffiliated security holders for either or both of two reasons.[26] First, the target shareholders—rather than public SPAC shareholders—may bear the effects of dilution. This is possible, although well-advised target companies are aware that the $10 value a convention. Second, the SPAC merger may promise to create significant value, such as that arising from public company status or from the expertise that sponsors may bring to the post-combination company. This latter reason seems more likely (but still far from certain or even probable) than assuming ignorance or weak bargaining on the part of target companies.

Whether a proposed merger will create enough value to overcome the dilutive effect of typical in SPACs is highly speculative. The greater the dilution, the greater these gains would need to be to make the merger fair to unaffiliated security holders. To give such an opinion, a financial advisor would need to consider first, the extent of dilution inherent in the transaction and second, whether sources of value exist to overcome that deficit from the perspective of unaffiliated security holders.

A study of market practices reveals that financial advisors giving fairness opinions have generally not disclosed analyses that would allow them to opine on the fairness of a de-SPAC to unaffiliated security holders. In de-SPACs, fairness opinions have tended to be given sparingly when a target company is affiliated with a sponsor.[27] In all but a small handful of de-SPACs, these opinions opined on the fairness of a transaction *to the SPAC*, rather than the transaction's

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[25] *Id*.

[26] Michael Klausner, Michael Ohlrogge & Harald Halbhuber, *Net Cash Per Share: The Key to Disclosing SPAC Dilution*, 40 YALE J. REG. BELLTIN 18, 21 (2022).

[27] Jenny Hochenberg & Justin C. Clarke, *SPAC Litigation: Current State and Beyond, 56 The Review of Securities & Commodities Regulation* 33 (2022), https://www.cravath.com/a/web/s1q7XMGjLjQMubcJsjWCFp/3DuuWK/hochenberg_clarke_rscr_final-b.pdf ("Fairness opinions are less common in SPACs, however, except when the target company has some affiliation with the sponsor.").

fairness to unaffiliated security holders. These opinions therefore avoided the issue that proposed Item 1606 would require SPACs to address.

In the 330 de-SPACs completed from January 1, 2019 to June 8, 2022, SPACs obtained fairness opinions from a financial advisor in 40 (or 12.1 percent) of the transactions.[28] I reviewed each of these fairness opinions. In 37 (or 92.5 percent) of these 40 opinions, the opinion stated, without more, that the consideration paid was fair from a financial point of view *to the SPAC*. In two (or 5 percent) of these fairness opinions the financial advisor opined that the transaction was fair *to unaffiliated security holders*. These fairness opinions were given by Scalar Group and Mediabanca.[29] One (or 2.5 percent) of the 40 fairness opinions—given by ThinkEquity LLC—stated simply that the transaction was fair, without stating to whom.[30]

All 40 opinions were provided by small or "boutique" advisors rather than major investment banks. Moelis & Company, Duff & Philps, and Houlihan Lokey were the most frequent authors of these letters, giving them in 10, 6, and 5 de-SPACs, respectively. Other financial advisors that gave fairness opinions (and the number of de-SPACs for which they did so) were BTIG (1), Cassel Salpeter (2), Craig-Hellum Capital Group (1), Guggenheim Securities (2), Lake Street Capital Markets (1), Mediabanca (1), Northland Capital (1), Northland Securities (1), Primary Capital (1), Rothschild (2), Scalar Group (1), SVB Leerink (1), ThinkEquity LLC (3), and Vantage Point Advisors (1).

Major investment banks advised on many of the de-SPACs for which fairness opinions were given. These included Goldman Sachs, Morgan Stanley, Credit Suisse Securities, Deutsche Bank Securities, Banc of America Securities, and Citigroup Global Markets. But none of these firms provided a fairness opinion. For example, in the SPAC merger involving Energy Vault, Inc.,

[28] This analysis relies on data from Deal Point Data to identify relevant transactions.

[29] The transactions were for acquisition of Ermenegildo Zegna Holditalia S.p.A. by Investindustrial Acquisition Corp, completed on December 17, 2021, for which Mediobanka provided a fairness opinion, and the acquisition of Revelation Biosciences by Petra Acquisition Inc., completed on January 10, 2022, for which Scalar Group provided a fairness opinion.

[30] The transaction was for FG New American Acquisition Corp.'s acquisition of Opportunity Financial, LLC, completed on July 20, 2021.

Goldman, Sachs & Co and Rothschild & Co. acted as advisors, with Rothschild providing a fairness opinion. Similarly, in the SPAC merger involving Matterport, Deutsche Bank Securities, Morgan Stanley, and Moelis acted as advisors, but only Moelis provided an opinion.

The financial advisors giving these opinions were generally careful to avoid any interpretation that they were opining as to fairness to SPAC shareholders. Again, all but three of these letters opined only on fairness to the SPAC, an entirely different question since SPAC interests can be expected to diverge from those of unaffiliated security holders. Many of these opinions also stated that they were giving no opinion as to the value of shares to SPAC shareholders or were assuming, for purposes of their analysis, that each SPAC share was valued at $10, an assumption that sidesteps the issue of dilution.

For example, the fairness opinion provided by Moelis in the 2021 merger between Gores Metropoulos II, Inc., a SPAC, and Sonder Holdings Inc, stated that the opinion "does not address the fairness of the [SPAC merger] or any aspect or implication thereof to, or any other consideration of or relating to, the holders of any class of securities, creditors or other constituencies of the [SPAC] or Target."[31] The opinion provided by Houlihan Lokey in the 2021 merger between Auror Innovation, Inc and Reinvent Technology Partners assumed a value per share of $10 and expressly disregarded the dilutive impact of founder shares.[32] Of course, the opinions were also careful to avoid lending weight to the projections they used as inputs in their valuation analyses, noting that these projections were supplied by management and had not been independently verified.

Of the 40 fairness opinions given in de-SPACs since 2019, only two opined that the merger transaction was fair to unaffiliated security holders. These were for the merger of Petra

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[31] Rule 424(b)(3) prospectus for merger of Gores Metropoulos II, Inc. and Sonder Holdings Inc., dated Dec. 23, 2021, at J-2.

[32] Rule 424(b)(3) prospectus for merger of Aurora Innovation, Inc. and Reinvent Technology Partners, dated Oct. 12, 2021, at K-1 ("We… have assumed that the value of each share of Acquiror capital stock … is equal to $10.00 per share (with such $10.00 value being based on Acquiror's initial public offering and Acquiror's approximate cash per outstanding Acquiror Class A Ordinary Share (excluding, *for the avoidance of doubt, the dilutive impact of outstanding Acquiror Class B Ordinary Shares or any warrants to purchase Acquiror Class A Ordinary Shares or Acquiror Class B Ordinary Shares*)) [emphasis added].

Acquisition Inc, a SPAC, and Revelation Biosciences, Inc. and that of Investindustrial Acquisition Corp, a SPAC, and Ermenegildo Zegna Holditalia S.p.A. In another transaction, the merger of SPAC FG New American Acquisition Corp. with Opportunity Financial, the financial advisor failed to state from whose perspective the merger consideration was fair, leaving open the possibility, at least based on its concluding statement of opinion, that it was speaking to the perspective of public SPAC shareholders.

Analysis of these opinions underscores concerns about the limits of SPAC fairness opinions in overcoming substantive fairness concerns. Despite their concluding opinions, none can reasonably be taken to provide unaffiliated security holders with reassurance about the relevant merger's fairness. This is not to say that appropriate opinions cannot be given; in principle, they can. Rather, opinions given to date would not be responsive to proposed Item 1606.

Consider first the Revelation Biosciences merger, in which Scalar Group provided an opinion that the merger consideration "is fair to [the SPAC] and [the SPAC's] unaffiliated stockholders from a financial point of view."[33] The letter demonstrates no explicit basis for this opinion. The letter compares the target company with selected comparable public companies in the biotech and pharmaceutical industries, allegedly chosen for the similarity of their operations to those of the target. The opinions applies numerous adjustments to determine "a range of selected implied equity values" for the target of $43 million to $126 million, which "compares to the equity consideration of $106 million to be issued to [the target's] shareholders per the Business Combination Agreement." Next, the financial advisor reviews IPOs of 25 comparable biotech and pharmaceutical companies. Using the 25th and 75th percentiles of the pre-money valuations of these comparable company IPOs, the financial advisor derives an implied valuation range for the target. Based on this analysis, the fairness opinion concludes that the merger consideration is fair to the SPAC and its public stockholders from a financial point of view.

What is missing is any analysis of the dilution caused by the founder shares, etc. The opinion fails to consider whether unaffiliated security holders bore the effects of this dilution, as we

[33] Rule 424(b)(3) prospectus for merger of Revelation Biosciences and Petra Acquisition, dated Dec. 16, 2021, at 111.

would expect if the target were well-advised or was aware of the dilution inherent in the conventional SPAC structure. And the opinion is devoid of any consideration of the possibility of uplift coming from public company status or the sponsor's ongoing role in advising the target. The opinion thus provides no apparent basis for its conclusion regarding fairness to unaffiliated security holders. Rather, its valuation analyses broadly mirror those of fairness opinions that expressed no opinion regarding fairness to public SPAC shareholders.

Consider next the merger with Ermenegildo Zegna Holditalia, Mediobanca, in which the fairness opinion regards the merger consideration as "fair, from a financial point of view, to the holders of the ordinary shares of [the SPAC]."[34] This letter also fails to disclose any basis for such an opinion. First, the financial advisor "assumed that the value of each Ordinary Share is equal to $10.00 per share," sidestepping the core issue of a lack of a market price for the SPAC stock, stripping the opinion of meaning. Second, as with the Revelation de-SPAC, the valuation analyses fail to speak to the fairness or otherwise of the merger consideration to public SPAC shareholders. Again, what is missing is any analysis of the dilution caused by the founder shares, warrants and expenses, or any examination of where these costs fall, or how they are apportioned between unaffiliated security holders and the target.

Neither of these opinions provides real comfort that the relevant transactions were fair from a financial point of view to public SPAC shareholders—despite their concluding statements.

In the merger of SPAC FG New American Acquisition Corp. with Opportunity Financial, ThinkEquity opined that the merger consideration paid by the SPAC "is fair from a financial point of view," without saying to whom.[35] This opinion, and the accompanying proxy statement disclosures, disclose scant valuation analyses. Nothing in them assesses the value of SPAC shares in the merger to public SPAC shareholders, and so this opinion, too, could not reasonably

[34] Rule 424(b)(3) prospectus for merger of Investindustrial Acquisition Corp and Ermenegildo Zegna Holditalia S.p.A, dated Nov. 29, 2021, at 145.

[35] Proxy Statement pursuant to Section 14(a) for merger of Opportunity Financial and New America Acquisition Corp, dated June 22, 2021, at K-3.

receive much weight in demonstrating fairness to public SPAC shareholders.[36] Moreover, the letter does disclose conflicts; this is a rare deal in which the financial advisor also served as an underwriter in the SPAC IPO and in connection with the IPO, received both common stock and warrants in the SPAC that would be worthless if no merger occurred within the defined investment window.[37] This conflict undermines the force of the letter's expressed opinion. Despite the apparent breadth of its conclusion, this opinion fails to address the issue of substantive fairness to public SPAC shareholders.

In short, only three of the fairness opinions given in de-SPACs since January 1, 2019 state an opinion that, on its face, even addresses fairness to unaffiliated security holders. On deeper inspection, none of these opinion letters can reasonably be regarded as addressing substantive fairness concerns for unaffiliated security holders. These fairness opinions lack convincing analysis and include statements undermining the force of their concluding opinions. None were provided by a major investment bank, even though these banks advised SPACs on many of the deals.

In view of this evidence, I make two recommendations. First, and most importantly, any fairness opinions provided in de-SPACs must be required to clearly state that they study fairness from the perspective of unaffiliated security holders. Opinions should grapple with the dilutive effects of the transaction. To buttress the required board opinion, opinions might therefore state the net cash per share at the time of the de-SPAC and precisely why the financial advisor considers the de-SPAC fair to unaffiliated security holders. Opinions should not assume a SPAC value of $10 per share for purposes of their analysis. Without such analysis, a bald statement as to fairness, even such a statement speaking to the position of unaffiliated security holders, lacks credibility and should not be regarded as allowing SPAC boards to satisfy their obligation under proposed Item 1606.

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[36] The opinion employs the comparable companies approach and the DCF approach without considering the implications for public SPAC shareholders.

[37] *Id*. at at K-2.

Second, consistent with my arguments above, proposed Item 1606 should be reserved for those de-SPACs in which conflict concerns are the most serious. Opinions addressing fairness to unaffiliated security holders are tough to give. Whether financial advisors will be willing to give them is doubtful; to date, no major investment bank has done so, and the small handful of opinions that appear to address the issue would seem to lack supporting analysis. When de-SPACs have already adopted effective measures to mitigate severe conflicts, imposing proposed Item 1606 would be unduly burdensome.

II. Aligning de-SPAC Transactions with Initial Public Offerings

A. A Need for Increased Deterrence Force

Absent the Proposed Rules, Section 11 provides a significantly weaker deterrent force in de-SPACs than traditional IPOs.[38] Proposed Rules designed to buttress the deterrent force of Section 11 in de-SPACs are generally well-tailored. First, the Proposed Reforms would help prevent disparities in regulation for transactions that vary in legal structure but not in economic substance. Second, Proposed Rules regarding underwriter liability are justified and, more specifically, the justification for underwriter liability for de-SPACs is as strong as it is for traditional IPOs. I touch on the reasons here, which are spelled out in more detail in the attached article.

B. Accounting for Differences in de-SPAC Transaction Structure

First, as Joel Seligman and I argue in *The Further Erosion of Investor Protection*, the liability risk of transaction participants depends on a de-SPAC's legal structure. Various structures exist for de-SPACs, including a conventional or "SPAC-on-top" structure, a "target-on-top" structure, and a double-dummy structure.[39] Relevantly, these structures differ according to whether the transaction involves a registered offering and for those that do involve a registered offering, whether the party that registers the securities offered is the SPAC, the target, or another entity. Variations exist along other dimensions too. For reasons

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[38] *See* Tuch & Seligman, *supra* note 2, at 26-46; Klausner et al., *supra* note 24, at 285-87.

[39] *See* Tuch & Seligman, *supra* note 2, at 29-31.

we explain, the upshot is that reforms need to account for variations in legal structure to assure that structures equivalent in economic substance are treated equivalently.

i. Private Operating Company as Co-Registrant to Form S-4 and Form F-4

Proposed reforms to Forms S-4 and F-4, making target operating companies co-registrants with SPACs, goes some way toward ensuring equivalence in treatment. These reforms have implications for the conventional SPAC-on-top structure, in which the SPAC or a subsidiary of the SPAC issues securities in a proposed offering and itself becomes the registrant. By making target companies co-registrants, the Proposed Rules ensure that target operating companies and their directors and officers have strong incentives under Section 11 to deter disclosure errors and other misconduct, even in conventionally-structured de-SPACs. To be sure, these proposed reforms making target operating companies co-registrants would subject both SPACs and target operating companies to strict liability, increasing the range of potential defendants under Section 11 relative to traditional IPOs (in which there is a single registrant). While this risks over-deterring misconduct in de-SPACs, the proposed reforms limit liability to those parties that have the capacity to actively deter disclosure wrongs, making the proposed regime closely analogous to that for traditional IPOs. SPACs and target operating companies, and their respective directors and officers, are aware of the accuracy and completeness of the disclosures required in a de-SPAC or at least have such control over disclosure in a registration statement that they can help ensure the statement's accuracy and completeness.

ii. Deeming business combination of shell company to involve a "sale"

Proposed Rule 145a would deem any business combination of a reporting shell company involving another entity that is not a shell company to involve a "sale" of securities to the reporting shell company's shareholders. This reform would also help prevent certain disparities in regulation for transactions that vary in legal structure but not in economic substance, ensuring that unaffiliated security holders enjoy the protections that come from investing in a registered offering.[40]

Any reform that goes further by also making sponsors an enumerated defendant under Section 11, such as by requiring the sponsor to sign a Form S-4 or Form F-4 filed in connection with a de-SPAC, as Request for Comment #68 suggests, would be going too far, tilting the regulatory balance against de-SPACs and in favor of alternative transactions including traditional IPOs. As it is, sponsors may find themselves liable under Section 11 as control persons (or liable under Section 12(a)). Under the Proposed Rules, for de-SPACs the strict liability net under Section 11 is cast wider than it is for traditional IPOs since it would encompass targets. Making SPAC sponsors signatories of registration statements may counteract incentives created by proposed Subpart 1600, which may lead sponsors to relinquish some control over de-SPACs, such as by making SPAC boards are more willing to promote the interests of unaffiliated SPAC investors.

C. Underwriter Status and Liability under Section 11

I broadly agree with the Proposed Rules intended to enhance Section 11 liability for underwriters. While the Proposed Rules go further than simply clarifying the law, I suggest that they are justified to the extent they would regard SPAC IPO underwriters as underwriters of de-SPACs. The case justifying Section 11 underwriter liability needs to be carefully made. Rather than simply establishing in an absolute sense that an increased risk of Section 11 liability for transaction participants in de-SPACs is justified, the SEC can better make the case by reference to traditional IPOs. In *The Further Erosion of Investor Protection: Expanded Exemptions, SPAC Mergers and Direct Listings*, Professor Joel Seligman and I give the following reasons for enhancing Section 11 liability in de-SPACs, focusing on underwriter liability in particular (omitting references):

> First, we contend that the benefits of underwriter liability are at least as great for SPAC mergers as they are for traditional IPOs. Both SPAC mergers and

[40] For further discussion, see Harald Halbhuber, *An Economic Substance Approach to SPAC Regulation*, 40 YALE J. ON REG. BULLETIN 44 (2022).

traditional IPOs introduce largely unknown and untested companies to public markets, and in such settings, information asymmetries between investors and companies seeking capital are likely to be substantial. In both transactions, information comes from the companies themselves, parties with incentives "to act opportunistically by misrepresenting the accuracy … of the information." After all, traditional IPOs and SPACs represent companies' best shot at capitalizing on their innovations, so firms face pressure to attract funds on the most favorable terms. These environments of high information asymmetries are precisely the ones in which the investor protections of federal securities law "are typically most needed." If anything, the benefits of underwriter liability may be greater in the SPAC setting because SPAC sponsors and SPAC IPO underwriters have incentives misaligned with those of SPAC investors, which magnifies the risk of disclosure error.

Second, the costs of underwriter liability are no greater for SPAC mergers than they are for traditional IPOs. In both settings, investment banks have roles that allow them to perform due diligence. These firms have developed time-tested methods for assuring the accuracy of registration statements and other disclosures, methods that would seem equally applicable in both settings. Indeed, some legal advisors have advised participants to consider performing IPO-style due diligence in SPAC mergers without regarding cost as a barrier to banks.

Assuming the accuracy of these claims regarding costs and benefits, the case for underwriter liability is as strong for SPAC mergers as it is for traditional IPOs. On this reasoning, underwriter liability would generate benefits for SPAC mergers at least as great as those accrued to traditional IPOs, without imposing additional costs. If Section 11 underwriter liability is justified for traditional IPOs, the same is true for SPAC mergers.

Professor Seligman and I also argue that Section 11 underwriter liability is indeed justified for traditional IPOs.[41]

The Proposed Rules are right to enhance the prospect of Section 11 underwriter liability in de-SPACs, although the discussion in the Release creates unnecessary ambiguity. The Release suggests that a range of actors *other than SPAC IPO underwriters* may be liable as statutory underwriters without specifying when this would occur. In doing so, the Release may cast doubt on the longstanding understanding that financial advisors in mergers and acquisitions (M&A advisors) are not statutory underwriters,[42] without explaining when these advisors would be statutory underwriters or what implications exist for the role of M&A advisors in M&A transactions other than de-SPACs.

A risk with the Commission's approach is that SPAC IPO underwriters would now have powerful incentives to cease advising SPACs they have taken public that have yet to undertake de-SPACs. Some investment banks are already considering taking this approach, according to reports.[43]

A preferable regulatory approach may be to treat a SPAC IPO and de-SPAC transaction as integrated by deeming SPAC IPO underwriters to be statutory underwriters for purposes of any associated de-SPAC. This would ensure that de-SPACs have the benefit of underwriter-level due diligence.

In *The Further Erosion of Investor Protection: Expanded Exemptions, SPAC Mergers and Direct Listings*, Professor Joel Seligman and I suggest an alternative:

> We recommend that a SPAC's IPO underwriters bear liability under Section 11 for any misstatements or omissions in registration statements used in connection

[41] Tuch & Seligman, *supra* note 2, at 12-16, 26-38, 46-48.

[42] As to the regulation of M&A advisors, see Andrew F. Tuch, *M&A Advisor Misconduct: A Wrong Without a Remedy?* 45 DEL. J. CORP. L. 177 (2021).

[43] Goldman Is Pulling Out of Most SPACs Over Threat of Liability, Bloomberg, May 9, 2022, https://news.bloomberglaw.com/capital-markets/goldman-is-pulling-out-of-most-spacs-over-threat-of-liability ("Goldman Sachs Group Inc. is pulling out of working with most SPACs it took public, spooked by new liability guidelines from regulators").

> with a SPAC merger. This could be achieved by viewing a SPAC IPO and its associated SPAC merger as one integrated transaction. The purpose would be to treat underwriters of the SPAC IPO as underwriters of the SPAC merger under Section 11. These investment banks may be formally retained by the SPAC as M&A advisors and in any event, often advise on or otherwise facilitate the SPAC merger—having incentives to do so because of their deferred compensation. If these investment banks were to face suit, they would benefit from the due diligence defense under Section 11. In practice, such liability would likely result in an underwriter undertaking due diligence to avoid liability, including seeking negative assurance and comfort letters from the SPAC's counsel and auditors, respectively, attesting to the accuracy of the relevant registration statement. These heightened standards would apply to SPAC mergers only, a distinguishable class of merger in which special investor risks arise, rather than to mergers generally. These proposed standards would also align due diligence standards with those of traditional IPOs, buttressing investor protections.

However, if SPAC IPO underwriters are to be statutory underwriters for de-SPACs, the Commission might consider giving these parties control over whether a de-SPAC proceeds. In traditional IPOs, underwriters are true gatekeepers in the sense that they can prevent a transaction from proceeding if they are, for example, dissatisfied with the content of the registration statement; underwriters can then simply refuse to underwrite the offering, giving them powerful sway over an issuer impatient to execute a transaction. The same is true of auditors, which must give an opinion before an IPO can proceed. In de-SPACs, it is not apparent that SPAC IPO underwriters have a similar "gate" to "keep" during a de-SPAC, even if they are serving as M&A advisors in the transaction. It may be that transaction participants can proceed with a de-SPAC over the objections of the SPAC IPO underwriters and M&A advisors. If the Commission intends to make SPAC IPO underwriters liable as statutory underwriters, it might consider allowing these actors to dissociate themselves from a transaction, such as by making a statement to that effect. This mechanism would give SPAC IPO underwriters and other potential statutory underwriters influence consistent with that of conventional underwriters in a traditional IPO, giving SPACs and targets strong incentives not to proceed with a de-SPAC if the statutory underwriter has concerns about the registration statement's accuracy or completeness.

In Request for Comment #85, the Release raises the issue of "tracing." In *The Further Erosion of Investor Protection*, Professor Seligman and I do not regard tracing with as much concern as other commentators do.[44]

Finally, the Commission's approach toward underwriter liability in the setting of direct listings is worth considering. In permitting direct floor listings, the Commission rejected concerns about the inadequacy of underwriter liability, stating that "the financial advisors to issuers in Primary Direct Floor Listings have incentives to engage in robust due diligence, given their reputational interests and potential liability, including as statutory underwriters under the broad definition of that term."[45] Although the Commission might consider engaging in more rulemaking for direct listings, its emphasis in the Release is consistent with its approach toward primary direct floor listings of insisting on the importance of statutory underwriter liability in deterring wrongs in IPO-equivalent transactions.

D. PSLRA Safe Harbor

I support the Proposed Rules intended to limit the application of the PSLRA safe harbor to de-SPACs. Just as the legal structure of de-SPACs determines the threat of liability to transaction participants, it also determines the application of the PSLRA safe harbor. Recall that there are at least three main transactional forms for de-SPACs.[46] In the target-on-top and double-dummy structures, a private target and a newly formed holding company make *initial* offerings of securities to the public during a de-SPAC. These structures contrast with the conventional structure whereby an issuer of securities in the de-SPAC (the SPAC) has already undertaken an initial offering of securities. The argument that de-SPACs are not "initial public offerings" within the PSLRA exclusions is more plausible for transactions that

[44]Tuch & Seligman, *supra* note 2, at 29-31.

[45] Securities Exchange Act Release No. 90,768, at 33.

[46] *See supra* note 39 and accompanying text.

do not adopt the conventional structure. In interviews undertaken in writing the *Further Erosion of Investor Protection: Expanded Exemptions, SPAC Mergers, and Direct Listings*, practitioners were candid that many de-SPACs do not rely on PSLRA safe harbors for forward-looking statements.[47] Nevertheless, SPACs have routinely made use of forward-looking statements in de-SPACs, without apparent regard for how they are structured. This practice suggests that the availability of the PSLRA safe harbor may *not* be a significant factor in determining the use of forward-looking statements in de-SPACs; at a minimum, it suggests that the PSLRA safe harbor is not necessarily regarded by transaction participants as essential protection in de-SPACs. If that is right, it overstates the case to argue that the Proposed Rules would put SPACs between a rock and a hard place, depriving SPACs of protections for statements that state law requires them to disclose. At a minimum, the Commission needs to understand why transaction participants have willingly disclosed projections in circumstances when the safe harbor is generally understood not to be available.

Relatedly, I agree that de-SPACs should not be regarded as "initial public offerings" for purposes of the PSLRA (see Request for Comment #77). That is a strained interpretation of the term "initial public offering." For example, a de-SPAC might involve an offer and sale of the SPAC's securities to holders of the target company's securities in consideration of their interests in the target company. In this case, the offer and sale to target shareholders may not be regarded accurately as the SPAC's *initial* public offering. While there may be other reasons why de-SPACs should not be regarded as initial public offerings for purposes of the PSLRA, this reason should be enough because it shows that regarding de-SPACs as IPOs for purposes of the PSLRA may well produce disparities in the treatment of de-SPACs based on the legal structure participants use—a result inconsistent with a motivating principle of the Proposed Rules.

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[47] *See* Tuch & Seligman, *supra* note 2, at 46-47.

Thank you for the opportunity to comment on the Release. I would be pleased to discuss these comments further.

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[submission version with emendation]

THE FURTHER EROSION OF INVESTOR PROTECTION: EXPANDED EXEMPTIONS, SPAC MERGERS AND DIRECT LISTINGS

Andrew F. Tuch and Joel Seligman[*]

ABSTRACT

This article examines the decades-long decline of investor protections enshrined in the Securities Act of 1933, most notably Section 11, which imposes near strict liability on corporate insiders and certain secondary actors, primarily underwriters. The provision, the most potent in the federal securities regulatory arsenal, popularized the concept of outside gatekeepers and transformed practices in securities offerings, making due diligence a byword for careful investigation of facts whether required by legal process or otherwise. The measures required by Section 11 restored confidence in US capital markets in the wake of the Great Depression and have been instrumental in these markets' long standing as the world's deepest and most liquid.

We argue that the deterrent force of these protections has diminished significantly. The SEC and Congress have all but encouraged this decline by expanding exemptions from registration under the Securities Act, putting the vast majority of capital raised today beyond the reach of these protections. More recently, corporations have increasingly avoided these protections by turning to SPAC mergers and direct listings instead of traditional IPOs.

We assess the perceived benefits of these recent developments alongside the threats they pose to investor protection, arguing that many of the purported benefits of SPAC mergers and direct listings are overstated and, in any case, fail to justify the erosion of investor protection implicit in these transactions—a further degradation of critical safeguards. Our focus on deal structure is novel and key to understanding the risks these transactions, SPAC

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* Andrew Tuch is Professor of Law, Washington University in St Louis. Joel Seligman is President Emeritus and University Professor at the University of Rochester and Dean Emeritus and Professor of Law at Washington University in St Louis. For helpful comments and discussions, we thank Ken Ayotte, Scott Baker, Bobby Bartlett, Jens Frankenreiter, Stavros Gadinis, Harald Halbhuber, Michael Klausner, Michael Ohlrogge, Frank Partnoy, Robert Pollack, Jay Ritter, Adam Rosenzweig, Kyle Rozema, Jonathan Smith, Holger Spamann, Robert Thompson, and participants at the Washington University in St. Louis faculty workshop and the Berkeley Law & Economics Workshop. For help in understanding market practices, we thank numerous market participants including Jon Avina, Ran Ben-Tzur, Calise Cheng, Douglas Ellenoff, Jared Gerber, Matthew Gray, Michael Kliegman, Ramey Layne, Greg Rodgers, David Segre, and Richard Truesdell. For excellent research assistance we thank Andrew Stubbs, Jim Yan, and Ryan Ellingson.

mergers in particular, pose to investors. We suggest reforms governing SPAC mergers and direct listings.

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I. INTRODUCTION

Since at least the 1930s, when the federal securities framework was adopted, most companies undertaking initial public offerings (IPOs) have relied on firm-commitment underwriters to act as intermediaries between themselves and investors. Underwriters buy issuers' securities and resell them to public investors at an agreed markup representing the underwriting fee.[1] The close relationship between IPOs and underwriting, governed by Section 11 of the Securities Act of 1933, is implicit in a regime that has proven enormously successful over the years.[2] Section 11 imposes near-strict liability on corporate insiders and certain secondary actors, primarily underwriters, incentivizing careful due diligence. Among other provisions of the Securities Act, Section 11 was instrumental in restoring confidence in US capital markets in the wake of the Great Depression and has helped them become the world's deepest and most liquid. It is no surprise that investors, their interests guarded by underwriters acting in the role of gatekeepers, made the IPO the pinnacle event for emerging companies seeking capital for growth.[3]

Today, traditional IPOs may be on the wane as firms increasingly turn to mergers with special purpose acquisition companies (SPACs) and direct listings, novel alternatives that provide routes to public markets entirely or partially without an underwriter or due diligence. SPAC mergers and direct listings dispense with nearly century-old techniques for capital raising, weakening investor protection. As a result, these IPO alternatives introduce new risks into financial markets. The shift in corporate activities has been

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[1] As to firm commitment underwriting, the most prevalent underwriting technique, see 1 LOUIS LOSS, JOEL SELIGMAN & TROY PAREDES, SECURITIES REGULATION [hereinafter 1 SECURITIES REGULATION 6TH ED.] 654-90 (6th ed., 2019).

[2] For example, it is said that "the registration and prospectus provisions of the Securities Act of 1933 can be understood—and their effectiveness evaluated—only on the background of the [underwriting] techniques by which securities are distributed in the United States." *Id*. at 647. As to criticisms of securities underwriting in IPOs, see Pt II.D.

[3] *See* Darian M. Ibrahim, *The New Exit in Venture Capital*, 65 VAND. L. REV. 1 (2012) ("Initial public offerings… [are] the gold standard in venture capital success"); Robert B. Thompson & Donald C. Langevoort, *Redrawing the Public-Private Boundaries in Entrepreneurial Capital Raising*, 98 CORNELL L. REV. 1572, 1573 (2013) (referring to IPOs as "long the gold standard for capital raising by successful emerging companies").

permitted, indeed encouraged, by Congress and the Securities and Exchange Commission (SEC).[4]

SPAC mergers and direct listings comprise a significant proportion of IPO activity. In 2021, SPACs accounted for over half of all US IPOs.[5] The value and volume of SPAC mergers soared to record levels in 2020 and 2021. In 2020, SPACs undertook 92 mergers valued at $139 billion, more than doubling 2019 activity levels.[6] While frenetic dealmaking has slowed in recent months,[7] activity levels in 2021 doubled again, with SPACs merging with, and taking public, 221 companies in transactions valued at $404 billion.[8] With over 600 SPACs still seeking merger targets,[9] high SPAC merger levels are assured for some time to come. For their part, direct listings do not occur at the same rate as SPAC mergers, but companies intending to "go public" today routinely consider direct listings as alternatives to traditional IPOs, and their popularity may well increase.

The idea of the SPAC merger originates with reverse mergers, transactions long regarded with suspicion.[10] SPACs are shell companies formed for the purpose of raising capital to merge with an as-yet-unidentified private company.[11] In merging with private companies, SPACs confer on them public status. In this way, a SPAC merger fulfills the primary functions of a traditional IPO: the target company's newly dispersed owners provide cash for growth, and the formerly private company can issue registered shares that are freely tradeable. But the decision to merge rather than undertake a traditional IPO obviates the need for conventional underwriters, largely

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[4] *See* Pt II.
[5] *See* SPAC ANALYTICS, https://www.spacanalytics.com/ (968 US IPOs in 2021 included 613 SPACs).
[6] White & Case, US De-SPAC & SPAC Data & statistics roundup (2021), https://www.whitecase.com/sites/default/files/2022-01/us-spac-de-spac-data-statistics-round-up.pdf. 2019 saw 39 SPAC mergers valued at $24.4 billion. David A. Curtiss, *Market Trends 2020/21: Special Purpose Acquisition Companies (SPACs)*, LEXISNEXIS PRAC. GUIDANCE (2021).
[7] Amrith Ramkumar, *The SPAC Ship is Sinking. Investors Want Their Money Back*, WALL ST. J., Jan. 21, 2022, https://www.wsj.com/articles/the-spac-ship-is-sinking-investors-want-their-money-back-11642761012 ("One of the pandemic's hottest trades is cooling down, as the hype surrounding 'blank-check' companies gives way to reality.").
[8] White & Case, *supra* note 6..
[9] *See* SPAC ANALYTICS, https://www.spacanalytics.com/ (last viewed Feb. 26, 2022) (602 SPACs seeking acquisition targets).
[10] *See infra* notes 98 – 99.
[11] *See* Part III.B.

removing the threat of Section 11 liability for investment banks. Mergers also benefit from certain regulatory accommodations under federal securities law.

Direct listings also exclude the conventional underwriting role but are otherwise much like a traditional IPO. This is possible due to rule changes enacted in 2018 by the New York Stock Exchange (NYSE), which now allows private companies to become publicly traded by listing their shares on the exchange without undertaking an underwritten offering.[12] Spotify quickly took advantage of this regulatory accommodation in an offering for selling shareholders and was soon followed by Slack, Palantir, and Coinbase. In December 2020, the SEC approved NYSE rule changes permitting direct listings that include a primary offering.[13] In 2019 and 2021, the Nasdaq was granted authority for selling shareholder- and primary-offering direct listings, respectively.[14]

Both SPAC mergers and direct listings are now in the cross hairs of regulators.[15] Congress has proposed legislation to strip SPAC mergers of protections for the use of forward-looking information—protections that allow SPAC sponsors unusual leeway in communicating financial forecasts to potential investors.[16] In testifying before Congress in 2021, SEC Chair Gary Gensler cited IPOs and SPACs first among "trends that will affect [the SEC's] resource needs going forward," asking whether "SPAC investors [are] being appropriately protected."[17] More recently, Chair Gensler asked SEC staff to propose new rules to "better align" investor protections in SPAC

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[12] Securities and Exchange Commission, Release No. 34-82627 (Feb. 2, 2018); File No. SR-NYSE-2019-67, https://www.sec.gov/rules/sro/nyse/2018/34-82627.pdf.

[13] *See* Securities and Exchange Commission, Release No. 34-90768 (Dec. 22, 2020); File No. SR-NYSE-2019-67, https://www.sec.gov/rules/other/2020/34-90768.pdf.

[14] Securities Exchange Act Releases 87,648 (2019) selling shareholder direct listings); 91,947 (2021) (primary offerings).

[15] On March 29, 2022, the SEC proposed rules intended to enhance investor protections in SPAC IPOs and mergers. SEC, Release Nos. 33-11048; 34-94546 (Mar. 29, 2022), https://www.sec.gov/rules/proposed/2022/33-11048.pdf.

[16] The Investor Protection, Entrepreneurship, and Capital Markets Subcommittee of the U.S. House Committee on Financial Services held hearings on "Going Public: SPACs, Direct Listings, Public Offerings, and the Need for Investor Protections," on May 24, 2021. Proposed legislation would amend the Securities Act of 1933 and Securities Exchange Act of 1934. *See* https://financialservices.house.gov/uploadedfiles/5.24_bills-117pih-hr____.pdf.

[17] Gary Gensler, Testimony Before the Subcommittee on Financial Services and General Government, U.S. House Appropriations Committee, May 26, 2021, https://www.sec.gov/news/testimony/gensler-2021-05-26.

mergers with those in traditional IPOs.[18] SEC staff have also signaled enhanced scrutiny of SPACs and warned of the need for regulatory change.[19] Reform may occur for direct listings as well. Two SEC Commissioners, Allison Herren Lee and Caroline Crenshaw, opposed 2020 SEC rules expanding the use of direct listings.[20] Both are now members of a majority voting block within the Commission.

SPAC mergers in particular have courted controversy, with SPAC participants facing allegations of securities fraud. The SEC recently charged participants in the SPAC merger of Momentus, Inc. with securities fraud for having "repeatedly told investors that [Momentus] had 'successfully tested' its propulsion technology in space" when, in fact, the company's only in-space test had failed.[21] To the SEC, the case "illustrates risks inherent to SPAC transactions, as those who stand to earn significant profits from a SPAC merger may conduct inadequate due diligence and mislead investors."[22] SPAC mergers have also generated numerous private lawsuits.[23]

This article critically examines SPAC mergers and direct listings, assessing their perceived benefits alongside the threats they pose to investor protection, and proposes strategies for reform. The article situates these IPO alternatives in the context of the decades-long decline of investor protections in federal securities law. The purported benefits of these developments are

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[18] Gary Gensler, Remarks Before the Healthy Markets Association Conference, Dec. 9, 2021, https://www.sec.gov/news/speech/gensler-healthy-markets-association-conference-120921.

[19] *See, e.g.,* John Coates, Acting Dir., SEC Div. of Corp. Fin., 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; John Coates & Paul Munter, Acting SEC Chief Accountant, Staff Statement on Accounting and Reporting Considerations for Warrants Issued by Special Purpose Acquisition Companies (SPACs), April 12, 2021, https://www.sec.gov/news/public-statement/accounting-reporting-warrants-issued-spacs.

[20] *See* Allison Herren Lee & Caroline A. Crenshaw, *Statement on Primary Direct Listings*, Dec. 23, 2020, https://www.sec.gov/news/public-statement/lee-crenshaw-listings-2020-12-23.

[21] Press Release, SEC, SEC Charges SPAC, Sponsor, Merger Target, and CEOs for Misleading Disclosures Ahead of Proposed Business Combination (July 13, 2021), https://www.sec.gov/news/press-release/2021-124.

[22] *Id.* For another example, see Press Release, SEC, Post-SPAC Music Streaming Company Reaches $38.8 Million Settlement in Ongoing Fraud Action (Oct. 27, 2021), https://www.sec.gov/news/press-release/2021-216 (SEC settles of charges against a purported music-streaming business "for allegedly defrauding investors out of tens of millions of dollars" in connection with a 2019 SPAC merger).

[23] Roger E. Barton, Caution Ahead: Litigation Trends Provide a Roadmap for Directors and Officers, Reuters, Sept. 2, 2021, https://www.reuters.com/legal/legalindustry/caution-ahead-spac-litigation-trends-provide-road-map-directors-officers-2021-09-02/ (reporting an increase in lawsuits concerning SPACs).

overstated and, in any case, fail to justify the erosion of investor protection implicit in these transactions—a further degradation of critical safeguards. These transactions reduce the effectiveness of Section 11 in the heartland of its operation: the IPO-equivalent transactions to which the provision has, until now applied with full force.

In Part II we trace the decline of Section 11, observing that decisions by the SEC and Congress have permitted the decline by substantially increasing the number and scope of exemptions from Securities Act registration. A result is that a significant majority of the capital raised in securities offerings today lie beyond the section's reach. As an illustration, consider that in 1970, roughly 17 percent of funds raised in new corporate offerings relied on an exemption;[24] by 2019, the corresponding figure was around 70 percent.[25] We also take stock of other forces that have made experimentation with SPAC mergers and direct listings more appealing to those looking to take companies public.

Part III addresses SPAC mergers specifically, focusing on the regulatory leniency they enjoy, the troubling incentives they create for certain transaction participants, and the high costs they impose. We are not the first to note problems with SPAC mergers, but our emphasis on their deal structures and arguments justifying underwriter liability are novel. Focusing on structure provides a more nuanced understanding of the regulatory accommodations SPAC mergers enjoy, showing, for instance, that because structure drives the availability of safe harbors for forward-looking statements, some SPAC mergers fall outside safe harbor protections.

Because transaction structure shapes the extent of Section 11 liability, generally little risk of underwriter liability exists in SPAC mergers, significantly limiting the force of Section 11. This produces weaker incentives for all gatekeepers—not only investment banks but also auditors and legal counsel—to assure the accuracy of corporate disclosures, relative to the incentives in traditional IPOs. Meanwhile, other factors give transaction participants incentives to act contrary to investor interests.

We assess the merits of underwriter liability in SPAC mergers by using traditional IPOs as a benchmark. This comparison shows that underwriter liability would generate benefits in SPAC mergers at least as great as those accrued to traditional IPOs, without imposing additional costs. Accordingly,

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[24] *See infra* notes 76–77 and accompanying text.
[25] *Id.*

the case for underwriter liability is at least as strong for SPAC mergers as it is for traditional IPOs. If underwriter liability is cost-justified for traditional IPOs, as we contend, the same is true for SPAC mergers.

We also assess the empirical evidence regarding SPAC mergers, highlighting salient areas of dispute among scholars. In particular, it is uncertain whether the high costs of SPAC mergers fall on outside SPAC investors holding stock at the time of the merger or whether those costs fall on the companies with which SPACs merge—or on both parties. An appreciation of this uncertainty should limit any regulatory impulse to steer private companies toward traditional IPOs and away from SPAC mergers, although it does not alter our conclusions as to Section 11. Regarding other potential reforms, we liken the position of SPAC mergers to going-private transactions, transactions in which participants often have misaligned incentives and are denied safe harbors protections.

In Part IV, we assess direct listings, questioning the purported advantages of these transactions, which are said to provide significant cost savings over traditional IPOs. Even if the purported advantages do materialize, they fail to justify the omission of underwriter liability, the merits of which turn on a comparison of the benefits and accompanying costs of Section 11 liability. Although the costs and benefits of underwriter liability are an empirical matter, good reason suggests they are also justified in this setting, a position the SEC has yet to refute.

We conclude in Part V by urging the Commission to undertake a comprehensive review of the Securities Act. The regulation of SPAC mergers and direct listings must be assessed alongside issues including the rise of private markets, the growth of exemptions, technological advances, and the mechanics of complying with provisions of the Securities Act.

II. REGULATORY AND HISTORICAL BACKDROP

Key provisions of federal securities law create powerful incentives for due diligence by underwriters in traditional IPOs. In this Part, we explain why the protections afforded by these incentives are justified. We then detail factors that have put the vast majority of capital raised in recent transactions beyond the reach of these provisions, diminishing their capacity to deter wrongdoing The Part concludes by considering critiques of IPOs and underwriters, arguing that, whatever the merits of these criticisms, they fail to defeat the case for underwriter liability in traditional IPOs.

A. The Securities Act of 1933

The Securities Act of 1933 was the initial response to the 1929-1933 Stock Market Crash, the greatest financial debacle of the 20th and 21st centuries.[26]

The Securities Act relies on three primary techniques to protect investors in public securities offerings.

First, Section 5 requires registration with the SEC of securities offered to the public through "any means or instruments of transportation or communication in interstate commerce" unless the security is exempted by Section 3 or Section 4. In those instances in which the full registration process is applicable, the Act creates a statutory waiting period of 20 days before the security registered with the SEC can be sold,[27] requires underwriters and securities dealers to furnish prospective investors with a prospectus based on the information in the registration statement,[28] and empowers the Commission to issue stop orders to prevent the sale of a security that "includes any untrue statement of a material fact or omits to state any material fact required to be stated or necessary to make the statements therein not misleading."[29]

Second, the Securities Act requires full disclosure of material information to be provided to the SEC in the registration statement and to investors in a

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[26] 15 U.S.C. § 77a et seq. From 1920 to 1933, some $50 billion of securities were sold in the United States. By 1933, half were worthless. In 1934, the American public also held over $8 billion of foreign securities, of which $6 billion had been sold in the years 1923 to 1930. By March 1934, $3 billion were in default. The aggregate value of all stocks listed on the New York Stock Exchange on September 1, 1929, was $89 billion. In 1932, the aggregate figure was $15 billion—a loss of 83 percent in two and one-half years. Securities Exchange Act Amendments, Hearings before Subcomm. of Senate Comm. on Banking & Currency on S. 2408, 81st Cong. 2d Sess. 10 (1950). *See also* JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE Ch. 1 (3d ed. 2003); RALPH DEBEDTS, THE NEW DEAL'S SEC: THE FORMATIVE YEARS Ch. 1 (1964); MICHAEL PARRISH, SECURITIES REGULATION AND THE NEW DEAL Ch. 3 (1970).

[27] 15 U.S.C. §77h(a). *See also* 1 SECURITIES REGULATION 6TH ED., *supra* note 1, at 753.

[28] Section 5(c), 6–7 of Securities Act of 1933, 15 U.S.C. §§ 77e(c), 77f, 77g.

[29] Section 8(d) of 1933 Act, 15 U.S.C. § 77h(d).

prospectus derived from the registration statement[30] superseding the inadequate, often minimal disclosure paradigms of earlier state law, the NYSE and the applicable accounting standards.[31]

Third, Section 11 transformed the process of selling securities to the public. The SEC, the Department of Justice, and any private person may bring a lawsuit whenever any part of a registration statement contains a material misrepresentation or omission. Section 11 creates virtually strict liability for a long list of corporate insiders, including every person who signed the registration statement, the firm's principal executive and financial officers, and every person who was or agreed in the registration statement to become a member of the corporate board.[32] The provision popularized the concept of outside gatekeepers.[33] Critically, Section 11(a) includes as potential defendants every underwriter and every expert, including accountants who certify "any part of the registration statement." Section 11 also requires joint and several liability for the persons specified in Section 11(a)[34] as well as any person who controls any person liable under Section 11.[35]

In sharp contrast to earlier state law, the plaintiff in a Section 11 claim does not have to prove reliance unless he or she bought after the issuer had made generally available to its security holders an earnings statement covering a period of at least 12 months beginning after the effective date. But

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[30] Section 10 of Securities Act, 15 U.S.C. § 77j. As to the content of the registration statement and prospectus, see 2 LOUIS LOSS, JOEL SELIGMAN & TROY PAREDES, SECURITIES REGULATION [hereinafter 2 SECURITIES REGULATION 6TH ED.] Chapter 2.D. (6th ed., 2019). For historical context, see JOEL SELIGMAN, MISALIGNMENT: THE NEW FINANCIAL ORDER AND THE FAILURE OF FINANCIAL REGULATION 328-44 (2020).

[31] *See, e.g.,* SELIGMAN, *supra* note 26, at 42–49; John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717, 722, 739–43 (1984) ("A particular flaw in [the theory of voluntary disclosure] is that it overlooks the significance of corporate control transactions and assumes much too facilely that manager and shareholder interest can be aligned.) *See generally* Joel Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J. CORP. L. 1, 9 (1983).

[32] 15 U.S.C. §§ 77k(a), 77f(a). Section 11 has been strictly enforced. *See, e.g.,* Escott v. BarChris Const. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968); In re WorldCom, Inc. Sec. Litig., 346 F. Supp. 2d 628 (S.D.N.Y. 2004) and reaches both direct purchasers of a registered offering and those who repurchase shares and can "trace" their shares back to a misrepresentation or omission in a registered offering. Barnes v. Osofsky, 373 F.2d 269 (2d Cir. 1967); Hertzberg v. Dignity Partners, 191 F.3d 1076 (9th Cir. 1999).

[33] *See, e.g.,* JOHN C. COFFEE, JR., GATEKEEPERS: THE ROLE OF THE PROFESSIONS AND CORPORATE GOVERNANCE 353 ("The underwriter's obligation to ensure full disclosure in this context is enforced by Section 11 of the Securities Act of 1933…").

[34] 15 U.S.C. § 77k(f).

[35] 15 U.S.C. § 77o(a).

even then "reliance may be established without proof of the reading of the registration statement by such person."[36] The plaintiff is not required in a *prima facie* case to prove scienter, that is intentional or reckless conduct by the defendants, only a material representation or omission. Nor need the plaintiff prove causation, although damages are reduced to the extent that the *defendant* proves that they did not result from her or his misconduct.[37]

The most transformative element of Section 11 for registered securities sales to the public involves the due diligence defenses of Section 11(b)(3). This provision creates exemptions from Section 11 liability for defendants—including underwriters—when they can establish that they used due diligence to affirmatively conduct a reasonable investigation and had grounds for belief equal to that of a prudent person when the registration statement became effective.[38] Because of the threat of liability and underwriters' interest in protecting their reputations, Section 11 made underwriters virtually full partners with the issuer in corroborating the truthfulness of the registration statement. Underwriters became prominent, if not dominant, participants in due diligence meetings for registered offerings.

Lead underwriters in registered offerings perform other functions, including marketing securities through their contact with other underwriters, with dealers who help sell the security without assuming an underwriter's risk, and with institutional investors, including at road show presentations. Underwriters distribute securities for the issuer, typically on a "firm commitment" basis, under which they agree to buy the offered securities at a fixed price. In return, underwriters receive a fee from the public sale price known as the gross spread, calculated as the difference between the price at which they purchase securities from the issuer and resell them to public investors.[39] Underwriters often also help stabilize the price of a security

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[36] 15 U.S.C. § 77o(b).

[37] § 11(e), 15 U.S.C. § 77k(e). The issuer's liability is absolute with one exception: The issuer has the improbable defense available to all defendants of showing that the plaintiff knew of the untruth or omission at the time of her or his acquisition of the security.

[38] 9 LOUIS LOSS, JOEL SELIGMAN & TROY PAREDES, SECURITIES REGULATION 322–73 (5th ed. 2018) [hereinafter 9 SECURITIES REGULATION 5TH ED.]. Regarding § 11, see generally *id.* at Ch. 11.C.d; JOHN C. COFFEE, JR., HILLARY A. SALE & CHARLES K. WHITEHEAD, SECURITIES REGULATION: CASES AND MATERIALS 919–22, 962–76, 980–82, 992–95 (14th ed. 2021).

[39] 1 SECURITIES REGULATION 6TH ED., *supra* note 1, at 674–76 (discussing the gross spread and its allocation among members of the underwriting syndicate and selling group).

during the offering period to the extent permitted by the SEC's stabilization rules.[40]

B. The Unique Position of Underwriters

In imposing liability on underwriters for the material misstatements or omissions of issuers, Section 11 conceives of underwriters as gatekeepers—as parties capable of deterring wrongdoing by issuers.[41] The provision recognizes underwriters' "unique position" among offering participants in assuring the accuracy and completeness of the issuer's disclosures.[42] Putting their reputations at stake in an offering,[43] underwriters certify to investors the accuracy of corporate disclosures and reduce the extent to which investors, fearing they will be sold "lemons," discount the value of newly issued securities.[44]

The structure and interpretation of Section 11 assure that multiple gatekeepers will exercise diligence in order to ensure the completeness and accuracy of issuer disclosures.[45] Section 11 makes underwriters the "first line of defense" against disclosure errors.[46] That is, among secondary actors, underwriters primarily face liability under Section 11, subject to a due

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[40] I*d.* at 654–90; 9 SECURITIES REGULATION 5TH ED., *supra* note 38, at 2–88 (describing price stabilization rules in Regulation M), *id.* at 322–73 (liability under §11); COFFEE, SALE & WHITEHEAD, *supra* note 38, at 67–92.

[41] Reinier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857, 890 (1984) [hereinafter Kraakman, *Corporate Liability*] ("The first requisite for gatekeeper liability is, of course, an outsider who can influence controlling managers to forgo offenses."). As to the monitoring function of gatekeepers, *see id.* at 891 and Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third Party Enforcement Strategy*, 2 J.L. ECON. & ORG. 53, 62–66 (1986) [hereinafter Kraakman, *Gatekeepers*]

[42] *See* Ernest L. Folk, III, *Civil Liabilities Under the Federal Securities Acts: The BarChris Case*, 55 VA. L. REV. 1, 56 (1969) (underwriters are "uniquely able to adopt an objective or even adverse posture towards the issuer regarding the accuracy of the registration statement"); In re Worldcom, Inc. Sec. Litig., 346 F. Supp. 2d. 628, 662 (S.D.N.Y. 2004) (quoting The Regulation of Securities Offerings, Securities Act Release No. 7606A, 63 Fed. Reg. 67174, 67230 (Dec. 4, 1998) (Underwriters' "unique position … enabled them to discover and compel disclosure of essential facts about the offering.").

[43] Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 620 (1984) [Hereinafter, Gilson & Kraakman, *Market Efficiency*] ("The investment banker represents to the market (to whom it, and not the issuer, sells the security) that it has evaluated the issuer's product and good faith and that it is prepared to stake its reputation on the value of the innovation.").

[44] As to the "lemons problem," see George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488, 489–90 (1970).

[45] See Andrew F. Tuch, *Multiple Gatekeepers*, 96 VA. L. REV. 1583, 1636-41, 1645-48 (2010) [Hereinafter, Tuch, *Multiple Gatekeepers*].

[46] In re Worldcom, Inc. Sec. Litig., 346 F. Supp. 2d 628, 662 (S.D.N.Y. 2004).

diligence defense. Specifically, underwriters may be liable for defects in a registration statement's non-expertised portions, which comprise the bulk of the statement and include both textual discussion and some financial and graphical data.[47] By contrast, auditors' Section 11 liability is largely limited to the financial statements that certify, and lawyers rarely face liability under Section 11.[48]

However, the rigor of underwriter liability affects other secondary participants, further ensuring investor protection. Courts allow due diligence performed by auditors and lawyers to help satisfy underwriters' diligence defense,[49] so underwriters in registered offerings secure assurances from the issuer's legal counsel and auditors as to the accuracy of non-expertised portions of registration statements. Underwriters require these assurances, known as 10b-5 letters and comfort letters, as conditions precedent to underwriting the proposed securities offering.[50] A law firm's 10b-5 letter attests that the firm, or individual lawyers, is unaware of any material misstatements or omissions in the registration statement. The auditor's comfort letter gives assurance as to a wide array of financial information in the registration statement, including information appearing in the text, charts, and graphs—information that is separate from the audited financial statements, which are expertised portions of a registration statement. Though the terms of these letters are highly tailored,[51] they expose their authors to liability for negligent or fraudulent preparation, creating incentives for their authors to perform robust due diligence.[52] Thus, while the liability regime places greater reliance on underwriters than on any other offering

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[47] Underwriters also face potential liability for expertised portions of registration statements, subject to a more generous defense that omits a requirement for a "reasonable investigation." 15 U.S.C. § 77k(b)(3)(C).

[48] Lawyers are not an enumerated category of defendant in Section 11.

[49] For example, in determining whether the due diligence defense is established, underwriters' "receipt of [a] comfort letter[] will be important evidence," although by itself it is insufficient to establish the defense. *See* In re Worldcom, Inc. Sec. Litig., 346 F. Supp. 2d 628, 683–84 (S.D.N.Y. 2004).

[50] *See* JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 121–22 (9th ed. 2020).

[51] *See* Tuch, *Multiple Gatekeepers*, supra note 45, at 1640.

[52] *See* COX ET AL., *supra* note 50, at 122.

participant,[53] Section 11 nonetheless assures that the expertise of multiple gatekeepers is brought to bear in the cause of deterring corporate misconduct.

In addition to shifting risks to other gatekeepers, underwriters routinely seek indemnification from issuers for liability under Section 11.[54] Because these indemnification arrangements may be unenforceable, underwriters also obtain contractual rights of contribution, as permitted by Section 11(f) of the Securities Act, allowing underwriters to recover from other parties that share fault.[55] This regime has created strong support for underwriter due diligence by not threatening financial ruin for underwriters.

The initial case for the Securities Act of 1933 was historical and based on both the greater than 80 percent investor losses in the 1929-32 stock market crash[56] and subsequent hearings documenting the failure of corporate selling materials, typically written by underwriters, to fully disclose material information to investors.[57] The historical case for the Securities Act repeatedly has been made in the period after the Act was adopted.[58] Specifically, we have seen on several occasions that market incentives alone fail to elicit desirable conduct by investment banks.[59] And more direct forms of liability, including enterprise and individual managerial liability, do not sufficiently deter corporate misconduct at an acceptable cost.[60] The costs of

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[53] Chris-Craft Industries, Inc. v. Piper Aircraft Corp., 480 F.2d 341, 370 (2d Cir.1973) ("No greater reliance in our self-regulatory system is placed on any single participant in the issuance of securities than upon the underwriter.").

[54] *See* 9 SECURITIES REGULATION 5TH ED., *supra* note 38, at 382-83 (referring to the "common practice" of issuers generally indemnifying underwriters other than "with respect to any information furnished by the underwriters expressly for the registration statement.").

[55] 1 EDWARD F. GREENE ET AL., U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS § 11.03[i] (12th ed. 2017).

[56] *See supra* note 26.

[57] Most significantly the Stock Exchange Practices Hearings of 1932-1934 described in Seligman, *supra* note 60, at Ch. 1, made key findings.

[58] *See, e.g.,* Seligman, *supra* note 26, at 42-49 (examining justifications in the 1930s) Joel Seligman, *The Historical Case for a Mandatory Disclosure System*, 9 J. CORP. L. 1 (1983) (documenting before the 1964 Securities Act amendments the extent to which over-the-counter securities not subject to the full disclosure requirements of those registered on the stock exchanges had greater levels of fraud and the extent to which through that date when SEC enforcement had waned, as it had notably in the late 1950s, fraud returned).

[59] Market incentives include reputational constraints and the ability of investors—the direct victims of misconduct—to contract to guard their interests. *See* Kraakman, *Gatekeepers*, *supra* note 41, at 93-100.

[60] *See* Kraakman, *Corporate Liability*, supra note 41, at 868 ("[Gatekeeper liability] serves to remedy enforcement insufficiencies . . . ."); *id*. at 888 ("Enforcement insufficiency occurs when both enterprise and individual penalties fail to elicit sufficient compliance at an acceptable cost.").

underwriter liability, by contrast, have often proved warranted, measured against the harm it averts.[61]

Though underwriters initially resisted the imposition of liability under Section 11,[62] this form of liability has become broadly accepted, including by underwriters—and for sound reason. Because issuers in IPOs are untested, information asymmetries are high, making verification costs for investors high and suggesting a role for third-party assurance mechanisms if they are cost-effective.[63] In this setting, issuers and managers have limited resources, raising the prospect that enterprise liability and individual managerial liability will be met with asset insufficiency, a condition justifying gatekeeper liability.[64] Issuers and founders may be tempted to overstate the merits of their product in an IPO,[65] again suggesting the need for a third-party certifier that, as a repeat player, has less to gain from misconduct in a given transaction. Underwriters are well suited for service as third-party certifiers because they are uniquely positioned among offering participants to detect disclosure errors, having had decades to hone their diligence practices and procedures. Underwriters are also cost-effective certifiers since issuers already engage them to act in transactions.[66]

It is not enough to rely on market incentives to ensure that underwriters take adequate precautions to deter client wrongs. Though underwriters' reputations restrict their incentives to facilitate issuer wrongdoing, their reputations are crudely calibrated to gatekeeper performance and convey limited informational content, suggesting the need for liability.[67] For their part, investors face formidable coordination problems that limit the prospect

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[61] *See* Merritt Fox, *Shelf Registration, Integrated Disclosure and Underwriter Due Diligence: An Economic Analysis*, 70 VA. L. REV. 1005, 1032-33 (1984) (assessing the desirability of gatekeeper liability based on its costs and benefits). As to limits of gatekeeper liability, see Stavros Gadinis & Colby Mangels, *Collaborative Gatekeepers*, WASH. & LEE L. REV. 797, 812-23 (2016); Andrew F. Tuch, *The Limits of Gatekeeper Liability*, 73 WASH. & LEE L. REV. ONLINE 619, 627–38 (2017).

[62] *See* SELIGMAN, *supra* note 26, at 71-78 (Wall Street, including investment banks, opposed civil liability provisions of the Securities Act); *Gatekeepers*, *supra* note 41, at 99-100.

[63] Gilson & Kraakman, *Market Efficiency, supra* note 43, at 618-21.

[64] *See* Howell E. Jackson, *Reflections on Kaye, Scholer: Enlisting Lawyers To Improve The Regulation of Financial Institutions*, 66 S. CAL. L. REV. 1019, 1047-48 (1993) (explaining that gatekeeper liability "makes sense" when a corporation "becomes insolvent or otherwise judgment-proof before [its] wrongdoing comes to light").

[65] Gilson & Kraakman, *Market Efficiency, supra* note 43, at 595 (originators of information "will have an incentive to act opportunistically by misrepresenting the accuracy, and therefore the value, of the information.").

[66] *See* Kraakman, *Gatekeepers*, *supra* note 41, at 93-99.

[67] *See* Tuch, *Multiple Gatekeepers*, *supra* note 51, at 1613-14.

that they will privately contract for underwriter gatekeeping in the absence of liability, again suggesting the need for underwriter liability.[68]

If anything, recent developments seem to have strengthened the justification for underwriter liability in traditional IPOs and the enhanced due diligence that results. Reputational constraints for investment banks have arguably weakened, diminishing the market discipline on underwriters.[69] The threat posed by alternative or supplementary legal controls on underwriters (and other secondary actors), most notably Rule 10b-5, seems to have weakened.[70] And, although companies have been delaying their IPOs, when they do "go public" they are less likely to be profitable than in past decades, increasing the prospect of asset insufficiency in the case of enterprise liability, which buttresses the case for gatekeeper liability.[71] The case for underwriter liability in IPOs is stronger still where secondary actors or other transaction participants have incentives misaligned with those of investors or have little reputational capital at stake.

C. Expansion of Exemptions

Section 11 had been the *bête noire* of the 1933 Securities Act, which opponents had urged would stifle finance.[72] New public issues of registered corporate securities—which had limped along and reached as low as $11

[68] For a more detailed analysis, see Kraakman, *Gatekeepers*, *supra* note 41, at 95-96.
[69] *See* Alan D. Morrison et al., *Investment-Banking Relationships: 1933-2007,* at 30–36 (Saïd Bus. Sch., Rsch. Paper 2014-1, 2014), http://ssrn.com/abstract=2376481 [http://perma .cc/UZ48-7Y8N] (presenting evidence on the weakening role of investment banking reputations in constraining conflicts of interest and other misconduct).; JONATHAN R. MACY, THE DEATH OF CORPORATE REPUTATION: HOW INTEGRITY HAS BEEN DESTROYED ON WALL STREET 49 (2013) ("the traditional model of reputation, that predicts that investment banks . . . will put their customers' interest ahead of their own and avoid conflicts of interest, no longer has much, if any, explanatory force.").
[70] *See infra* notes 154-155 and accompanying text.
[71] *See* Aswath Damodaran, *Disrupting the Disruptors? The "Going Public Process" in Transition* (July 14, 2021), available at https://ssrn.com/abstract=3892419 (between 1980 and 1990, 80 percent of firms undertaking IPOs were profitable; the corresponding figure was 20 percent between 2016 and 2020). As to the rising appetite of investors for companies subject to uncertainty in IPOs, see James J. Park, *Investor Protection in an Age of Entrepreneurship,* HARV. BUS. L. REV. (forthcoming), https://ssrn.com/abstract=3911454, at 26-33.
[72] *See* SELIGMAN, *supra* note 26, at 77 quoting Arthur Dean, criticizing the liability provisions of the 1933 Act as being so severe that they "would render financing exceedingly difficult." *See* Arthur Dean, *The Federal Securities Act: I*, FORTUNE, Aug. 1933 at 104, 106.

million in January 1935[73]—have skyrocketed in recent years to annual totals over $1 trillion.[74]

For decades, the due diligence procedures particularly of underwriters and their counsel and auditors, virtually eliminated private securities fraud in IPOs.[75] The very term *due diligence* entered the popular vocabulary as a byword for careful investigation of facts whether required by legal process or otherwise.

Nevertheless, the deterrent force of Section 11 has markedly diminished. The most important reason is that the SEC and Congress have permitted this decline by substantially expanding the exemptions from Securities Act registration.

By 2019, exempt offerings, valued at approximately $2.7 trillion, accounted for 69.2 percent of all new corporate offerings; registered offerings of $1.2 trillion accounted for a mere 30.8 percent.[76] This marks a remarkable reversal. In 1970, exempt offerings comprised just 17 percent of funds raised in new corporate offerings.[77] Indeed, by December 2021, there were 473

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[73] SELIGMAN, *supra* note 26, at 114.

[74] Sec. Exchange Act Release No. 10,763 (2020) (proposal), 10,884, 2020 Fed. Sec. L. Rep. (CCH) ¶82,416 (2020) (rule proposal) at nn.12–14.

[75] 9 SECURITIES REGULATION 5TH ED., *supra* note 38, at 322, n. 135 ("The 30,000 registration statements filed during the first 35 years of the SEC's history resulted in two adjudicated recoveries and six reported decisions approving settlements of class actions.").

[76] Sec. Exchange Act Release No. 10,763 (2020), 2020 Fed. Sec. L. Rep. (CCH) ¶82,416 at nn.12–14 (2020) (proposal) adopted in Sec. Act Rel. 10,884, 2020 Fed. Sec. L. Rep. (CCH) ¶82,737 (2020):

Exemption	Amounts Reported or Estimated as Raised in 2019
Rule 506(b) of Regulation D	$1,492.0 billion
Rule 506(c) of Regulation D	66.0 billion
Regulation A: Tier 1	0.044 billion
Regulation A: Tier 2	0.998 billion
Rule 504 of Regulation D	0.228 billion
Regulation Crowdfunding	0.062 billion
Other exempt offerings	1,167.0 billion

Since the mid 2000s, so-called unicorns, private companies with $1 billion or more in value, have dramatically increased. By 2015, Professor de Fontenay reported that 103 private companies had valuations exceeding $1 billion. Elizabeth de Fontenay, *The Deregulation of Private Capital and the Decline of the Public Company*, 68 HASTINGS L.J. 445, 495 (2017).

[77] *See* data in 3 LOUIS LOSS, JOEL SELIGMAN & TROY PAREDES, SECURITIES REGULATION 359 (6th ed., 2020) [hereinafter 3 SECURITIES REGULATION 6TH ED.], quoting 1988 Rule 144A Proposal Release, Sec. Act Rel. 6806, 42 SEC Dock. 76, 77 (1988).

"unicorns" or private firms with at least $1 billion in valuation. The aggregate number has skyrocketed from 43 in 2013 and 251 in December 2020. The aggregate implied valuation of unicorns was $1.58 trillion in December 2021, an 11-fold increase since 2013.[78]

One of the major sources of this shift is Rule 144A, which the Commission adopted in 1990.[79] This rule formally permits Qualified Institutional Buyers (QIBs) to sell exempt securities to other QIBs without registration or required disclosures. This created a parallel exempt securities market.

The SEC in a strikingly partisan 3-2 vote six days before the November 2020 elections further expanded several Securities Act exemptions.

Regulation D's Rule 504, previously limited to offers and sales of up to $5 million, was increased to $10 million. Rule 504 is a *de minimis* Securities Act exception.[80] Meanwhile, Tier 2 of Regulation A grew from maximum offerings of $50 million in a 12 month period to $75 million.[81]

Regulation Crowdfunding, which §4(a)(6) of the Securities Act authorized up to $1 million in any 12 month period, and after a specified five year cost of living increase was $1.07 million, was increased to $5 million, employing the Commission's authority under §28 of the Securities Act. Under the initial limits, Regulation Crowdfunding had been a success. Approximately 2,000 crowdfunding offerings were made in the three and a half years after the exemption first became available through December 31, 2019.[82]

Another 2020 expansion of exemptions lies in the Commission's adoption of a new definition of *accredited investor* in Regulation D's Rule 501(a), broadly increasing the number of individuals who could buy Rule 506 exempt offerings without fulfilling otherwise-mandatory disclosure requirements. The new definition adds 691,041 registered broker dealers, 13,400 registered and 4,244 exempt investment advisers, 17,500 state registered investment advisers, and between 2,500 and 10,489 family offices

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[78] See George S. Georgiev, *The Breakdown of the Public-Private Divide in Securities Law: Causes, Consequences, and Reforms*, 18 N.Y.U. J.L. & BUS. 221 (2021) (characterizing the rapid growth of unicorns as one reason for the breakdown of the public-private divide in Federal securities laws).

[79] *See, e.g.,* 1 SECURITIES REGULATION 6TH ED., *supra* note 1, at 682–703.

[80] *Id.* at 390–93.

[81] *Id.* at 274–315.

[82] *See* 1 SECURITIES REGULATION 6TH ED., *supra* note 1, at 457–516.

exempt under the Investment Advisers Act.[83] Rule 506 is the dominant Regulation D exemption. Between 2009 and 2017, 99.9 percent of all funds raised under Regulation D were raised under Rule 506.[84]

The November 2020 expansion of Securities Act exemptions occurred with little or no serious consideration of fraud risk.

D. Critiques of Section 11

Underwriting practices have faced a series of critiques in recent years. Critics assert, for example, that underwriters "underprice" IPOs at the expense of issuers,[85] generate excessive fees,[86] engage in collusive practices,[87] and otherwise exploit issuers.[88] While much disagreement exists on the reasons for and effects of these alleged practices, critics point to them as evidence that the IPO-underwriting process is deeply flawed.[89]

It is true that IPOs between 2001 and 2019 were underpriced, with an average "pop," or price increase, of 13.7 percent between the IPO and first-

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[83] Sec. Exchange Act Release No. 10,824, 2020 Fed. Sec. L. Rep. (CCH) ¶82,674 (2020) (adoption).

[84] COFFEE, SALE & WHITEHEAD, *supra* note 38, at 415.

[85] *See e.g.,* Alexander P. Ljungqvist & William J. Wilhelm Jr., *IPO Allocations: Discriminatory or Discretionary*, 65 J. FIN. ECON. 167 (2002); Patrick M. Corrigan, *The Seller's Curse and the Underwriter's Pricing Pivot: A Behavioral Theory of IPO Pricing*, 13 VA. L. & BUS. REV. 335, 363-71 (2019) (reviewing literature on IPO underpricing).

[86] *See, e.g.*, A.C. Pritchard, *Revisiting "Truth in Securities" Revisited: Abolishing IPOs and Harnessing Private Markets in the Public Good*, 36 SEATTLE U. L. REV. 999, 1013 (2013) (IPO underwriters "reap a substantial gain from IPOs" despite acting as "a mere salesman").

[87] *See, e.g.*, Hsuan-Chi Chen & Jay R. Ritter, *The Seven Percent Solution*, 55 J. FIN. 1105, 1108-12, 1130 (2000) (finding that IPO underwriting commissions being clustered at seven percent of deal value may be explained by implicit collusion); John William Hatfield et al., *Collusion in Markets with Syndication*, 128 J. POL. ECON. 3779 (2020) (explaining how underwriters of IPOs might sustain collusive pricing in the absence of high market concentration).

[88] *See, e.g.,* Corrigan, supra note 85, at 396 (contending that banks pursue a two-pronged strategy in underwriting IPOs, profiting when stock is either underpriced or over-priced); Patrick M. Corrigan, *Footloose with Greenshoes: Can Underwriters Profit From IPO Underpricing?*, 38 YALE J. ON REG. 908 (2021) (underwriters may and have incentives to use their over-allotment options to profit from IPO underpricing).

[89] *See, e.g*, Christine Hurt, *Moral Hazard and the Initial Public Offering*, 26 CARDOZO L. REV. 711, 790 (2005) (concluding, after having examined spinning, flipping, laddering, and price stabilization practices, that "the IPO process is broken…"); John J. Coffee, Jr., *The IPO Investigations: Who's the Victim? what's the harm?*, PBS (last visited Oct. 23, 2021), https://www.pbs.org/wgbh/pages/frontline/shows/dotcon/crying/coffeeipos.html (certain underwriting practices "indicate that something is seriously wrong, or at least dysfunctional, within the IPO market"); Pritchard, *supra* note 86, at 1013 ("IPOs are bad for companies,

day close.[90] However, no consensus exists as to why this is happening.[91] Indeed, for many issuers, a pop is desirable because it speaks to the attractiveness of the new issue.[92] Few events would be more disheartening than an instantaneous price decline in the aftermath of an IPO, which would make the listing appear to be a failure. Moreover, it is open to dispute whether the first day's closing price is a price at which issuers could have initially sold their shares, as critics assume in regarding a lower IPO price as "underpricing."[93]

Even assuming they have merit, the above criticisms—concerning underpricing, high fees, collusion, and exploitation—do not defeat the case for underwriter liability under Section 11. No one suggests that underwriting is costless; the question in seeking to protect investors is whether the benefits of underwriter liability, measured primarily by the harm it averts, exceed the accompanying costs. The available evidence suggests it does.[94]

Market participants have nonetheless explored new methods of taking companies public. IPOs declined soon after the dot-com bust, with annual averages falling from 310 between 1980 and 2000 to just 108 between 2001

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bad for insiders, and bad for retail investors. The few parties that do clearly benefit from these deals are the individuals who service them: accountants, lawyers, and underwriters.").

[90] Testimony of Scott Kupor, House of Representatives, Financial Services Comm. (May 24, 2021), at 5.

[91] *See, e.g.*, Tim Loughran & Jay R. Ritter, *Why Don't Issuers Get Upset about Leaving Money on the Table in IPOs?*, 15 REV. OF FIN. STUD. 413, 416 (underwriters underprice IPOs in expectation of reward from benefited investors); Janet Cooper Alexander, *The Lawsuit Avoidance Theory of who Initial Public Offerings Are Underpriced*, 41 U.C.L.A. L. REV. 17, 19 (explaining the theory that "IPOs are underpriced as a form of insurance against legal liability"); Ann E. Sherman & Sheridan Titman, *Building the IPO Order Book: Underpricing & Participation Limits With Costly Information*, 65 J. FIN. ECON. 3, 4–5 (2001) (describing underpricing IPOs as a mechanism for underwriters to recoup the costs of "extract[ing] information from their investors").

[92] *See, e.g.,* Connie Loizos, *An IPO Expert Bats Back at the Narrative that Traditional IPOs Are for 'Morons'*, TECHCRUNCH (Sep. 3, 2020, 1:02 AM), https://techcrunch.com/2020/09/02/its-not-just-airbnb-an-ipo-expert-pushes-back-against-the-spac-frenzy-and-other-new-ways-to-going-public (asserting that issuers often instruct underwriters to underprice their IPOs as a long-term business strategy).

[93] For example, if a class of investors are uninformed, issuers may need to underprice shares in the initial offering to get those investors to participate in the issue. See Kevin Rock, *Why New Issues Are Underpriced*, 15 J. FIN. ECON. 187 (1986). Under another theory, issuers may underprice issues to compensate institutional investors for revealing 'indication of interest' for use in determining the IPO price. *See* Lawrence M. Benveniste & Paul A. Spindt, *How Investment Bankers Determine the Offer Price and Allocations of New Issues*, 24 J. FIN. ECON. 343, 344 (1989).

[94] *See supra* notes 56-71 and accompanying text

to 2016.[95] Commentators suggest varying explanations, including a less attractive "IPO ecosystem" for smaller firms, increased compliance costs occasioned by the Sarbanes-Oxley Act of 2002, and the increased relative attractiveness of trade sales for small firms.[96] While this decline has reversed in the last couple of years, the two transactional structures that have emerged as mainstream IPO alternatives—the SPAC merger and direct listing—may further the decline of Section 11 in the heartland of its operation.[97]

III. SPAC MERGERS

Once regarded with disdain for the poor quality of the firms they brought public,[98] SPAC mergers have become a "viable substitute for a traditional IPO."[99] A SPAC merger is the second stage of a two-stage transactional process. In the first stage, a SPAC undertakes an IPO, raising funds for use in the second stage, in which it merges or otherwise combines with a private operating company, bringing the once-private company public.[100] From the

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[95] *See* John C. Coffee, *The Irrepressible Myth That SEC Overregulation Has Chilled IPOs*, THE CLS BLUE SKY BLOG (May, 29, 2018), https://clsbluesky.law.columbia.edu/2018/05/29/the-irrepressible-myth-that-sec-overregulation-has-chilled-ipos/. As IPOs dwindled, so did the number of publicly listed firms, which reduced by almost half in the past two decades. 1 SECURITIES REGULATION 6TH ED., *supra* note 1, at 741 ("Beginning in about 2000, … [d]omestic listings have declined by about 50 percent from over 7000 to under 4000.").

[96] *See* Xioahui Gao, Jay R. Ritter & Zhangyan Zhu, *Where Have All the IPOs Gone?*, 48 J. FIN. & QUANT. ANAL. 1663 (2013); de Fontenay, *supra* note 76; Paul Rose & Steven Davidoff Solomon, *Where Have All the IPOs Gone? The Hard Life of the Small IPO*, 6 HARV. BUS. L. REV. 83 (2016). *See also* COFFEE, SALE & WHITEHEAD, *supra* note 38, at 81 ("[T]he more popular theory among financial economists is that the vast difference between the 1999 and the 2019 IPO numbers means that a deeper force is at work: namely, globalization.").

[97] For detailed discussions of various IPO alternatives, see Thompson & Langevoort, *supra* note 3, at 1588–98; Jeff Schwartz, *The Twilight of Equity Liquidity*, 34 CARDOZO L. REV. 531, 564–69 (2012).

[98] Paul R. La Monica, *Why 2020 is the year of the SPACs (And what the heck is a SPAC?),* CEEN MONEY (Aug. 6, 2020), https://www.wral.com/why-2020-is-the-year-of-the-spacs-and-what-the-heck-is-a-spac/19222838/?version=amp.

[99] CHAMBERS AND PARTNERS USA, 2020 THE YEAR OF THE SPAC, https://chambers.com/guides/usa/2020-the-year-of-the-spac. *See also* Christopher M. Barlow et al., *Skadden Discusses "The Year of the SPAC,"* THE CLS BLUE SKY BLOG (Feb. 18, 2021), https://www.skadden.com/en/insights/publications/2021/02/skadden-discusses-the-year-of-the-spac ("SPACs have clearly established themselves as legitimate and, in many cases, preferred alternatives to a traditional IPO or M&A transaction for target companies seeking liquidity.").

[100] SPACs are also known as blank check companies, although they typically avoid treatment as such under Securities Act Rule 419 because they do not issue "penny stock," as defined in SEC Rule 3a51-1. Rule 419 imposes restrictions on certain offerings by blank check

perspective of the private company that merges with the SPAC, a SPAC merger serves the functions of a traditional IPO—providing cash for growth, Exchange Act-registered securities, opportunities for exit by investors in the private company, and significant publicity. The formerly private company adopts the merger process to achieve these objectives even as it sidesteps the traditional IPO process.

In this Part, we critically examine the SPAC merger, assessing its purported benefits alongside its threats to investor protection, giving particular attention to the extent to which transaction structure shapes liability risk.

A. General Terms and Primary Functions

In the first stage of the SPAC life-cycle, a shell company—the SPAC—is formed to merge or otherwise combine with a yet-to-be-identified private operating company.[101] The SPAC raises cash by undertaking an underwritten IPO. It does so in much the same way that an operating company would undertake a traditional IPO: by registering securities using a registration statement on Form S-1, or Form F-1 for foreign issuers. However, having no commercial operations or financial history, a SPAC has relatively little to disclose.[102] The SPAC holds the IPO proceeds in an interest-bearing escrow account. It then has a designated acquisition window, usually 18 to 24 months from the IPO,[103] to undertake the second stage of the process—a SPAC merger—for which it may use the IPO proceeds.[104] In the usual case,[105] a

companies, including their use of proceeds. SPACs nevertheless voluntarily tend to comply with many of Rule 419's restrictions. *See* William K. Sjostrom, Jr., *The Truth About Reverse Mergers*, 2 ENTREPRENEURIAL BUS. L.J. 743, 757–58 (2008).

[101] For a detailed study of SPACs' development and evolution, *see* Usha Rodrigues & Mike Stegemoller, *Exit, Voice, and Reputation: The Evolution of SPACs*, 37 DEL. J. CORP. L. 849, 871–90 (2012).

[102] For more detailed descriptions, *see* Michael Klausner, et al., *A Sober Look at SPACs*, YALE J. REG. (forthcoming 2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3720919; Minmo Gahng et al., *SPACs* 25, 43 (Working Paper, Jan. 29, 2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3775847.

[103] Shareholders may agree to extend the deadline. ROPES & GRAY, SPECIAL PURPOSE ACQUISITION COMPANIES (SPACS): AN INTRODUCTION 3, 21 (Jan. 2021), https://www.ropesgray.com/en/practices/Special-Purpose-Acquisition-Companies.

[104] The relevant transaction may be a merger, share exchange, or other similar business combination.

[105] *See* Jessica Bai et al., *Segmented Going-Public Markets and the Demand for SPACs* 8 (Working Paper, May 2021), https://ssrn.com/abstract=3746490, at 8 (of the 500 SPAC IPOs

SPAC merger occurs, with the SPAC and target continuing life in combined form. If no SPAC merger occurs within the acquisition window, the SPAC dissolves, returning the IPO proceeds with accrued interest to investors.[106]

SPACs are formed and operated by sponsors. These generally are private equity firms or other asset managers acting through small groups of individuals, who often include former public company executives, former investment bankers, or other financial professionals.[107] These individuals will raise funds in a SPAC IPO, identify potential targets, and seek to execute a merger. As compensation for its work, a sponsor receives "founder" shares, typically a 20 percent stake in the SPAC after its IPO, for a nominal consideration.[108] Sponsors may also profit by investing in warrants and other securities issued by the SPAC in private placements at the time of the IPO.[109] Founder shares and these other securities are worthless if no SPAC merger occurs.

In its IPO, a SPAC issues "units" typically priced at $10 and consisting of a share and a warrant (or a fraction of a warrant) to purchase additional equity.[110] Importantly, the shares are redeemable when the SPAC proposes a merger, meaning that shareholders can, at that time, elect to have their initial investment (of $10 per share) returned, plus interest, rather than remain as shareholders and participate in the merger.[111] Since SPAC IPO shares are tradeable, shareholders may sell their positions at any time. For example, a shareholder might sell at a profit before a merger occurs if the share price is

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between 2003 and the third quarter of 2020, 90 had liquidated, 276 had announced or completed an acquisition, and the remainder were still seeking a target).

[106] Public Statement by Paul Munter, Acting Chief Accountant, SEC, Financial Reporting and Auditing Considerations of Companies Merging with SPACs, March 31, 2021, https://www.sec.gov/news/public-statement/munter-spac-20200331.

[107] *See* ROPES & GRAY, *supra* note 103, at 3.

[108] *See, e.g.,* In Re Alta Mesa Resources, Inc., Securities Litigation, Case No. 4:19-cv-00957, Second Corrected Consolidated Amended Complaint for Violations of the Federal Securities Laws, filed April 6, 2020, at 19-20 (describing general terms of SPAC transactions).

[109] These offerings tend to cover SPAC IPO costs, including underwriting fees, giving sponsors more "skin in the game" and reassuring public IPO investors that their funds will not be depleted by IPO expenses. For further discussion, *see* ROPES & GRAY, *supra* note 103, at 17.

[110] For a discussion of the terms of SPACs, see ROPES & GRAY, supra note 103, at 16-17, Klausner, et al., *supra* note 102, at 10–15.

[111] Shareholders are entitled to their pro rata share of IPO proceeds held in trust, although because limited withdrawals from trust funds are permitted, the redemption amount typically equals the IPO price of $10 per share. *See* Ramey Layne et al, *Special Purpose Acquisition Companies: An Introduction*, HARV. LAW SCH. F. ON CORPORATE GOV. (July 6, 2018), https://corpgov.law.harvard.edu/2018/07/06/special-purpose-acquisition-companies-an-introduction/.

trading above its redemption value of $10. SPACs also issue warrants—call options giving holders the option to buy a share in the SPAC at a fixed price, the strike price, within five years of any merger. Most SPACs select a strike price of $11.50. Like a SPAC's shares, its warrants are also tradeable.[112]

The terms of these securities give SPAC shareholders key decisions to make at the time of a proposed merger. Once a SPAC has negotiated and announced a proposed merger, its shareholders must typically decide whether to approve the merger and whether to have their shares redeemed.[113] Shareholders routinely approve mergers,[114] even bad mergers, since a failed merger vote prevents shareholders from redeeming their shares and keeps their cash tied up as the SPAC seeks a better target under greater time pressure.[115] Even shareholders that have voted in favor of a merger can—and do—demand redemption.[116] Shareholders who are to vote receive materials soliciting their proxies in the form of a merger proxy statement under Section 14(a) of the Securities Exchange Act. If securities are to be registered in the transaction, a registration statement on Form S-4 (or Form F-4 for foreign issuers) is permitted to serve as a proxy statement.[117] These materials provide the basis for shareholders' decisions, making informational accuracy and completeness a vital policy objective.

In a conventionally structured SPAC merger, the SPAC survives the merger, keeping its status as a public company. It absorbs the target, usually

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[112] Although shares and warrants are initially bundled as units, they soon trade separately.

[113] *See* SEC OFFICE OF INVESTOR EDUCATION AND ADVOCACY, WHAT YOU NEED TO KNOW ABOUT SPACS – UPDATED INVESTOR BULLETIN https://www.sec.gov/oiea/investor-alerts-and-bulletins/what-you-need-know-about-spacs-investor-bulletin#:~:text=SPACs%20generally%20invest%20the%20proceeds,account%20investments%20to%20pay%20taxes ("Once the SPAC has identified an initial business combination opportunity, the shareholders of the SPAC will have the opportunity to redeem their shares and, in many cases, vote on the initial business combination transaction.").

[114] *See* Usha Rodrigues & Michael A. Stegemoller, *SPACs: Insider IPOs* (2021), https://ssrn.com/abstract=3906196, at 30-39.

[115] Harald Halbhuber, *An Economic Substance Approach to SPAC Regulation,* at 10, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4005605 ("If a merger vote fails, everybody's cash stays in the trust account at low yield and poor liquidity, including cash of shareholders who elected to redeem."). Also, warrants are worthless unless a SPAC merger occurs, giving shareholders incentives to approve. *Id*; Rodrigues & Stegemoller, supra note 114, at 30-39.

[116] *See* Gahng et al., *supra* note 102, at 34. For detailed explanations of such apparently contradictory voting behavior, *see* Mira Ganor, *The Case for Binary, Contingent, Shareholder Action*, 23 U. PENN. J. BUS. L. 390, 411–14 (2021) and Usha Rodrigues & Michael A. Stegemoller, *SPACs: Insider IPOs* (2021), https://ssrn.com/abstract=3906196, at 30-39.

[117] 3 SECURITIES REGULATION 6TH ED., *supra* note 77, at 190–91.

in a reverse triangular merger, takes the target's name, and appoints target managers to run the business.[118] The SPAC issues shares to target shareholders, making them shareholders of the SPAC, a company that now combines the target's business with the SPAC's cash.

SPACs have generally experienced high redemptions, with mean and median rates above 50 percent, except during periods of inflated stock prices.[119] Redemptions diminish the IPO proceeds available for a merger, making it a practically necessity for SPACs to raise further funds for their proposed mergers.[120] To do so SPACs may make private placements to selected institutional investors—often on favorable terms—in PIPE transactions, or private investments in public equity. PIPEs qualify for an exemption from registration,[121] but shortly after the merger SPACs register the resale of the PIPE shares on a shelf registration statement, which allows investors to freely sell their shares over an extended period of time.[122]

Conceptual differences exist between SPAC mergers and traditional IPOs. Structured as mergers, de-SPACs avoid the need for conventional underwriters. They invert the traditional IPO process by raising funds from investors before any IPO candidate has been identified. Initial investors do not bet on a particular company, as they do in the case of a traditional IPO. Rather, they bet on a sponsor's skill in identifying a merger candidate by providing cash to get the sponsor's acquisition vehicle up and running.[123] And a SPAC is a safe bet for initial investors, because if they still hold shares when

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[118] *See* SEC OFFICE OF INVESTOR EDUCATION AND ADVOCACY, *supra* note 113. As to the structure, *see* Pamela Marcogliese et al., *20 Key considerations for private companies evaluating whether to be acquired by a SPAC*, FRESHFIELDS (July 27, 2020), https://blog.freshfields.us/post/102gcbg/20-key-considerations-for-private-companies-evaluating-whether-to-be-acquired-by ("The most typical structure for domestic SPAC acquisitions involves the SPAC setting up a merger subsidiary which merges with and into the target company so that the target company becomes a wholly-owned subsidiary of the SPAC.").

[119] Mean and median redemption rates reported by Klausner et al., are, respectively, 58 percent and 73 percent during 2019-20, 22 percent and 0 percent during late 2020 and early 2021 when prices were inflated, and 57 percent and 68 percent in late 2021. *See supra* note 102, at 19 and Klausner et al., *A Second Look at SPACs: Is This Time Different?*, HARV. L. SCH. F. ON CORP. GOV. (Jan. 24, 2022), https://corpgov.law.harvard.edu/2022/01/24/a-second-look-at-spacs-is-this-time-different/#more-142879.

[120] *See* Klausner, et al., *supra* note 102, at 21 (77 percent of SPACs raised additional funds; of these SPACs, 83 percent raised funds from investors other than sponsors).

[121] *See* William K. Sjostrom, Jr., *PIPEs*, 2 ENTREPRENEURIAL BUS. L. J. 381, 391 (2007).

[122] *Id.* at 393–95. In the absence of registration, the PIPE shares would remain "restricted" securities and in practice would be subject to holding periods specified in Rule 144.

[123] Klausner et al., *supra* note 102, at 16 ("The SPAC's IPO simply gets the SPAC established as a public company").

the merger occurs, they can decide to have their initial investment returned. Non-redeeming investors then bear the risk of the merger.

However, from private companies' perspective, SPAC mergers can be viewed as alternatives to traditional IPOs.[124] Both transactional structures provide permanent capital for growth; give companies Exchange Act–registered securities—publicly traded currency they can use to make acquisitions and remunerate their employees; provide companies' existing shareholders the opportunity to sell shares; and enhance corporate brands. Moreover, like many traditional IPOs, SPAC mergers leave the target's business intact, its management in place, and its existing shareholders largely in control, with new shareholders effectively contributing cash for a minority position in the company. Despite functioning as traditional IPOs, de-SPACs occur via a business combination, which typically involves a merger, rather than by the public offering of stock through firm commitment underwriting.[125] Threats to investor protection result. Gaps in Section 11 liability arise. Transaction participants benefit from more liberal rules on deal publicity and on the use of forward-looking statements. Typical compensation structures further weaken participants' incentives to deter misconduct. We consider these threats, focusing on the merits of underwriter liability in this setting.

B. The Deterrent Force of Underwriter Liability

Generally no underwriter liability arises in SPAC mergers, significantly limiting the force of Section 11. This produces weaker incentives for all gatekeepers to assure the accuracy of corporate disclosures, relative to the incentives in traditional IPOs.

1. Liability Exposure

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[124] *See* Public Statement by John Coates, Acting Dir., SEC Div. of Corp. Fin., 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.

[125] SPAC mergers may therefore been seen as an example of regulatory arbitrage by "investment switching," since they are designed "to provide the same economics as heavily regulated or prohibited investment but subject to a much lower regulatory tax." *See* ERIK F. GERDING, LAW, BUBBLES, AND FINANCIAL REGULATION 11 (2014); *see also id.* at 235-38. We do not argue for reform based on the existence of regulatory arbitrage, aware that arbitrage may be net positive or negative, depending on the merits of the underlying rules avoided. *See* Victor Fleischer, *Regulatory Arbitrage*, 89 TEX. L. REV. 227, 234-35 (2010).

Commentators have argued that SPAC mergers benefit from more lenient liability exposure for disclosure errors than do traditional IPOs. This is a matter of controversy.[126] In assessing liability exposure of SPACs, we first consider the conditions under which SPAC mergers will be subject to Section 11. That question turns first on the use of registration statements in SPAC mergers, an issue on which the scholarly literature diverges.[127]

A SPAC may file three kinds of registration statements; only one of these is of special interest here, but we will briefly lay out the others as well. The first of these statements comes during the IPO, when a SPAC files a registration statement much as an operating company would in a traditional IPO. But, with no operating or financial history, a SPAC has little to disclose other than the obvious risks in such an offering.[128] Moreover, this registration statement predates the crucial investor decisions taken when a SPAC merger occurs. The last of the three statements may come after consummating a merger, at which point a SPAC will likely file a shelf registration statement to register the resale of securities for the benefit of PIPE investors and warrant holders.[129] But such statements come too late to influence investors'

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[126] John Coates, former acting director of the SEC Division of Corporation Finance, disagrees, contending that "[a]ny simple claim about reduced liability exposure for SPAC participants is overstated at best, and potentially seriously misleading at worst." Coates, *supra* note 124. Nevertheless, Coates appears to acknowledge the differences in the application of Section 11 by asking whether "current liability provisions give those involved … sufficient incentives to do appropriate due diligence on the target and its disclosures to public investors, especially since SPACs are designed not to include a conventional underwriter at the de-SPAC stage." *Id*. He also questions whether "current liability provisions give those involved—such as sponsors, private investors, and target managers—sufficient incentives to do appropriate due diligence on the target and its disclosures to public investors." *Id*.

[127] *Compare* Thompson & Langevoort, supra note 3, at 1590 n.80 (2013) ("In the SPAC transaction, … The result is less intense '34 Act disclosure, due diligence, and liability for the deal.") and JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 420 (8th ed., 2017) ("[A] company that goes public through a reverse merger [defined to include SPAC mergers] thereby avoids the lengthy review process of Securities Act registration as well as the threat of Section 11 liability") *with* QUINN EMANUEL URQUHART & SULLIVAN LLP, QUINN EMANUEL PRIVATE EQUITY LITIGATION PRACTICE ALERT: LITIGATION RISK IN THE SPAC WORLD 5 https://www.quinnemanuel.com/the-firm/publications/litigation-risk-in-the-spac-world/ ("[I]n some circumstances the SPAC merger requires issuance of shares by the merged company, and thus necessitates a registration statement."). These descriptions may reflect practices existing at the time they were written.

[128] *See* QUINN EMANUEL URQUHART & SULLIVAN LLP, QUINN EMANUEL PRIVATE EQUITY LITIGATION PRACTICE ALERT: LITIGATION RISK IN THE SPAC WORLD 5 https://www.quinnemanuel.com/the-firm/publications/litigation-risk-in-the-spac-world/.

[129] *See supra* notes 121–122 and accompanying text.

decisions concerning whether to approve the merger and whether to demand redemption. We are focused on the second registration statement—made using Form S-4 or F-4—which may come at the time of the SPAC merger. Disclosures on this statement will inform basic investor decisions as to merger approval and redemption.

The contents of this merger registration statement are vital, and in most cases registration will probably occur. The need to register securities depends on the merger structure adopted and the particular demands of target shareholders. At least three structures are common: a conventional or SPAC-on-top structure, a target-on-top structure, and a double-dummy structure.

Under the conventional structure, the SPAC sets up a subsidiary, which merges with the target, with the target surviving as a wholly-owned SPAC subsidiary.[130] In consideration for the merger, the SPAC issues securities to target shareholders. Whether the issued securities need registration depends on whether they qualify for an exemption from registration under the Securities Act of 1933.[131] The most common exemption is Rule 506 under Regulation D, for private placements to accredited investors and up to 35 non-accredited investors.[132] When the proposed offering fails to satisfy the exemption requirements—say, because the target has a large number of non-accredited investors under an employee incentive plan—the SPAC will register the securities using a Form S-4 (or F-4).[133] Not all qualified SPACs will choose to take their exemption. Even if the proposed offering would qualify for an exemption from registration, a SPAC may nevertheless register

[130] *See supra* note 118 and accompanying text. For an example, consider the merger involving Soaring Eagle Acquisition Corp and Ginkgo, on which see Soaring Eagle Acquisition Corp., Registration Statement (Form S-4) (May 14, 2021).

[131] The exchange of acquirer securities for target securities is considered a sale under Securities Act, § 2(a)(3) and within the scope of the prohibition on offers and sales of securities under Securities Act, § 5.

[132] Under Rule 506, non-accredited investors must meet certain financial and business sophistication requirements. For further discussion of privately placed securities as acquisition currency, see *also* CLAIRE HILL, BRIAN J.M. QUINN & STEVEN DAVIDOFF SOLOMON, MERGER AND ACQUISITIONS: LAW, THEORY, AND PRACTICE 155–61 (2016).

[133] *See, e.g.*, Silver Run Acquisition Corporation II, Definitive Merger Proxy Statement on Schedule 14A, dated January 19, 2018, https://www.sec.gov/Archives/edgar/data/0001690769/000119312518014904/d510702ddefm14a.htm (outlining a business combination—without the use of a registration statement—among SPAC Silver Run Acquisition Corporation II and Alta Mesa Holdings, LP and Kingfisher Midstream, LLC).

the securities it issues to provide target shareholders the flexibility to freely trade their shares.

The target-on-top structure reverses the conventional SPAC. In this case, it is the target or a subsidiary that survives the business combination and issues securities to SPAC shareholders in consideration of a merger.[134] Under this structure, the target will be required to register the securities issued because the offering will fall beyond the usual exemptions available for private offerings, given the number and character of SPAC shareholders.

In a third transactional form, the double-dummy structure, either the SPAC or target forms a holding company that acquires both the SPAC and target by exchanging newly issued shares for those of the SPAC and target.[135] The new holding company must therefore make a public offer of securities, one falling outside exemptions from registration.

In sum, liability under Section 11 cannot arise for conventionally structured SPAC mergers that rely on an exemption from registration. But conventionally structured SPAC mergers may be required to use registration statements, and some that are not required to do so nevertheless will. For any of these companies, Section 11 liability will arise, as it will for SPAC mergers structured using the target-on-top and double-dummy models. Casual empiricism suggests that many if not most SPAC mergers will involve registration of securities, bringing them within the scope of Section 11, although the exact proportion is an issue requiring empirical investigation.

Some commentators have noted that, even if a SPAC files a registration statement that becomes effective, the potential for Section 11 liability may be

[134] *See, e.g.*, SPAC merger of The Lion Electric Company with Northern Genesis Acquisition Corp., on which see The Lion Electric Company, Registration Statement (Form F-4) (Dec. 31, 2020); SPAC merger of Foley Trasimene Acquisition Corp. II and Paysafe Limited, on which see Paysafe Limited, Registration Statement (Form F-4) (Feb. 24, 2021); the merger of Taboola and Ion Acquisition Corp, on which see Taboola.Com Ltd., Registration Statement (Form S-4) (May 20, 2021).

[135] The new holding company in fact forms two new subsidiary corporations and merges the SPAC and target into each subsidiary, respectively, with the SPAC and target surviving. SPAC and target shareholders exchange their respective shares for those of the holding company. As an example, consider the merger involving Genius Sports and SPAC dMY Technology Group. See Galileo NewCo Limited (Form F-4) (Jan. 15, 2021) https://www.sec.gov/Archives/edgar/data/0001834489/000119312521010240/d22937df4.htm. For further discussion, *see* Bruce A. Ericson et al., *The SPAC Explosion: Beware the Litigation and Enforcement Risk*, HARV. L. SCH. F. ON CORP. GOV. (Jan. 14, 2021), https://corpgov.law.harvard.edu/2021/01/14/the-spac-explosion-beware-the-litigation-and-enforcement-risk/.

limited for secondary market purchasers by the concept of "tracing"—the requirement that purchasers be able to trace each security for which they claim damages to an actionable registration statement. Section 11(a) limits recovery to any person "acquiring such security," a phrase Judge Friendly in *Barnes v. Osofsky*[136] interpreted narrowly to mean "acquiring a security pursuant to the registration statement," rather than "acquiring a security *of the same nature as that issued* pursuant to the registration statement."[137] However, this is less of an impediment than it sounds. Indeed, tracing raises no impediment to those shareholders issued shares pursuant to a registration in a corporate merger.[138] Specifically, when an entity other than the SPAC issues securities to SPAC and target shareholders in a corporate merger, as it often will,[139] SPAC shareholders may trace their shares to the issuer's registration statement.[140] These shares will be distinguishable from those shares issued in the SPAC IPO because they will have been exchanged for those IPO shares.[141] Target shareholders may themselves have claims under Section 11, although when claims regarding the accuracy of registration statements or other corporate disclosures made in connection with SPAC

[136] 373 F.2d 269 (2d Cir. 1967).
[137] *Id*. at 271-73 (emphasis added).
[138] These individuals would be "acquiring" a registered security under Section 11 as in, for example, *Hildes v. Arthur Andersen LLP*, 734 F.3d 854, 862 (9th Cir. 2013).
[139] This is true of double dummy and other structures such as those in In re Akazoo S.A. Securities Litigation, United States District Court for the Eastern District of New York, Case No. 1:20-cv-01900-BMC, September 8, 2020; In re Ability Inc. Securities Litigation, United States District Court for the Southern District of New York, Case No. 16-cv-03893 (VM), June 15, 2017.
[140] Matters get more complicated for shareholders that have irrevocably agreed to vote their shares in favor of the merger before the registration statement is declared effective, as in APA Excelsior III L.P. v. Premiere Techs., Inc., 476 F.3d 1261 (2007). In the Eleventh Circuit under these circumstances, the Section 11 presumption of reliance to which the plaintiff is generally entitled may be rebutted. APA Excelsior, 1277 ("the Section 11 presumption of reliance does not apply in the limited and narrow situation where sophisticated investors participating in an arms-length corporate merger make a legally binding investment commitment months before the filing of a defective registration statement."). In contrast, the Ninth Circuit allows a plaintiff to recover under Section 11 "without regard" to whether the plaintiff actually relied on the tainted registration statement. *See* Hildes v. Arthur Andersen LLP, 734 F.3d 854, 856 (9th Cir. 2013).
[141] It should be clear that such newly issued stock would not be "mixed in" with any other issuances.

mergers arise, major target shareholders are likely to find themselves defendants.[142]

As for purchasers in secondary markets of the surviving company's shares, tracing difficulties may arise under Section 11 but need not. Every court of appeals to consider the issue has adopted Judge Friendly's "narrow" version, requiring claimants to trace each individual security for which they claim damages to the particular registration statement at issue.[143] However, if the market contains only shares issued under the allegedly actionable registration statement, traceability would be possible. Consider a SPAC merger in which the SPAC forms a subsidiary ("Hold Co."). The SPAC and Hold Co. merge, with Hold Co. surviving and taking the SPAC's status as a public company. In a closely related transaction, Hold Co. merges with the target company, surviving and absorbing the target's business, taking the target's name, and appointing the target's managers to run the business.[144] Hold Co. will file a single registration statement on Form S-4 or F-4, registering securities to be issued to SPAC shareholders (in exchange for SPAC IPO shares) and target shareholders (in exchange for target shares). If Hold Co.'s stock "has only entered the market via a single offering," then "traceability is satisfied, as a matter of logic."[145] Because Hold Co. has only issued stock once, secondary-market purchasers may not have difficulty tracing their shares to the allegedly flawed registration statement.[146] Similar

[142] Major shareholders of a target routinely have management positions in the target and responsibility for providing information disclosed in registration statements, proxy statements, and other materials provided to investors. *See, e.g.,* SEC v. Hurgin, 19CV-5705 (S.D.N.Y); In re Akazoo S.A. Sec. Litig., 1:20-cv-1900-BMC (E.D.N.Y.) Securities Act Release No. 10955, Administrative Proceeding File No. 3-20393, In the Matter of Momentus, Inc. et al., Order Instituting Cease-and-Desist Proceedings (July 13, 2021).

[143] Pirani, 13 F.4th 940, at 952 (Miller, J., dissenting).

[144] For examples of this transactional structure, *see* In re Akazoo S.A. Securities Litigation, United States District Court for the Eastern District of New York, Case No. 1:20-cv-01900-BMC , September 8, 2020; In re Ability Inc. Securities Litigation, United States District Court for the Southern District of New York, Case No. 16-cv-03893 (VM), June 15, 2017.

[145] *See* Krim v. pcOrder.com, Inc., 402 F.3d 489 496 (2005)*; see also* DeMaria v. Andersen, 318 F.3d 170, 176 (2003) ("where there has been only one stock offering, any person who acquires the security may sue under § 11, 'regardless of whether he bought in the initial offering, a week later, or a month after that.'") (citing Hertzberg v. Dignity Partners, Inc., 191 F.3d 1076, 1080 (9th Cir. 1999)).

[146] Scattered cases nevertheless indicate that a plaintiff must be able to trace the ownership history of their shares, even if the company at issue has only ever made one issuance. *See* Hillary A. Sale, *Disappearing Without a Trace: Sections 11 and 12(A)(2) of the 1933 Securities Act*, 75 WASH. L. REV 429, 465–66.

analysis would pertain to the double-dummy structure because shares will have been sold via a single offering.

2. Investment Banks' Diligence: Incentives and Market Practices

For some transactions, the requirement for "tracing" does not give SPACs substantial protection against Section 11 suits. The more pressing concern—applicable to all SPAC mergers, and in fact to mergers generally—is the likely absence of underwriter liability under Section 11. As defined in the Securities Act, the term *underwriter* applies not to investment banks in particular but to any actor—whether a professional investment bank or amateur—that performs a specified function,[147] such as "purchas[ing] from an issuer with a view to, or offer[ing] or sell[ing] for an issuer in connection with, the distribution of any security."[148] In SPAC mergers, investment banks routinely act as M&A advisors to SPACs or target companies and as placement agents in PIPE transactions.[149] In acting as M&A advisors or placement agents, investment banks will rarely perform any of the specified functions for underwriter status[150]; in fact, they may deliberately avoid performing any of those functions, wary of the potential for Section 11 liability if they do.[151]

The absence of underwriter liability in SPAC mergers can be expected to significantly weaken incentives for investment banks to perform due diligence to assure the accuracy of corporate disclosures. Professor Joseph Leahy observes that, in traditional IPOs, Section 11 liability gives issuers and underwriters "maximum incentive to test the accuracy of the assertions in [disclosure] document[s]. This same incentive is not present, for example,

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[147] *See* 2 SECURITIES REGULATION 6TH ED., *supra* note 30, at 1469 (interpreting the term *underwriter*).
[148] *See* Section 2(a)(11) of the Securities Act of 1933.
[149] *See infra* notes 182-183 and accompanying text.
[150] M&A advisors advise on the merits of a proposed transaction and alternatives to it; on a transaction's timing, structuring, and pricing; on the structuring of a sales process; and on financing issues. *See* Andrew F. Tuch, *Banker Loyalty in Mergers and Acquisitions*, 94 TEXAS L. REV. 1079, 1093-94 (2016); Andrew Tuch, *Investment Banks as Fiduciaries: Implications for Conflicts of Interest*, 29 MELB. U. L. REV. 478, 489 (2005). When investment banks "arrang[e] a private placement on behalf of the issuer or a person in a control relationship with the issuer," they are not typically regarded as statutory underwriters either. *See* 2 SECURITIES REGULATION 6TH ED., *supra* note 30, at 1469–70 ("[E]ven a professional investment banker is *not* a statutory underwriter … in arranging a private placement on behalf of the issuer or a person in a control relationship with the issuer.").
[151] A similar argument has been made in the direct-listings setting, on which *see* Lee & Crenshaw, *supra* note 20 ("Sophisticated institutions that advise on primary direct listings may be incented to structure their participation to avoid such [underwriter] status.").

when the investment banker advises a client concerning a potential merger."[152] More than this, investment banks have little incentive to require comfort letters and negative-assurance letters from auditors and lawyers, respectively, of the type they require as underwriters in traditional IPOs. If freed from responsibility for providing these letters, on which liability can arise, auditors and lawyers would not face potential liability to underwriters for material misstatements in or omissions from non-expertised portions of registration statements, as they do in traditional IPOs.[153]

Transaction participants in SPAC mergers, including investment banks, can be held liable under other federal securities law than Section 11. But provisions such as the omnibus fraud provision §10(b) and Rule 10b-5 or the proxy fraud provision Section 14(a) and Rule 14a-9 under the Exchange Act are inadequate substitutes for Section 11. In the SPAC context, the force of private suits under Section 10(b) and Rule 10b-5 is limited. Specifically, the Supreme Court's decision in *Central Bank of Denver v. First Interstate Bank of Denve*r[154] shields investment banks and other secondary actors from liability for aiding and abetting wrongdoing by issuers. More recent decisions have further reduced the threat of liability for secondary actors under Rule 10b-5.[155] Accordingly, for placement agents the prospect of primary liability under 10b-5 is remote.[156] The same is true for M&A advisors unless they engage in misconduct such as "purposefully and intentionally caus[ing] a false statement to be issued" in a fairness opinion.[157] Similarly, investment

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[152] Joseph K. Leahy, *What Due Diligence Dilemma? Re-Envisioning Underwriters' Continuous Due Diligence After Worldcom*, 30 CARDOZO L. REV. 2001, 2062 n.330.

[153] As to these assurances and the potential liability they create for law firms and auditors, see *supra* notes 50-51.

[154] 511 U.S. 164, 185 (1994). Investment banks continue to face such aiding-and-abetting liability in SEC actions, under Section 20(e) of the Securities Exchange Act.

[155] *See, e.g., Stoneridge Investment v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008) (narrowing circumstances in which secondary actors may be liable under Rule 10b-5 for participating in a "scheme" to defraud); *Janus Capital Group, Inc. v. First Derivative Trader*, 564 U.S. 135 (2011) (narrowly interpreting the requirement to "make" a statement under Rule 10b-5(b)).

[156] Accordingly, treatises considering liability arising from defective disclosures in private placements identify corporate insiders, controlling shareholders, and selling shareholders as targets for liability, but not placement agents. *See, e.g.,* 1 EDWARD F. GREENE ET AL., U.S. REGULATION OF THE INTERNATIONAL SECURITIES AND DERIVATIVES MARKETS § 6.05 (12th ed. 2017).

[157] Helfant v. Louisiana Southern Life Ins. 459 F.Supp. 720, 725 (E.D.N.Y. 1978) (dismissing claim that a bank's fairness opinion was a misrepresentation under Section 10(b) because it did not "alleg[e] that the firm purposefully and intentionally caused a false statement to be issued or that the financial data upon which the firm based its opinion was false or omitted from the proxy statement"). *See also* Robert J. Giuffra, Jr., *Investment Bankers' Fairness Opinions in Corporate Control Transactions*, 96 YALE L.J. 119, 129

banks have rarely faced liability under Section 14(a) of the Securities Exchange Act and only then for fairness opinions shown to be objectively and subjectively false.[158] And corporate fiduciary litigation and enforcement by the industry regulators similarly pose little risk to investment banks acting on SPAC mergers.[159]

If securities-law provisions are unable to offset the deterioration of Section 11 underwriter liability, nor can non-legal forces be expected to do so. Among the non-legal forces that have robust influence in traditional settings is reputational capital. In traditional IPOs, investment banks acting as underwriters put their reputations at stake, giving the banks incentives to perform due diligence and ensure the accuracy and completeness of corporate disclosures, even apart from the incentives produced by the threat of liability for disclosure errors. There is no reason to think that investment banks acting as M&A advisors or placement agents for SPACs have more reputational

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("Plaintiff shareholders rarely, if ever, can prove that …. investment bankers acted with scienter."); Charles M. Elson, *Fairness Opinions: Are They Fair or Should We Care?,* 53 OHIO ST. L.J. 951, 975 (1992) ("Given … the firmly rooted scienter requirement … it does not appear likely that shareholders angered by a misinformed fairness opinion will find any solace through an action under the federal securities laws").

[158] *See* In re McKesson HBOC, Inc. Securities Litigation, 126 F.Supp. 2d 1248, 1265 (N.C.Cal. 2000) (dismissing a plaintiff's Section 14(a) claim against an investment bank for failure to "plead[] with particularity why the fairness opinion was knowingly false"); In re Reliance Securities Litigation, 135 F.Supp.2d 480, 516 (D. Del. 2001) (granting summary judgment for defendant investment banks on Section 14(a) claims because "no reasonable juror could find that [their] statements were subjectively false"); In re AOL Time Warner, Inc. Sec. & "ERISA" Litig., 381 F. Supp. 2d 192, 243-44 (S.D.N.Y. 2004) (finding an investment bank's fairness opinion objectively false, but dismissing the plaintiff's Section 14(a) claim because the investment bank did not subjectively believe the fairness opinion was false); Washtenaw County Employees' Retirement System v. Wells REIT, Inc., No. 1:07-CV-862, at 8 (N.D. Ga. Mar. 31, 2008) (dismissing a plaintiff's Section14(a) claim against an investment bank for failure to allege subjective falsity). As a practical matter, establishing investment bank liability for false opinions is difficult. Steven M. Davidoff, *Fairness Opinions*, 55 AM. U. L. REV. 1557, 1567 n.36 (2006).

[159] Liability may be assessed when an actor is found to have aided and abetted a fiduciary breach by directors, but that actor must "knowingly participate" in the breach. Egregious facts tend to be required. *See* Andrew F. Tuch, *M&A Advisor Misconduct: A Wrong Without a Remedy?*, 45 DEL. J. CORP. L. 177 (2021). The risk of investment banks is greater if they are not independent third party advisors. See In Re Multiplan Corp. Stockholders Litigation, No. 2021-0300-LWW, Del. Ch. Ct, Jan. 3, 2022. Placement agents, as broker-dealers, must conduct a suitability analysis for PIPE offerings, an obligation falling short of requiring a sustained investigation that would satisfy the Section 11 due diligence defense. *See* Financial Industry Regulatory Authority Rule 2310. FINRA has rarely enforced rules against investment banks when those harmed are large, sophisticated investors (as they would tend to be in PIPE offerings). *See* Andrew F. Tuch. *The Self-Regulation of Investment Bankers*, 83 GEO. WASH. L. REV. 101, 108–10, 159–61 (2014).

capital at stake than do underwriters in traditional IPOs—certainly not enough to make up for the absence of Section 11 liability. Indeed, traditional IPO underwriters may face greater reputational discipline. Significantly, underwriters act as principals on a firm-commitment basis, buying the securities at issue. Doing so more closely associates them with the transaction than are M&A advisors and placement agents involved in SPACs, which have more distant roles.

Beyond the lack of incentives created by liability and other forces, we can look to market practices for evidence that investment banks involved in mergers undertake relatively little due diligence. These banks respond predictably to their incentives, which promote weaker due diligence to assure the accuracy of corporate disclosures than in traditional IPOs. In mergers, neither an investment bank nor any other transaction participant requires comfort letters or negative-assurance letters attesting to the accuracy of corporate disclosures—a basic difference from the verification process in traditional IPOs. Indeed, in mergers generally, investment banks' due diligence role is often limited. Guides on market practices concerning M&A due diligence tend to assign banks a secondary role, focusing instead on the diligence roles of lawyers and auditors. One guide, indicating a narrow diligence role for bankers, suggests they merely provide feedback on the due diligence checklist prepared by lawyers, "perhaps" assist the buyer in reviewing operational information about the target, and give "input" to the buyers and public accountants whose job it is to "carefully analyze" the target's financial statements and other financial data.[160] Reinforcing this picture of bankers' limited diligence role in mergers, bankers themselves routinely disclaim responsibility for verifying the information on which they have relied in preparing fairness opinions. Their opinions are heavily qualified, for example cautioning that they have, with their client's consent, "relied on the information supplied to [them]… [and] have not assumed any responsibility for independent verification of, and have not independently verified, any of such information."[161] In an interview with one of the authors,

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[160] LOU KLING AND EILEEN NUGENT, NEGOTIATED ACQUISITIONS OF COMPANIES, SUBSIDIARIES AND DIVISIONS § 8.02 (LEXIS 2021) ("The Buyer's public accountants together with the Buyer's management (again with input from its investment bankers) should carefully analyze the Company's financial statements and other financial data."). *See also* JEFFREY M. WEINER, DUE DILIGENCE IN M&A TRANSACTIONS: A CONCEPTUAL FRAMEWORK (2010) (identifying key players in due diligence teams in M&A without mentioning investment banks).

[161] *See* fairness opinion provided by Moelis & Company LLC in the merger of SPAC Gore Holdings IV, Inc. with United Shore Financial Services, LLC. Moelis & Company LLC, Fairness Opinion (Sept. 22, 2022),

one SPAC advisor explained that investment banks in particular tend to confine their diligence review of registration statements in SPAC mergers to any references made to their own institutions, which typically arise in the section outlining the background of the business combination.[162]

3. Diligence by other Transaction Participants

It seems straightforward that investment banks in particular perform weaker diligence in SPAC mergers than they do in traditional IPOs, stemming from the absence of underwriter liability. But what of other participants? It is not self-evident that due diligence in mergers is necessarily weaker than that in IPOs; respected commentators resist this assertion, suggesting that the opposite may be true—that merger diligence may be more "extensive" or "go further" than that of traditional IPOs.[163] Nor can we dismiss the possibility that due diligence will be performed by cast members in SPAC mergers that have no role in IPOs, including sponsors and PIPE investors.

However, we are skeptical that due diligence in SPAC mergers is generally as extensive as it is in IPOs. The structure of SPACs' and sponsors' remuneration gives them incentives to support a deal if the alternative is no deal, especially as the acquisition window closes, diluting their incentives to perform robust diligence. Moreover, when mergers occur in the context of a competitive auction—as is often the case with SPAC mergers, and which may be expected given the large numbers of SPACs seeking targets—the incentives for due diligence may weaken since diligence may not be possible until after the price has been largely settled.[164] IPOs look different. Although conducting due diligence for an IPO is also an adversarial process, issuers need not fear disclosure to potential competitors. Rather, the disclosure is to

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https://www.sec.gov/Archives/edgar/data/1783398/000119312520262465/d36177dprem14a.htm#rom36177_47.

[162] Interview with Market Participant on June 22, 2021.

[163] STEPHEN M. BAINBRIDGE & IMAN ANABTAWI, MERGERS AND ACQUISITIONS: A TRANSACTION PERSPECTIVE 256 (2017) ("M&A due diligence may be either more or less extensive than the due diligence conducted by potential § 11 defendants, depending on the particular goals of the parties to the transaction."); KLING AND NUGENT, *supra* note 160, at § 8.02 ("in many circumstances a [due diligence] review in the context of an acquisition must go further [than a review in the public offering area] if the Buyer is to be placed in a position to make a reasonable judgment about the achievability of its plans for, and prospects of, the Company.").

[164] As to mergers generally, see Sean J. Griffith, *Deal Insurance: Representation & Warranty Insurance in Mergers and Acquisitions*, 104 MINN. L. REV. 1839, 1915 (2019); see also WEINER, *supra* note 160 (in auctions, "adequate time [for due diligence] may simply be unavailable.").

gatekeepers selected by the issuers themselves. In addition, these gatekeepers take a less oppositional posture than a prospective buyer.

What about due diligence performed by PIPE investors in SPAC mergers? That may inure to the benefit of public SPAC investors. Investors in PIPEs are accredited institutions and have access to non-public information about a SPAC and its target. These sophisticated investors are capable of verifying the information they obtain. However, we doubt that these investors generally undertake due diligence that substitutes for the due diligence underwriters perform in an IPO. We cannot speak conclusively to the point for lack of relevant data; the question is, after all, an empirical one. But we note that PIPE investors may invest on more favorable terms than public investors, potentially undermining claims their due diligence protects those investors.[165] Moreover, PIPE investors seek to be "cleansed" of material nonpublic information for insider trading purposes, generally will want any such information they receive to be publicly disclosed by the time of either the announcement or consummation of the SPAC merger.[166] That imperative necessarily limits the scope of PIPE investors' due diligence on a SPAC and its target. We also note that these investors have weaker incentives to perform due diligence than underwriters: PIPE investors avoid Section 11 liability investing in PIPEs and are likely to face less reputational harm for failing to deter disclosure errors.[167] Reputational incentives surely exist for some investors, but the "portfolio approach" many sophisticated investors adopt—making multiple investments with the hope that outsized gains in some will more than compensate for losses in others[168]—diminishes the reputational harm they suffer from making a poor investment that results from inadequate

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[165] *See* Klausner et al., supra note 102, at 14 (PIPE investors enjoyed discounts of 10 percent or more in one-third of all 47 SPACs that merged between January 2019 and June 2020 in the study).

[166] *See* Anna T. Pinedo et al., *Top 10 Practice Tips: PIPE Transactions by SPACs*, LEXIS PRAC. ADVISOR (Oct. 25, 2020), https://www.mayerbrown.com/en/perspectives-events/publications/2020/10/top-10-practice-tips-pipe-transactions-by-spacs;; BAKER MCKENZIE,GLOBAL PIPE GUIDE: YOUR QUESTIONS ANSWERED (2020), https://www.bakermckenzie.com/-/media/files/insight/publications/2020/06/global-private-investment-in-public-equity-guide-050620.pdf.

[167] Sjostrom, *supra* note 121, at 409–10 ("[A] hedge fund generally does not face potential liability under Section 11 when investing in a PIPE deal nor is its investment in a deal viewed as an implicit certification of the issuer. Hence, it can get away with performing minimal due diligence.").

[168] Bob Zider, *How Venture Capital Works*, HARV. BUS. REV. 131, 136 (Dec. 1998) (under this approach used by VC firms "more than half the companies will at best return only the original investment and at worst be total losses" while "only 10% to 20% of the companies funded need to be real winners to achieve the targeted return rate ….").

diligence, assuming their shortcomings come to light.[169] To be sure, PIPE investors' due diligence is likely to vary according to the type of investor and the intended holding period. But not all investors are in for the long haul, and commentators express doubts about the rigor of PIPE investors' due diligence in some settings, observing that "[p]ublic investors lose a significant component of certified due diligence in PIPE deals, even under circumstances where it could be helpful."[170] According to experienced practitioners, data rooms for PIPEs often contain little more than slide presentations known as "investor decks" that SPACs publicly disclose soon after the merger announcement,[171] making underwriter-style due diligence impossible for PIPE investors.

Finally, the involvement of PIPE investors may create particular pressures that compromise the integrity of due diligence efforts. Certainly, SPAC participants "often face pressure to expedite the [due diligence] process."[172] Before any merger proxy or registration statement on Form S-4 is prepared and filed, SPACs and targets provide investor decks to PIPE investors and, once the merger is announced, to analysts and other investors. These presentations soon become publicly available, being filed with the SEC in order to cleanse PIPE investors from insider trading restrictions.[173] According to transaction participants, transaction participants preparing proxy statements may feel pressure not to later disclose information inconsistent with that already publicly released.[174] These pressures rarely arise in traditional IPOs, because the issuer's first public disclosure in

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[169] Sophisticated investors, keen to avoid embarrassment, are reluctant to reveal when they are victims of securities fraud. Matt Levine, *You Never Want to Be Suckered This Badly: Even with Due Diligence, Sophisticated Investors Still Get Hoodwinked by Fraudulent Businesses*, BLOOMBERG (May 17, 2018, 5:00 PM CDT), https://www.bloomberg.com/opinion/articles/2018-05-17/securities-fraud-can-happen-with-private-transactions, https://perma.cc/Y2M4-FS7S.

[170] *See* Thompson & Langevoort, *supra* note 3, at 1603. *See also supra* note 167.

[171] Telephone Interviews with Legal Advisors on Sept. 21, 2021 and Oct. 1, 2021.

[172] *See* FTI CONSULTING & LATHAM & WATKINS, FIVE KEY TAKEAWAYS: SPAC RELATED LITIGATION RISKS AND MITIGATION STRATEGIES, https://www.lw.com/thoughtLeadership/spac-related-litigation-risks-mitigation-strategies-five-key-takeaways.

[173] For an example of the timing of these events in a SPAC merger, *see* Securities Act Release No. 10955, Administrative Proceeding File No. 3-20393, In the Matter of Momentus, Inc. et al., Order Instituting Cease-and-Desist Proceedings (July 13, 2021), at 7.

[174] Interview with Market Participant on June 22, 2021.

connection with its IPO will typically be a heavily-vetted draft registration statement.

In sum, the analysis suggests that, while SPAC participants, including a SPAC and its directors and officers, are vulnerable to Section 11 liability, investment banks will escape liability for the roles they perform, resulting in weaker incentives for due diligence by gatekeepers in SPACs than in traditional IPOs. Structural differences between mergers and traditional IPOs are also likely to weaken the diligence role of transaction participants in SPACs, exacerbating concerns created by the absence of underwriter liability. We are skeptical that due diligence by sponsors or PIPE investors can substitute for the absence of gatekeeper liability required for traditional IPOs.

C. Other Factors Weakening Investor Protection

Other factors contribute to the weakened deterrent force of underwriter liability under Section 11. First, SPACs' structure distorts the incentives of sponsors and IPO underwriters, creating pressure for SPACs to act contrary to the best interest of their outside investors, including by overpaying for targets. Second, SPAC mergers do not face the same restrictions on publicity as traditional IPOs, with the result that SPAC investors may make investment decisions on information that is more weakly-vetted than information available to their counterparts in traditional IPOs. Finally, federal securities law provides a safe harbor from liability for estimates, projections, and other forward-looking statements—a safe harbor widely interpreted as applying to SPAC mergers but not to traditional IPOs. Although we suggest there are many transactions to which this safe harbor does not apply, its potential availability may encourage greater use of forward-looking information in SPAC mergers, meaning that investors may rely on relatively weakly-tested projections of target companies, predictions that are inevitably uncertain and often not borne out.

1. Misaligned Incentives

SPAC mergers also distort the incentives of sponsors and underwriters, potentially harming outside SPAC investors. Sponsors are largely compensated via founder shares, which gives them a substantial stake in the SPAC for a nominal consideration.[175] Their incentives diverge from those of outside SPAC investors both because they receive their securities on more

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[175] *See supra* note 108 and accompanying text.

favorable terms than do investors and because these shares provide no return unless the SPAC consummates a merger within the defined time frame.[176] Sponsors therefore will often have incentives to undertake a merger, even at a lofty price, because the remuneration structure allows them to profit even if shareholders lose. Otherwise put, a sponsor may choose to merge with a "lemon" rather than have to liquidate the SPAC and lose the benefit of its founder shares and other securities.[177]

Sponsors may choose to transfer a portion of their founder shares or warrants to the target company or other parties in order to facilitate a SPAC merger.[178] Studying the twenty most recently completed business combinations as of October 2020, Minmo Gahng and coauthors show that, on average, sponsors gave up 34 percent of their founder shares and 42 percent of their warrants, transferring most of these securities to other participants—primarily PIPE investors—to induce them to invest new capital or at least not to demand redemption.[179] Consistent with an interpretation of these transfers as inducements, Gahng et al. find greater transfers for deals that were poorly received by investors, as evidenced by high redemption rates.[180]

Give-ups confirm sponsors' powerful incentives to pursue even loss-producing deals. The need for give-ups suggests both that the terms otherwise may be inadequate from the perspective of those investors receiving the give-ups and that investors who do not receive these inducements experience harm. Underscoring the perversity of sponsors' incentives, in recent years

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[176] *See* KIRKLAND & ELLIS, FAMILY OFFICES AND SPACS PART I: SPAC OVERVIEW AND THE CURRENT MARKET, https://www.kirkland.com/publications/private-investment-and-family-office-insights/2021/01/spac-overview-and-the-current-market ("Sponsor promote shares and warrants will have no value unless a business combination is consummated.").

[177] *See* Bai et al., *supra* note 105, at 5 ("SPAC sponsors may prefer to bring a 'lemon' firm public rather than liquidate the SPAC.").

[178] Gerry Spedale & Eric Pacifici, *9 Factors to Evaluate When Considering A SPAC*, LAW360 (Mar. 11, 2019), https://www.gibsondunn.com/wp-content/uploads/2019/03/Spedale-Pacifici-9-Factors-To-Evaluate-When-Considering-A-SPAC-Law360-03-11-2019.pdf ("While the SPAC sponsor would rather not give up any of these securities, some or all of them can be offered to the target company (or an additional financing source needed to fund the deal) as an incentive to enter into the business combination.").

[179] Gahng et al., *supra* note 102, at 6, 33. *See also* Klausner, et al., *supra* note 102, at 73 ("it is common for PIPEs either to be priced at a discount, for PIPE investors to be issued warrants or other sweeteners, or for sponsors to transfer shares or warrants to PIPE investors to subsidize their investment.").

[180] Gahng et al., *supra* note 102, at 6.

they earned outsized positive returns even when SPAC mergers performed poorly.[181]

Investment banks experience similarly compromised incentives. In SPAC mergers, investment banks routinely act as M&A advisors to SPACs or target companies and as placement agents in PIPE transactions. SPACs tend to select their M&A advisors and placement agents from among the underwriters to their earlier IPO,[182] allowing investment banks to have designated roles in both SPAC stages by underwriting the IPO and then advising on the SPAC merger and/or facilitating the related PIPE offering. Some evidence suggests that underwriters in the SPAC IPO that are not formally engaged as M&A advisors will nevertheless "typically assist [the] SPAC in finding targets and assisting with capital structure matters for SPAC mergers"[183] and therefore perform an informal advisory role.

Consider that the majority of underwriting fees for SPAC IPOs are deferred until, and conditional upon, the closing of the SPAC merger.[184] These arrangements create incentives for investment banks to recommend or support mergers even if they do not serve SPAC interests, because the banks lose their deferred compensation if no merger occurs within the acquisition window.[185] This situation holds whether a bank is operating as M&A advisor or in an informal capacity on the deal. Both roles are common.[186] The same goes for placement agents because they may simultaneously be serving as M&A advisors to the SPAC or target,[187] roles that award "outsized benefits

[181] Klausner, et al., *supra* note 102, at 43 (finding that "sponsors tend to do very well [from SPAC mergers], even where SPAC investors do quite poorly.").
[182] For instance, Goldman Sachs underwrote the IPO of SPAC Diamond Eagle Acquisition Corp. and also acted as exclusive financial advisor to Diamond Eagle on its merger with DraftKings. See Diamond Eagle Acquisition Corp., Registration Statement 136 (Form S-1) (May 9, 2019); DEAC NV Merger Corp., Registration Statement 95 (Form S-4) (Jan. 6, 2020).
[183] ROPES & GRAY, supra note 103, at 26; see also *id.* ("Underwriters for the IPO often continue to assist SPAC through back-end mergers.").
[184] *See id.* at 26 (underwriters typically earn fees of 5.5 to 6.0 percent, with 2.0 percent paid at the IPO's closing and the balance deferred until closing of any SPAC merger).
[185] *See* Usha R. Rodrigues, Testimony Before the Investor Protection, Entrepreneurship, and Capital Markets Subcommittee of the U.S. House Committee on Financial Services, "Going Public: SPACs, Direct Listings, and Public Offerings, and the Need for Investor Protections," May 24, 2021 ("[T]the underwriter is incentivized [by the structure of its compensation] to make sure that an acquisition—*any* acquisition—closes and that the target goes public.").
[186] ROPES & GRAY, *supra* note 103, at 26.
[187] *See* Pinedo et al., supra note 166 (placement agents may be selected from target or SPAC M&A advisors).

from completing acquisitions,"[188] giving them added incentives to solicit PIPE investors. Illustrating the strength of these incentives, SPAC IPO underwriters often forego fees to facilitate SPAC mergers; in a study of the 20 most recently completed SPAC mergers as of October 2020, they forfeited an average of 24 percent of their deferred fees.[189]

Traditional IPOs do not seem to create such strongly misaligned incentives between transaction participants on the one hand and outside investors on the other. Sponsors perform no role in traditional IPOs. For their part, underwriters receive contingent compensation in IPOs, receiving a fee only if an IPO occurs, but they have powerful incentives to protect the interests of outside investors, and are often alleged to underprice securities with the intention of doing so.[190]

2. Sales Promotion

Traditional IPOs face firm limits on offers and sales of securities prior to the filing of a registration statement and require written offers to be made in connection with a statutory prospectus. Although these so-called gun-jumping rules are not as strict as they once were,[191] in practice they continue to discourage investment activity before a well-vetted registration statement has been filed with the SEC.[192] This "generally prevents executives from providing information not previously disclosed in the registration statement and prospectus until forty days after the new stock begins trading."[193] In marked contrast, mergers, including SPAC mergers, benefit from more lenient rules intended to allow companies and other participants to announce a proposed transaction long before a registration statement has been filed.[194]

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[188] Afra Afsharipour & Travis Laster, *Enhanced Scrutiny on the Buy-side*, 53 GA. L. REV. 443, 456 (2019).
[189] Gahng et al., *supra* note 102, at 6, 52.
[190] *See* Part II.C.
[191] As to which, *see* 1 SECURITIES REGULATION 6TH ED., *supra* note 1, at 788-926.The traditional prohibitions have been relaxed most for Well-Known Seasoned Issuers, or WKSIs, which benefit from an "automatic" shelf-registration process. *See id*. at 716-33.
[192] *See* Harald Halbhuber, *An Economic Substance Approach to SPAC Regulation,* at 22 n 133, at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4005605 (discussing the institutional forces that in practice "preserve the quiet period").
[193] Jonathan S. Kolodner, *DOJ Indicts Founder of Nikola for Allegedly Defrauding Retail SPAC Investors*, Cleary Enforcement Watch, HARV. L. SCH. F. ON CORP. GOV. (Aug. 15, 2021), https://corpgov.law.harvard.edu/2021/08/15/doj-indicts-founder-of-nikola-for-allegedly-defrauding-retail-spac-investors/.
[194] *See* KLING & NUGENT, supra note 160, at § 23.04. Specifically, *see* Securities Act Rules 145, 165, and 166, and SEC, Final Rule: Regulation of Takeovers and Security Holder Communications, Release No. 33-7760 (Oct. 22, 1999).

SPACs typically announce their mergers many weeks before the filing of a registration statement. They may also make other communications before a registration statement has been filed, so long as that communication is filed with the SEC.[195] The SPAC merger announcement is often quickly followed by the disclosure of the investor deck used to solicit PIPE investors. These materials are typically lengthy slide presentations promoting the SPAC, the target, and the proposed merger; they include earnings and other projections for the target. These materials—which would not be permitted in a traditional IPO—"condition the market" for the SPAC before any well-vetted registration statement has been filed. After the announcement of the SPAC and the filing of these materials, SPACs and targets then undertake "roadshows" with potential investors, give presentations at industry conferences, have conference calls with research analysts, issue press releases, and update previously disclosed information—filing with the SEC promotional materials at a steady pace that would not be permitted in a traditional IPO. In industry parlance, the purpose of these materials is to "cycle out" the yield-oriented investors, the "SPAC mafia," and "cycle in" long-only fundamental investors, many of them retail investors.

This regulatory leniency, leaves SPAC investors vulnerable to less reliable disclosures. SPACs and their merger targets get to arouse investor interest much earlier in the deal process than issuers in traditional IPOs, before a registration statement has been prepared, with the result that SPAC investors may make investment decisions on information that is more weakly vetted than information available to investors in traditional IPOs. Although investors may yet redeem their shares, this decision too depends on the accuracy and completeness of information available. Transaction participants report feeling pressure not to later disclose information in proxy statements inconsistent with that already publicly released,[196] and in any case, these later disclosures may be compromised by diminished incentives for due diligence.

3. Use of Forward-Looking Statements

Relatedly, the forward-looking or prospective statements disclosed in SPAC mergers probably enjoy greater protection from liability than such statements would in a traditional IPO. Under provisions of the Securities Act and Securities Exchange Act enacted by the Private Securities Litigation Reform Act (PSLRA),[197] issuers benefit from safe harbors from liability for certain forward-looking statements in private suits provided that the

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[195] *See* Securities Act, Rule 165(a).
[196] *See supra* note 174 and accompanying text.
[197] *See* Securities Act, Section 27A; Securities Exchange Act, Section 21E.

statements are accompanied by meaningful cautionary language.[198] The safe harbors are subject to exclusions, including for forward-looking statements "made in connection with an initial public offering."[199] Yet legal practitioners generally regard SPAC mergers as benefiting from the safe harbors—that is, they do not regard a SPAC merger as an "initial public offering" within the terms of the exclusion.[200]

The perceived availability of these liability safe harbors for SPAC-merger participants, not participants in traditional IPOs, has been thought to explain differences in deal practices.[201] Issuers in traditional IPOs do not publicly disclose forward-looking statements, including in their registration statements "other than vague narrative disclosure in response to the SEC's management discussion and analysis [MD&A] rules," while issuers and targets in SPAC mergers "routinely provid[e]" forward-looking information in their proxy and registration statements and in other materials.[202] In traditional IPOs, it is not that projections of revenue or earnings and other forward-looking information is unavailable but that such information is not publicly disclosed in the offering process. Issuers in traditional IPOs generate forward-looking information, which their underwriters scrutinize as part of

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[198] For a detailed discussion of these safe harbors, *see* 2 SECURITIES REGULATION 6TH ED., *supra* note 30, at 127–61; Joel Seligman, *The SEC's Unfinished Soft Information Revolution*, 63 FORDHAM L. REV. 1953 (1995).

[199] Securities Act, Section 27A(b)(2)(D). Also excluded are forward-looking statements made in connection with an offering of securities by a blank check company. Securities Act, Section 27A(b)(1)(B).

[200] *See, e.g.,* MAYER BROWN, DE-SPACING: OVERVIEW, SECURITIES LAW & FINANCIAL STATEMENT CONSIDERATIONS; DERISKING WITH A PIPE TRANSACTION 34 (Jan. 27, 2021), https://www.mayerbrown.com/-/media/files/perspectives-events/events/2021/01/despacing-mbpli-webinar-materials-jan2021.pdf ("forward-looking statements will benefit from the safe harbor"); Josh DuClos & Martin Wellington, *Two Paths. One Destination? How De-SPACs and IPOs Can Both be Fruitful*, THE RECORDER (Mar. 31, 2021), https://www.sidley.com/en/insights/publications/2021/03/two-paths-one-destination-how-de-spacs-and-ipos-can-both-be-fruitful ("[I]n the de-SPAC context, the securities laws provide companies the benefit of a safe harbor for forward looking statements"); FTI CONSULTING & LATHAM & WATKINS, *supra* note 172 (referring to "[t]he general view that de-SPAC transactions would be shielded by the protections of safe harbor").

[201] Although, as Amanda Rose observes, state fiduciary obligations are considered to compel the disclosure of projections in SPACs. *See* Amanda M. Rose, *SPAC Mergers, IPOs, and the PSLRA's Safe Harbor: Unpacking Claims of Regulatory Arbitrage* (October 19, 2021), SSRN: https://ssrn.com/abstract=3945975 or http://dx.doi.org/10.2139/ssrn.3945975.

[202] *See* Spencer Feldman, *Growth Cos. Should Disclose Projections In IPO Prospectuses*, LAW360 (Apr. 9, 2021, 6:02 PM), https://www-law360-com.ezproxy.law.wustl.edu/articles/1372725/growth-cos-should-disclose-projections-in-ipo-prospectuses (noting differences in disclosure practices in traditional IPOs and SPAC mergers and attributing them "largely … to the SEC's decision to exclude IPOs from the [PSLRA] liability safe harbor").

their due diligence in order to "avoid surprises and investor disappointment."[203] By contrast, public investors in SPAC mergers have ready access to such information, including in the proxy or S-4 disclosures, giving them information that may mitigate information asymmetry but is likely the product of a weaker diligence process than that applied in traditional IPOs. The irony is that IPO issuers refuse to release earnings projections, even though they have benefited from third-party review, while SPACs routinely disclose the relatively weakly-tested projections of target companies, exposing investors to risk. Whether that risk results in investor harm awaits further evidence.[204]

Whether the safe harbors apply or should be applied to SPACs is a matter of debate. John Coates recently cast doubt on the prevailing practitioner interpretation, suggesting that "initial public offerings" as used in the exemptions "may include de-SPAC transactions."[205] Pointing to similarities in the "economic and information substance" of SPAC mergers and IPOs, the statement opines that whether the PSLRA safe harbors apply differently to traditional IPOs and SPAC mergers is "uncertain at best."[206] The statement goes further, arguing that "the PSLRA safe harbor[s] should not be available for any unknown private company introducing itself to the public markets… regardless of what structure or method it used to do so."[207]

Although we defer our discussion of whether the PSLRA safe harbors ought to apply to SPAC mergers until Part D, we contend that some SPAC

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[203] CHARLES J. JOHNSON, JR. & JOSEPH MCLAUGHLIN, CORPORATE FINANCE AND THE SECURITIES LAWS 166–67 (3d ed. 2004). Underwriters may in turn disclose an issuer's forward-looking information to sophisticated institutional investors. *See* Donald C. Langevoort & Robert B. Thompson, *IPOs and the Slow Death of Section 5*, 102 KY L. J.891, 921 (2013-14).

[204] The available evidence is mixed. *Compare* Kimball Chapman, Richard M. Frankel & Xiumin Martin, *SPACs and Forward-Looking Disclosure: Hype or Information?* (October 20, 2021), available at https://ssrn.com/abstract=3920714 (finding evidence that is "consistent with the argument that forward-looking information mitigates information asymmetry, aiding price discovery" and "inconsistent with the supposition that disclosing such information enables SPACs to hype and mislead investors.") *with* Michael Dambra et al., *Should SPAC Forecasts be Sacked?* (September 29, 2021), available at https://ssrn.com/abstract=3933037 (providing evidence that forward-looking statements in SPAC mergers "are overly optimistic and misleading to uninformed investors") and Elizabeth Blankespoor et al., *A Hard Look at SPAC Projections* (Nov. 1, 2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3961848 (SPAC targets make more optimistic projections than comparable firms in in other settings).

[205] Coates, *supra* note 124. .

[206] *Id.*

[207] *Id.*

structures are more plausibly regarded as "initial public offerings" than others and may therefore not benefit from the safe harbor. Recall the three main transactional forms for SPAC mergers.[208] In the target-on-top and double-dummy structures, a private target and newly formed holding company, respectively, make *initial* offerings of securities to the public during a SPAC merger. These structures contrast with the conventional structure—which commentators seem to have in mind—whereby an issuer of securities in the SPAC merger (the SPAC) has often already undertaken an initial offering of securities. The argument that SPAC mergers are not "initial public offerings" within the PSLRA exclusions is more plausible for transactions not adopting the conventional structure.[209] Nevertheless, SPACs routinely make use of forward-looking statements in SPAC mergers, without apparent regard for how they are structured.[210]

D. Assessment and Proposals

1. SPAC Outcomes

Empirical evidence suggests that, in SPAC mergers, transaction participants often act based on misaligned incentives. SPAC mergers have often performed poorly for public investors, harming those SPAC shareholders who elected to hold their shares through the merger rather than selling or demanding redemption.[211]

Sponsors have nevertheless tended to earn outsized returns even when SPAC mergers performed poorly.[212] This comes as no surprise considering sponsors' receipt of founder shares amounting to 20 percent of the post-IPO company for nominal consideration, conditional on a merger occurring. In Michael Klausner, Michael Ohlrogge, and Emily Ruan's 2019–2020 merger cohort, sponsor returns, on average, were around 500 percent, measured 12

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[208] *See supra* notes 133–134 and accompanying text.

[209] SPAC mergers are occasionally also structured as tender offers. Forward-looking statements made in connection with a tender offer are outside the protection of the PSLRA safe harbors. *See* Securities Act of 1933, Section 27A(b)(2)(C).

[210] *See, e.g.,* Testimony of Scott Kupor, Andreessen Horowitz, U.S. House of Representatives, Financial Services Committee, May 24, 2021, at 10 ("[M]any SPACs provide 5-year forward forecasts that are used in connection with the marketing process for the pending acquisition.").

[211] *See*, e.g., Klausner et al., *supra* note 102, at 33-39; Johannes Kolb & Tereza Tykvova, *Going public via special purpose acquisition companies: Frogs do not turn into princes*, 40 J. CORP. FIN. 80, 88-93 (2016) (finding SPACs performed poorly and severely underperform comparable IPOs).

[212] *See supra* note 181 and accompanying text.

months post-merger on a market-adjusted basis.[213] The authors find that "while sponsors are not absolutely guaranteed to profit, they have a very good chance of doing so, even when investors do quite poorly."[214] These results suggest that sponsors prefer to enter into deals that harm outside investors' interests when the only alternative is to undertake no deal at all.

2. Justifying Regulation

In assessing the merits of underwriter liability under Section 11 in SPAC mergers, we use traditional IPOs as a benchmark for analysis, arguing that the case for underwriter liability is as strong in the setting of SPAC mergers as it is in that of traditional IPOs.

First, we contend that the benefits of underwriter liability are at least as great for SPAC mergers as they are for traditional IPOs. Both SPAC mergers and traditional IPOs introduce largely unknown and untested companies to public markets, and in such settings, information asymmetries between investors and companies seeking capital are likely to be substantial. In both transactions, information comes from the companies themselves, parties with incentives "to act opportunistically by misrepresenting the accuracy … of the information."[215] After all, traditional IPOs and SPACs represent companies' best shot at capitalizing on their innovations, so firms face pressure to attract funds on the most favorable terms.[216] These environments of high information asymmetries are precisely the ones in which the investor protections of federal securities law "are typically most needed."[217] If anything, the benefits of underwriter liability may be greater in the SPAC setting because SPAC sponsors and SPAC IPO underwriters have incentives misaligned with those of SPAC investors, which magnify the risk of disclosure error.

Second, the costs of underwriter liability are no greater for SPAC mergers than they are for traditional IPOs. In both settings, investment banks have roles that allow them to perform due diligence. These firms have developed time-tested methods for assuring the accuracy of registration statements and

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[213] Klausner et al., *supra* note 102, at 43. Returns measured 12 months post-merger were somewhat lower but still suggest that sponsors "tend to do very well even where SPAC investors [that hold post-merger] do quite poorly."). *Id*. at 39.
[214] *Id.* at 43.
[215] *Id.* at 595.
[216] In traditional IPOs, the use of underwriters is a market technique adopted by issuers and investors to address the problem of verification. *Id.* at 619–28.
[217] *See* Coates, *supra* note 124.

other disclosures, methods that would seem equally applicable in both settings. Indeed, some legal advisors have advised participants to consider performing IPO-style due diligence in SPAC mergers, without regarding cost as a barrier to banks.[218]

Assuming the accuracy of these claims regarding costs and benefits, the case for underwriter liability is as strong for SPAC mergers as it is for traditional IPOs. On this reasoning, underwriter liability would generate benefits for SPAC mergers at least as great as those accrued to traditional IPOs, without imposing additional costs. If Section 11 underwriter liability is justified for traditional IPOs, the same is true for SPAC mergers.

The empirical evidence is nevertheless mixed on where the high costs of SPAC mergers fall and the extent of any benefits SPAC mergers provide. Accordingly, scholars studying these questions cannot conclude that traditional IPOs are necessarily superior to, or strictly dominate, SPAC mergers. Studies assessing SPAC mergers provide consistent results in some respects but diverging results in important other respects.

Scholars agree that SPAC mergers are significantly more costly than traditional IPOs, contrary to the oft-repeated claims that SPAC mergers offer cost savings.[219] IPOs and SPAC mergers impose somewhat different categories of costs. In traditional IPOs, costs primarily take the form of fees paid to underwriters and the potential losses resulting from "underpricing" of shares, whereby shares sold in an IPO tend to be priced below investors' apparent willingness to pay for them. While SPAC mergers do not suffer from such underpricing and face slightly lower underwriting fees (around 5.5 percent in total), other elements of their structure—founder shares and rights and warrants that SPACs issue—dilute the cash backing each SPAC share,[220] which is amplified when SPAC shareholders have their shares redeemed and depletes the cash available for a proposed merger.[221] These dilution costs

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[218] Adam Brenneman et al, *Rising Threat of Securities Liability for SPAC Sponsors*, HARV. L. SCH. F. ON CORP. GOV. (Nov. 9, 2020), https://corpgov.law.harvard.edu/2020/11/09/rising-threat-of-securities-liability-for-spac-sponsors/ ("SPAC sponsors may consider performing the type of diligence associated with a traditional IPO, in addition to the valuation-focused due diligence typical of the merger context.").

[219] *See, e.g.*, Ortenca Aliaj et al., *Can SPACs Shake Off Their Bad Reputation?,* FIN. TIMES (Aug. 12, 2020), https://www.ft.com/content/6eb655a2-21f5-4313-b287-964a63dd88b3 ("By using SPACs, they [sponsors] can skip over the expensive and time-consuming IPO process.").

[220] *See* Klausner et al., *supra* note 102, at 22–30.

[221] Klausner et al., *supra* note 102, at 22.

must be borne by the post-merger company. In a seminal study of a cohort of SPAC mergers in 2019 and 2020, Klausner et al. estimate the median cost of SPAC mergers at 62 percent of the cash delivered, roughly double the corresponding figure for traditional IPOs.[222] Measuring costs as a percentage of target or issuer market values using a similar analytical framework, Gahng and coauthors find SPAC mergers to be almost three times as costly as traditional IPOs.[223]

On which of the primary transaction participants—SPAC shareholders, target shareholders, or sponsors—do these costs largely fall? Scholars tend to agree that initial investors in SPAC IPOs earn attractive returns. The option to have their shares redeemed allows investors to recoup their investment, giving them a "money back guarantee" plus interest.[224] Their warrants, which they can sell or exercise, also have value.[225] Investors that redeemed their shares earned mean annualized returns of 11.6 percent from their shares and warrants, despite facing no downside risk on their investment.[226]

As a class, initial SPAC investors—those investing in the SPAC IPO—are largely distinct from those SPAC shareholders holding at the time of merger and beyond. Initial SPAC investors generally have their shares redeemed or sell their shares before a SPAC merger, with the result, according to Klausner et al., that "very few pre-merger shareholders hold their shares until after the merger's completion."[227] The primary role these SPAC investors perform is "to create a public vehicle that will be later used to bring a private company public through a merger in which new shareholders will invest."[228]

Importantly, however, scholarly views diverge on which of the remaining transaction participants bear the high costs of raising funds via a SPAC merger: target shareholders or nonredeeming SPAC shareholders, a group that includes retail investors. The answer will depend on the terms of the

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[222] *Id*. at 49. The figure for traditional IPOs accounts for the potential cost to issuers of IPO underpricing.
[223] Gahng et al. report figures of 14.1 percent and 4.8 percent for SPAC mergers and IPOs, respectively. See Gahng et al., *supra* note 102, at 35, 45.
[224] *See* Gahng et al., *supra* note 102, at 2.
[225] *Id*. at 3, 28.
[226] Klausner et al., *supra* note 102, at 25 (based on a cohort of SPACs in 2019 and 2020). Gahng and coauthors provide a "back of the envelope" calculation showing why initial SPAC investors would enjoy abnormal positive returns on their shares and warrants. *See* Gahng et al., *supra* note 102, at 28–29.
[227] Klausner et al., *supra* note 102, at 21.
[228] *Id.* at 22.

agreement the merger parties strike and, in particular, whether targets negotiating mergers account for the heavily dilutive effect of founder shares, warrants, and rights, a consequence of which is that SPACs hold less cash per share than their $10 nominal share value suggests.[229] Klausner et al. suggest that, in negotiating with SPACs, targets protect their interest by accounting for SPAC's dilutive structure.[230] Pointing to the substantial price declines SPACs experience after a merger and to their own finding of a strong correlation between those declines and the extent of dilution,[231] Klausner et al. infer that "SPAC shareholders bear the costs … embedded in the SPAC structure," although "they extract some [modest] surplus from the deal, so their net losses are partially mitigated."[232] Non-redeeming SPAC shareholders "unwittingly subsidize" target companies, with the result that, from a target's perspective, going public via a SPAC "has been cheap—cheaper than an IPO."[233]

The evidence presented by Klausner et al. that SPAC shareholders—rather than target companies—bear the brunt of the expense is equivocal. Considering *immediate* post-merger prices, rather than the longer-term post-merger prices on which Klausner et al. base their inferences, and taking an alternative perspective to valuing IPO costs, Klausner et al. report the opposite result, that "SPACs would seem to be very expensive for target companies."[234] But Klausner et al. are skeptical of this alternative approach, suggesting instead that SPAC post-merger prices may be slow to adjust.[235] Rather than rely on a SPAC's immediate post-merger price, Klausner et al. point to evidence that SPAC prices decline in the weeks and months post-merger, which they interpret as consistent with the view that SPAC investors are bearing the cost of SPAC mergers.[236] Again, however, this interpretation

[229] *Id.* at 32 ("The terms of a merger agreement determine which party bears a SPAC's costs.").
[230] *Id.* at 33-42 (finding evidence consistent with the implication that "targets tend to negotiate deals that protect themselves from SPACs' costs.").
[231] *Id.* at 39-41.
[232] *Id.* at 41.
[233] *Id*. at 7-8.
[234] *Id*. at 86-87.
[235] Id. at 87. In an earlier version, the authors explain, "Especially for companies that are difficult to value—the type of target for which SPACs are supposedly best suited—the market may need time and additional quarters of financial results to arrive at accurate valuations."
[236] The implication is that a SPAC's price weeks or months after a SPAC merger more accurately reflects its true value at the date of the merger. On this view, a SPAC price of less than $10 weeks or months after the merger, when markets have had enough time to arrive at accurate valuations, suggests that SPAC shareholders—rather than target shareholders—carry the dilution costs, even if the price one day post-merger may suggest the opposite.

hinges on the view that SPAC prices are not highly informationally efficient but rather adjust slowly, a plausible but contestable claim.

Gahng and coauthors prefer the alternative approach, regarding the costs at the time of merger as falling on target shareholders rather than SPAC shareholders. Gahng and coauthors therefore pose the difficult question of why target companies would engage in SPAC mergers rather than less costly conventional IPOs.[237] Klausner et al. need not answer that question, as they suggest that, *from a target's perspective*, SPAC mergers are cheaper than traditional IPOs,[238] making the appeal of SPACs more obvious, especially considering the higher regulatory burdens traditional IPOs carry. But Klausner et al. must explain why SPAC shareholders would have agreed to bear these costs, a question they cannot answer definitively.[239] Under both interpretations, however, the bottom line is that SPAC mergers have been significantly more costly than traditional IPOs, largely due to their highly dilutive structure.

In addition to disputing which participants bear the high costs of SPAC mergers, scholars contest the extent to which SPAC mergers provide unique benefits. Scholars speculate that SPAC mergers offer advantages for firms with information that is difficult to convey to investors or firms that investors have difficulty valuing.[240] SPAC deals are thought to be speedier to execute,[241] have more certain deal terms,[242] and benefit from sponsors giving advice and certification to private companies.[243] If these benefits exist, they might well explain why so many companies have preferred SPAC mergers when, on Gahng et al.'s view, SPAC mergers are more expensive than traditional IPOs for target companies. However, Klausner et al. doubt

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[237] Gahng et al., *supra* note 102, at 6–15.
[238] *See* Klausner et al., *supra* note 102, at abstract (SPAC investors are "in effect subsidizing the companies they bring public"); *id*. at 4 ("From the perspective of companies going public, therefore, SPACs have indeed been cheap.").
[239] *Id*. at 42 ("We cannot answer that question definitively, but … at least a partial answer may lie in poor disclosure practices and sponsor incentives that are misaligned with shareholder interests.")
[240] Klausner et al., *supra* note 102, at 5. These companies might also "expect difficulty communicating their story to the market." *Id*. at 45. Bai et al. suggest systematic differences exist between firms preferring SPAC mergers and firms preferring traditional IPOs, but the Gahng study casts doubt on the possibility that SPAC mergers benefit a distinct set of firms.
[241] Gahng et al., *supra* note 102, at 12 ("[I]t is frequently stated that the time it takes for an operating company to negotiate a merger with a SPAC and win shareholder approval is less than that of a traditional bookbuilt IPO.").
[242] *Id*. at 13 ("[M]erging with a SPAC may provide relative certainty compared to a traditional IPO.").
[243] *Id*. at 12.

whether SPAC mergers are executed more quickly or result in more certain deal terms. They accept that sponsors may provide value in selecting and advising targets and that PIPE investors may certify the transaction and thus aid in price discovery. But Klausner et al. suggest that these benefits are available at less cost by integrating certain features of SPACs into traditional IPOs.[244]

The point, however, is that dispute exists as to where the high costs of SPAC mergers fall and to the existence and size of any benefits they provide. Moreover, even critics of de-SPACs find that de-SPACs during their study period created social value, meaning that they provide, on average, a net collective gain among all parties involved.[245] This suggests that *with changed terms*, de-SPACs might also be value-increasing for non-redeeming SPAC shareholders, although that would mean lower returns for SPAC sponsors, IPO investors, and underwriters. The evidence therefore fails to establish that traditional IPOs strictly dominate SPAC mergers by providing greater welfare, or vice versa, suggesting that reforms should avoid seeking to channel private companies away from one type of transaction to the other. However, the evidence *does* justify imposing Section 11 liability in SPAC mergers. The case for underwriter liability in SPAC mergers is as strong as it is in traditional IPOs: comparing the former setting to the latter, underwriter liability provides as significant benefits without imposing greater costs. If, as we contend in Part II, underwriter liability is justified for traditional IPOs, the same holds true for SPAC mergers.

We recommend that a SPAC's IPO underwriters bear liability under Section 11 for any misstatements or omissions in registration statements used in connection with a SPAC merger. This could be achieved by viewing a SPAC IPO and its associated SPAC merger as one integrated transaction. The purpose would be to treat underwriters of the SPAC IPO as underwriters of the SPAC merger under Section 11. These investment banks may be formally retained by the SPAC as M&A advisors and in any event often advise on or otherwise facilitate the SPAC merger[246]—having incentives to do so because of their deferred compensation. If these investment banks were to face suit, they would benefit from the due diligence defense under Section 11. In practice, such liability would likely result in an underwriter undertaking due diligence to avoid liability, including seeking negative assurance and comfort

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[244] Klausner et al., *supra* note 102, at 60–66.
[245] Id. at 266-67 (The "entire SPAC process results, on average, in a net collective gain among all parties involved in SPACs, and that the costs that we have analyzed constitute a distribution of the surplus value created by having a company go public.")
[246] *See supra* note 183 and accompanying text.

letters from the SPAC's counsel and auditors, respectively, attesting to the accuracy of the relevant registration statement. These heightened standards would apply to SPAC mergers only, a distinguishable class of merger in which special investor risks arise, rather than to mergers generally. These proposed standards would also align due diligence standards with those of traditional IPOs, buttressing investor protections.[247]

We can also analogize the regulation of SPAC mergers with that of going-private transactions under federal securities law. The quintessential going-private transaction is the management buyout (MBO), a transaction that, like SPAC mergers, creates conflicts of interest for transaction participants, including corporate fiduciaries. In MBOs, managers of a firm participate in buying the firm, a position that pits managers' self-interest against their fiduciary duties of loyalty.[248] Federal securities law responds to these transactions by requiring enhanced disclosure.[249] Rule 13e-3 compels an issuer and affiliates engaged in a going-private transaction to file with the SEC and to publicly disseminate a Schedule 13E-3, which requires disclosure of the transaction's purposes and a written justification of its structure. The target company and its affiliates must attest that they reasonably believe the transaction is fair to shareholders and must explain why this is so.[250]

SPAC sponsors could be required to attest that they reasonably believe a SPAC merger is fair to SPAC shareholders and explain why. They could also discuss factors bearing on their incentives—and those of their advisors—to act contrary to or in congruence with the interests of outside SPAC shareholders. This discussion could include information about remuneration for sponsors, underwriters, and advisors as well as details of arrangements

[247] SPAC sponsors would not be exempt from liability. They might face Section liability as control persons or under Section 12 of the Securities Act for soliciting sales.

[248] *See* Andrew F. Tuch, *Managing Management Buyouts: A US-UK Comparative Analysis*, *in* RESEARCH HANDBOOK ON COMPARATIVE CORPORATE GOVERNANCE 477, 478 (A. Afsharipour & M. Gelter eds., 2021) [hereinafter Tuch, *Management Buyouts*]

[249] *See* 17 C.F.R. § 240.13e-3(d) (2019). This schedule requires disclosure of the purposes of the transaction and the reasons for its structure. The target company and its affiliates must attest that they reasonably believe the transaction is fair to shareholders and must explain why this is so. For a more detailed discussion of MBOs and required disclosures, *see* Tuch, *Management Buyouts*, *supra* note 248, at 494–95.

[250] 17 C.F.R. § 240.13e-100.

with third parties, such as PIPE investors and SPAC shareholders, as sponsors seek these third parties' support for a proposed merger to proceed.[251]

We also recommend harmonizing safe harbors for forward-looking statements used in SPAC mergers and traditional IPOs. The case for reform of safe harbors is more contested than that for Section 11 liability because the existing regime for traditional IPOs (denying PSLRA safe harbor protections) is contested. We take no firm position on what those rules ought to be, recognizing that forward-looking information may be particularly important for a range of small companies that investors find difficult to value in the absence of good-faith estimates and projections.[252] We recognize also that if SPACs base their decisions to merge on such information, "fairness" might require the disclosure of this information to outside SPAC investors as well.[253] But it is difficult to see why any allowances in SPAC mergers ought not also apply in traditional IPOs, given the evidence at hand. We see no barrier to denying safe harbor protection on the basis that state law requires the disclosure of projections. Forward-looking information is already required and disclosed in SPAC mergers that now probably fall beyond the protection of PSLRA safe harbors (because of the particular transaction structure adopted).[254] The same is true of going-private transactions, which the PSLRA deprives of safe harbor protections. If SPAC mergers were exempted from the PSLRA safe harbor, we would see this exemption as falling into line with the exclusion of going-private transactions, transactions that also suffer from misaligned incentives where transaction participants have stronger-than-usual incentives to over- or under-state figures for personal benefit.[255]

In suggesting reforms, we do not seek to channel private companies toward traditional IPOs or vice versa since neither transaction strictly dominates the other. Nevertheless, the case for Section 11 underwriter liability finds as strong justification for SPAC mergers. If, as we argue,

[251] *See* Klausner et al., *supra* note 102, at 73 ("All PIPE transactions and associated side payments are material to a public shareholder's decision to redeem or remain invested in a merger.").
[252] *See* Coates, *supra* note 124 ("forward-looking information can of course be valuable. Modern finance and valuation techniques focus on risk and expected future cash flows. Investors and owners commonly view forward-looking information as decision-useful and relevant. That is true for companies being acquired, as well as for companies going public.").
[253] *Compare* ROBERT CHARLES CLARK, CORPORATE LAW 754 (1986) (referring to the argument, made by proponents of allowing predictive information in SEC filings, that "fairness required disclosure of management's projections to the ordinary investor, because the projections were already being given to professional securities analysts.").
[254] *See supra* notes 208-209 and accompanying text.
[255] Securities Act, Section 27A(b)(1)(E).

underwriter liability is warranted for traditional IPOs, the same is true for SPAC mergers. The SEC will have much to explain if, in its expected reforms of SPAC mergers, it allows these transactions to sidestep underwriter liability under Section 11. We also suggest that doctrinal coherence favors aligning PSLRA safe harbors for SPAC merges with those for traditional IPOs and going-private transactions.

IV. Direct Listings

Direct listings have been much less frequently employed than SPAC mergers or traditional IPOs. Beginning with Spotify in 2018, there have been a total of 12 direct listings in the United States through February 2022.[256]

As with traditional IPOs, direct listings require the filing of a Securities Act registration statement. However, in contrast to traditional IPOs, direct listings do not rely on investment banks as conventional underwriters. Nor do direct listings generally use lock-up agreements, a fixture of most IPOs whereby underwriters require existing shareholders to agree not to sell their shares on the public market for a specified period, usually 180 days after the date of the final prospectus. The practical consequence of these differences is to render the application of Section 11 of the Securities Act uncertain and to weaken investor protection.

A. Regulatory Backdrop

While there are several means to distribute securities to the public,[257] historically the most prevalent type of underwriting has been the firm

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[256] Spotify, Registration Statement (Form S-1) (Feb. 28, 2018). Watford Holdings Form S-1 (Mar. 26, 2019); Slack Tech., Registration Statement (Form S-1) (Apr. 26, 2019); Asana, Registration Statement (Form S-1) (Aug. 24, 2020); Palantir Tech., Registration Statement (Form S-1) (Aug. 25, 2020); Thryv Holdings Form S-1 (Sept. 23, 2020); Roblox Corp., Registration Statement (Form S-1) (Nov. 19, 2020); Coinbase, Registration Statement (Form S-1) (Feb. 25, 2021); ZipRecruiter, Registration Statement (Form S-1) (Apr. 23, 2021); Squarespace, Registration Statement (Form S-1) (Apr. 26, 2021). See also https://site.warrnigton.ufl.edu/ritter/riles/IPOs-Direct-Listings.pdf.

There has been a limited literature to date with respect to Direct Listings. *See, e.g.,* COFFEE, SALE & WHITEHEAD, *supra* note 38, at 147–50; Brent J. Horton, *Spotify's Direct Listing: Is It a Recipe for Gatekeeper Failure?*, 72 SMU L. REV. 177, 185 (2019); Anat Alon-Beck, Robert Rapp & John Livingstone, *Investment Bankers as Underwriters – Barbarians or Gatekeepers? A Response to Brent Horton on Direct Listings,* 73 SMU L. REV. F. 251 (2020); FENWICK, THE RISE OF DIRECT LISTINGS: UNDERSTANDING THE TREND, SEPARATING FACT FROM FICTION, https://www.fenwick.com/insights/publications/the-rise-of-direct-listings-understanding-the-trend-separating-fact-from-fiction.

[257] *See, e.g.,* 1 SECURITIES REGULATION 6TH ED., *supra* note 1, at 647-748.

commitment. In a firm commitment IPO, underwriters buy issuers' securities and resell them to public investors at an agreed markup representing the underwriting fee.[258] The issuer accepts the possibility that underwriters will underprice (or overprice) the securities offered to the public because the underwriters provide the issuer a contractually guaranteed sum of money, engage in sales activities to market the securities and may stabilize the public offering price by buying back securities during the public offering period. The underwriters' reputations, due diligence and willingness to assume losses are the key to the success of many IPOs.[259]

A direct listing is different. A direct listing does not require an investment bank to serve as a conventional underwriter. Nor does it generally require corporate managers, sponsors, affiliates and other existing shareholders to enter lock-up arrangements. The offering price in a direct listing is not determined by agreement between the underwriter and the issuer; rather, it is determined by the law of supply and demand when public trading begins.

There are two types of direct listing on the NYSE and Nasdaq stock exchanges: the Selling Shareholder Direct Floor Listing and the Primary Direct Floor Listing. We focus on the more widely used NYSE rules.[260]

Under §102.01B, Footnote (E) of the NYSE Listing Manual, for several years it was possible for common stock not previously registered under §12(b) of the Securities Exchange Act as shares on a National Securities Exchange to be sold through a private placement such as Regulation D and then listed on the NYSE simultaneously with the filing of a Securities Act registration statement. This type of sale often is made by board members,

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[258] *See* 1 SECURITIES REGULATION 6TH ED., *supra* note 1, at 654-90. *See also supra* notes 39-40 and accompanying text.

[259] *See* generally LOSS, SELIGMAN & PAREDES, supra n. 1, at 654–95; Sec. Exchange Act Release No. 90,768 (2020) at 5.

[260] *See* Securities Exchange Act Rels 90,768 (full SEC approval of NYSE selling shareholder and primary direct listings); 87,648 (2019) (Nasdaq Selling shareholders approval); 91,947 (primary offerings).

To date, there have been three direct listings on the Nasdaq, Amplitude, Thryv and Watford Holdings. Nine have been on the NYSE.

See also Sec. Exchange Act Release No.82,627 (2018), in which the SEC approved amendments to NYSE Listing Manual §101.03 Footnote (E) to allow companies without a prior Exchange Act registration to simultaneously sell securities for the Selling Shareholders under a Securities Act registration statement and register their shares under the Securities Exchange Act to enable listing on the NYSE. *See* Sec. Exchange Act Release No. 90,768 at 6–7, nn.15–17.

executives and other existing shareholders, such as sponsors or founders, when a firm goes public.

In 2020, the full Commission approved the two variants of direct listings. (Earlier, in 2018, the SEC Staff had approved the Selling Shareholder form.) When the Commission approved the NYSE Selling Shareholder Direct Floor Listings in 2020, it did so subject to the issuer demonstrating that it has $100 million aggregate market value of publicly held shares based on (i) an independent third-party valuation of the company and (ii) the most recent trading history for the company's common stock in a trading system for unregistered common stock operated by a National Securities Exchange or a registered broker-dealer under Rule 144A (Private Placement Market). Selling Shareholder Direct Floor Listings involve only sales by existing shareholders to the public and do not raise new money for the firm. When a Private Placement Market for unregistered shares is not available, the selling shareholder alternatively can provide a valuation evidencing a market value of publicly-held shares of at least $250 million. To date, all direct listings have been for selling shareholders.

In December 2020, the SEC approved the Primary Direct Floor Listing, although, to date, this transaction has never been used. In this variant of direct listings, an issuer registers its shares with the SEC and the Exchange and then directly sells those shares to the public in the opening auction on the Exchange. To satisfy the market value requirement, the company has to either sell $100 million or more in the opening auction or, if the company anticipates selling a lesser amount, to provide a determination that the company has an aggregate market value of at least $250 million. Unlike a Selling Shareholder Direct Floor Listing, a Primary Direct Floor Listing can occur without any prior trading in a Private Placement Market.

Proponents of direct listings explain that Primary Direct Floor Listings will not be possible unless the SEC Division of Trading and Markets provides relief from Regulation M, the Commission's anti-manipulation rules under which in a public offering underwriters can buy back shares to stabilize the offering price.[261] On March 23, 2018, the Commission did provide a no-

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[261] The concern is that the SEC might view a direct listing as a distribution in violation in Regulation M. *See* David Lopez et al., *Direct Listings 2.0-Primary Direct Listings*, HARV. L. SCH. F. ON CORP. GOV., (Sept. 20, 2020), https://corpgov.law.harvard.edu/2020/09/20/direct-listings-2-0-primary-direct-listings/ (suggesting direct listings, especially Primary Direct Floor Listings, pose difficulties under Regulation M without SEC no-action relief).

action letter to permit Regulation M relief to Spotify, limited to a Selling Shareholder Direct Floor Listing.[262]

The NYSE urged approval of both types of direct listing on the basis that a traditional IPO has a minimum $40 million market value[263] "and in the Exchange's experience in listing IPOs, a liquid trading market develops after listing for issuers with a much smaller value of publicly-held shares that the Exchange anticipates would exist after the opening auction in a Primary Direct Floor Listing" and in a Selling Shareholder Direct Floor Listing.[264]

A Selling Shareholder Direct Floor Listing without a recent sustained history of trading in a Private Placement Market is required to cause the NYSE Designated Market Maker to consult with the issuer's financial advisor in order to effect a fair and orderly opening of the security. This requirement does not apply to a Primary Direct Floor Listing which includes a price range within which the issuer anticipates selling its shares in the offering.[265]

In December 2020, when the Commission approved the NYSE rule changes to permit both types of direct listings, the Commission found that the NYSE rule changes were consistent with the protection of investors, the maintenance of fair and orderly markets and the facilitation of capital markets.[266] Specifically the SEC found that the NYSE Direct Floor Listing requirements set the opening price at the lowest price in the range established by the issuer after discussion with the financial advisors and market makers. The SEC emphasized that the NYSE proposal had been modified to highlight the requirements for direct listings to be conducted consistent with

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[262] Spotify Technology S.A., SEC No Action Ltrs. WSB File No. 0402201810 (Mar. 23, 2018).

[263] With the exception of Primary Direct Floor Listings, shares held by officers, directors or owners of more than 10 percent of the common stock are not included in calculations of publicly-held shares under the NYSE listing rules.

With either a Primary Direct Floor Listing or a Selling Shareholder Direct Floor Listing, a company would be subject to all other applicable initial listing requirements. These include having 400 round lot shareholders (shareholders owning 100 shares or more) and 1.1 million publicly held shares outstanding at the time of the initial listing with a minimum price of $4.00. Sec. Exchange Act Release No. 90,768 at 10, n.29.

[264] Sec. Exchange Act Release No. 90,768 at 8–9.

[265] NYSE, Listing Manual Rule 7.35A(d)(2)(A)(iv).

[266] Sec. Exchange Act Release No. 90,768 at 15, n.54. The Commission also found that both types of direct listings were consistent with §6(b)(5) of the Securities Exchange Act.

Regulation M stabilization rules and other anti-manipulation provisions and for the NYSE to retain FINRA to monitor compliance with Regulation M.[267]

The SEC, in effect, trusted the market because of benefits to existing and potential investors:

> First, because the securities to be issued by the company in connection with a Primary Direct Floor Listing would be allocated based on matching buy and sell orders, in accordance with the proposed rules, some investors may be able to purchase securities in a Primary Direct Floor Listing who might not otherwise receive an initial allocation in a firm commitment underwritten offering. The proposed rule change therefore has the potential to broaden the scope of investors that are able to purchase securities in an initial public offering, at the initial public offering price, rather than in aftermarket trading. Second, because the price of securities issued by the company in a Primary Direct Floor Listing will be determined based on market interest and the matching of buy and sell orders, some believe that Primary Direct Floor Listings may be a more accurate way to price securities offerings.[268]

The Commission emphasized, "The opening auction in a Primary Direct Floor Listing provides for a different price discovery method for IPOs which may reduce the spread between the IPO price and subsequent market trades, a potential benefit to existing and potential investors. In this way, the proposed rule change may result in additional investment opportunities while providing companies more options for becoming publicly traded."[269]

The 3-2 Commission majority was unpersuaded that direct listings would increase risks for investors by circumventing traditional due diligence and traditional underwriter liability. One commentor had vociferously complained that allowing companies to raise primary capital through a direct listing "would be a complete end run around the traditional underwriting

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[267] *Id*. at 18. Regarding Regulation M, *see* 9 SECURITIES REGULATION 5TH ED., *supra* note 38, at 2–88.
[268] *See* Securities Exchange Act Release No. 90,768, at 37–38.
[269] *Id.* at 38.

process and . . . create a massive loophole in the regulatory regime that governs the offerings of securities to the public."[270]

But the Commission rejected this type of concern, stating:

> [T]he Securities Act does not require the involvement of an underwriter in registered offerings. Moreover, given the broad definition of *underwriter* in the Securities Act, a financial advisor to an issuer engaged in a Primary Direct Floor Listing may, depending on the facts and circumstances including the nature and extent of the financial advisor's activities, be deemed a statutory *underwriter* with respect to the securities offering, with attendant underwriter liabilities. Thus, the financial advisors to issuers in Primary Direct Floor Listings have incentives to engage in robust due diligence, given their reputational interests and potential liability, including as statutory underwriters under the broad definition of that term.[271]

Two SEC Commissioners, Allison Herren Lee and Caroline A. Crenshaw, dissented from the direct floor listing approval, lamenting, "Had [the Commission] acted with greater deliberation, we could have considered or debated possible approaches to mitigating these increased risks to investors." They continued:

> In particular, we should have provided guidance addressing what might trigger status as a statutory underwriter for other market participants involved in a primary direct listing. This guidance could have been targeted to the anticipated roles of financial advisors involved in a primary direct listing offering, given their potential role as one of the main market participants to guide companies through the listing process. We support considering what guidance is needed in the future as primary direct listing market practices evolve.[272]

B. Transactional Practice

In practice, the firms choosing direct listings are little different from many high-tech companies that have recently pursued traditional IPOs. Backed by

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[270] *Id.* at 26, n.78. *See generally id.* at 26–30. It acknowledged that other participants, including issuers, officers, and accountants also "play important roles" in assuring accurate and complete disclosures.
[271] *Id.* at 33.
[272] Lee & Crenshaw, *supra* note 20.

leading investment banks and law firms, sales on the opening day typically were substantial.[273]

Firm	**Industry**	**Shares Registered**	**Trading Volume Day 1**	**Closing Price**
Spotify	Audio streaming	55,731,480	30,525,500	$149.01
Watford Holdings	Property and casualty insurance	3,593,003	129,131	$27.00
Slack	Enterprise software	118,929,640	137,364,200	$38.62
Asana	Work management platforms	30,030,516	40,825,900	$28.80
Palantir	Software platforms	257,135,415	338,584,400	$9.50
Thryv Holdings	Digital marketing services	26,726,538	9,569	$11.08
Roblox	3D virtual applications	198,917,280	97,069,300	$69.50
Coinbase	Cryptocurrency	114,850,769	81,065,700	$328.28
ZipRecruiter	Employee recruitment	86,598,896	16,606,300	$21.10
Squarespace	Website design	40,401,820	5,471,000	$43.65
Amplitude	Product analytics software	35,398,389	11,529,531	$54.80
Warby Parker	Eyewear	77,741,942	13,805,076	$54.49

The companies that were directly listed posed considerable risk for investors. Most had a recent record of net income losses or a negative

[273] Spotify's principal legal advisor in the United States was Latham & Watkins. Spotify, Registration Statement 185 (Form S-1) (Feb. 28, 2018). Davis Polk & Wardwell served as legal advisor to the financial advisors. Tom Zanki, *Spotify Opens Door to Direct Listings Among Tech Unicorns*, LAW360 (Apr. 3, 2018, 10:30 PM EDT), https://www.law360.com/articles/1029200/spotify-opens-door-to-direct-listings-among-tech-unicorns.

In addition to Latham & Watkins and Davis Polk & Wardwell, leading law firms including Clifford Chance, Goodwin Proctor, Wilson Sonsini, Weil, Gotshal & Manges, stockholder equity.[274] Most did not intend to pay dividends for the foreseeable future.[275] Many were emerging growth companies with less than $1.07 billion in revenue during the fiscal year preceding their listing and faced reduced mandatory disclosure requirements.[276] Most disclosed, "Our management team has limited experience managing a public company."[277] In each direct listing, existing shareholders sold shares, reaping a payoff from the going-public event while adding no resources to the issuing company.[278]

Each direct listing was conducted without investment banks acting as conventional underwriters and reaching out to potential investors such as institutional investors to gauge their interest in a potential purchase or book building. Spotify, in its 2018 direct listing, provided a template for the subsequent direct listings when it wrote:

> There are no underwriters. Consequently, prior to the opening of trading on the NYSE, there will be no book building process and no price at which underwriters initially sold shares to the public to help inform efficient price discovery with respect to the opening trades on the NYSE. Therefore, buy and sell orders submitted prior to and at the opening of trading of our ordinary shares on the NYSE will not have the benefit of being informed by a published price range or a price at which the underwriters initially sold shares to the public. Moreover,

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Cooley, Schiff Hardin, Orrick Herrington & Sutcliff, Skadden Arps and Fenwick & West were involved in each other direct listing as counsel to the company or financial advisors.

[274] Slack Tech., Registration Statement 5, 53 (Form S-1) (Apr. 26, 2019); Squarespace, Registration Statement 50 (Form S-1) (Apr. 26, 2021).

[275] *See, e.g.,* Spotify, Registration Statement 59 (Form S-1) (Feb. 28, 2018); ZipRecruiter, Registration Statement 52 (Form S-1) (Apr. 23, 2021); Slack Tech., Registration Statement 59 (Form S-1) (Apr. 26, 2019); Asana, Registration Statement 47 (Form S-1) (Aug. 24, 2020); Squarespace, Registration Statement 47 (Form S-1) (Apr. 26, 2021).

[276] Slack Tech., Registration Statement 8-9, 43 (Form S-1) (Apr. 26, 2019); Asana, Registration Statement 11, 39 (Form S-1) (Aug. 24, 2020); Roblox Corp., Registration Statement 10, 64–65 (Form S-1) (Nov. 19, 2020); ZipRecruiter, Registration Statement 1, 17, 52 (Form S-1) (Apr. 23, 2021); Squarespace, Registration Statement 6, 84–85 (Form S-1) (Apr. 26, 2021).

[277] *See, e.g.,* Slack Tech., Registration Statement 41 (Form S-1) (Apr. 26, 2019) ; ZipRecruiter, Registration Statement 45 (Form S-1) (Apr. 23, 2021).

[278] Spotify, Registration Statement 185 (Form S-1) (Feb. 28, 2018)("We will not receive any proceeds from the sale of ordinary shares by Registered Shareholders"). Virtually identical language appears in each other direct listing. *See* Slack Tech., Registration Statement 58 (Form S-1) (Apr. 26, 2019); Palantir Tech., Registration Statement 242 (Form S-1) (Aug. 25, 2020; Roblox Corp., Registration Statement 71 (Form S-1) (Nov. 19, 2020); Coinbase, Registration Statement 78 (Form S-1) (Feb. 25, 2021); ZipRecruiter, Registration Statement 58 (Form S-1) (Apr. 23, 2021); Squarespace, Registration Statement 46, 142 (Form S-1) (Apr. 26, 2021).

> there will be no underwriters assuming risk in connection with the initial resale of our ordinary shares. . . . Given that there will be no underwriters' option to purchase additional shares or otherwise underwriters in engaging in stabilizing transactions, there could be greater volatility in the public price of our ordinary shares during the period immediately following the listing. . . . The public price of our ordinary shares may be volatile, and could, upon listing on the NYSE, decline significantly and rapidly.[279]

While none of the direct listings had an investment bank serving as a conventional underwriter, all of the companies engaged investment banks to act as financial advisors. Based on the Commission's no-action letter guidance, financial advisors in a direct listing may be engaged to provide advice and assistance to the company in filing its registration statement and listing its shares, including to help value the company's securities and advise the designated market maker in setting an opening price or price range.[280] However, financial advisors may not further assist the company by planning or actively participating in investor meetings. Nor may financial advisors engage in stabilizing transactions or special selling efforts, as do underwriters in a traditional IPO.[281] While financial advisors may not permissibly market securities in a direct listing, as do underwriters in traditional IPOs, they often serve as market makers in the security and provide analyst coverage.

It is difficult to understand the use of multiple high profile investment banks as financial advisors, with financial advisor groups as numerous as 13 in direct listings.[282] In off-the-record interviews we conducted, proponents of direct listings were adamant that financial advisors in direct listings do not engage in sales activity either by reaching out to institutional investors or attending meetings with investors. They argued that multiple financial advisors ensure there will be continued analyst coverage of an issuer after a

[279] Spotify, Registration Statement 45 (Form S-1) (Feb. 28, 2018). *See* similar statements in Slack Tech., Registration Statement 46 (Form S-1) (Apr. 26, 2019); Asana, Registration Statement 39–40 (Form S-1) (Aug. 24, 2020); Palantir Tech., Registration Statement 66 (Form S-1) (Aug. 25, 2020; Roblox Corp., Registration Statement 57, 191–92 (Form S-1) (Nov. 19, 2020); Coinbase, Registration Statement 65 (Form S-1) (Feb. 25, 2021); ZipRecruiter, Registration Statement 46 (Form S-1) (Apr. 23, 2021); Squarespace, Registration Statement 34 (Form S-1) (Apr. 26, 2021).
[280] *See* Spotify Technology S.A., SEC No Action Ltrs. WSB File No. 0402201810 (Mar. 23, 2018) (specifying permissible activities of financial advisors).
[281] *Id*.
[282] Horton, *supra* note 256, at [16] doubts that financial advisors perform marketing and selling.

direct listing, a means to protect against abrupt stock price declines. Analyst coverage only can occur if a financial advisor also serves as a market maker.

Spotify set the pace for investment banker participation in direct listings by hiring Goldman Sachs, Morgan Stanley, and Allen & Co. as financial advisors.[283] Subsequent direct listings usually involved leading investment banks as financial advisors.[284]

To compensate for the lack of a roadshow combining executive and underwriter presentations, each of the direct listings held an investor day and other investor education meetings for prospective investors,[285] conducted by senior management.

With one limited exception, none of the direct listings had lock-up arrangements.[286] These arrangements prevent existing shareholders selling their unregistered securities, even though these securities may be exempt from registration, and in consequence only registered shares trade immediately after a traditional IPO. In a direct listing, however, the general absence of lock-up arrangements means that registered as well as

[283] Spotify, Registration Statement 186–87 (Form S-1) (Feb. 28, 2018).

[284] Slack Tech., Registration Statement 47, 171–72 (Form S-1) (Apr. 26, 2019), engaged Goldman Sachs, Morgan Stanley, and Allen & Co. as financial advisors and Credit Suisse, Barclays, Citigroup, RBC Capital Markets, KeyBanc Capital Markets, Canaccord Genuity and William Blair as associate financial advisors.

The firms involved in the Spotify direct listing were involved in many of the other direct listings as were other leading investment banks including JP Morgan, Bank of America, Jefferies, and HSBC.

[285] Spotify, Registration Statement 4–5 (Form S-1) (Feb. 28, 2018); Slack Tech., Registration Statement 47 (Form S-1) (Apr. 26, 2019),; Asana, Registration Statement 40 (Form S-1) (Aug. 24, 2020); Palantir Tech., Registration Statement 67 (Form S-1) (Aug. 25, 2020); Roblox Corp., Registration Statement 58 (Form S-1) (Nov. 19, 2020); Coinbase, Registration Statement 66, 210 (Form S-1) (Feb. 25, 2021); ZipRecruiter, Registration Statement 47 (Form S-1) (Apr. 23, 2021); Squarespace, Registration Statement 35 (Form S-1) (Apr. 26, 2021)

[286] Spotify, Registration Statement 45–49 (Form S-1) (Feb. 28, 2018); Slack Tech., Registration Statement 46, 51-52 (Form S-1) (Apr. 26, 2019); Asana, Registration Statement 40 (Form S-1) (Aug. 24, 2020).; Roblox Corp., Registration Statement 58, 62 (Form S-1) (Nov. 19, 2020); Coinbase, Registration Statement 65–66, 70–71 (Form S-1) (Feb. 25, 2021); ZipRecruiter, Registration Statement 46, 48–49 (Form S-1) (Apr. 23, 2021); Squarespace, Registration Statement 35, 38 (Form S-1) (Apr. 26, 2021)

Spotify, Registration Statement 45–49 (Form S-1) (Feb. 28, 2018) did have lock-ups with two investors, TME and Tencent, owners of 9.1 and 7.2 percent of Spotify respectively. Spotify, Registration Statement 150 (Form S-1) (Feb. 28, 2018).

unregistered shares exempt from registration trade once trading begins, a feature that complicates the application of Section 11.

C. Purported Advantages

Proponents and others identify several advantages of direct listings.

First, the SEC characterized direct listings as democratizing the market, explaining that "some investors may be able to purchase securities in a Primary Direct Floor Listing who might not otherwise receive an initial allocation in a firm commitment underwritten offering."[287] The equalizing of opportunity for retail investors with major institutions in public offerings is a long-sought goal of the federal securities laws. But, in fact, it is at most a momentary advantage. Democratization only occurs with respect to the initial sale. Once trading of a traditional IPO begins, anyone can buy shares.

Second, the Commission urged that "because the price of securities issued by the company in a Primary Direct Floor Listing will be determined based on market interest and the matching of buy and sell orders," some believe that Primary Direct Floor Listings may be a more accurate way to price securities offerings.[288] For proponents of direct listings, this is a key advantage. Selling shareholders receive the benefits of the market-determined price, which may be higher than the amount underwriters would have agreed to had the offering been a traditional IPO.

It is true that traditional IPOs are sometimes underpriced, giving rise to share pops. But, as previously noted, it is not self-evident that issuers are harmed in these cases.[289] It is notable that so few selling shareholder groups have employed a direct listing if market discovery is a large advantage. Again, trading in traditional IPOs and direct listings once a stock is listed and traded on the Exchange is identical. In both cases, the matching of buy and sell orders determines prices.

Third, commentators point to the elimination of underwriting fees as a key advantage of the direct listing. These commentators observe that financial advisors are paid a fixed advisory fee, while underwriters in traditional IPOs receive a "spread" between their purchase price from the issuer and sale of the securities in the market, so it is conceivable that costs of financial advising would be lower than those of underwriting. Indeed,

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[287] Sec. Exchange Act Release No. 90,768 at 37.
[288] *Id*. at 37–38.
[289] *See supra* notes 90 - 93 and accompanying text.

some proponents of direct listings urge that financial advisory fees are as low as 50 percent of underwriting spreads in traditional IPOs.[290] It is uncertain whether this claim can be corroborated; it may be greatly exaggerated.

In fact, given the reported cost of financial advisors in direct listings, there does not appear to be as much of an advantage. In a much cited 2015 PricewaterhouseCoopers estimate of the costs of IPOs raising more than $300 million, total expenses would be $44.35 million, with the underwriting fees equal to $37 million or 84 percent of total expenses.[291] Financial advisor expenses in direct listings are a comparable percentage of registration expenses. Spotify paid $35 million of the $45.7 million it incurred in registration statement expenses, or 77 percent, to financial advisors.[292] Slack Technologies paid its financial advisors $22 million of $26.7 million in registration expenses, or 82 percent.[293] Asana paid $19.9 million to register and list its Class A common stock; $14.5 million, or 73 percent, went to financial advisors.[294]

Proponents of direct listings counter that underwriting fees are often about 7 percent of gross proceeds.[295] In contrast Spotify's $35 million in financial advisory fees amounted to just 0.42 percent of the $8.3 billion of shares registered, based on the first day's closing price.[296] But this apparent

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[290] Interviews with Market Participant on Sept. 29, 2021 and Oct. 1, 2021.
[291] PWC DEALS, CONSIDERING AN IPO? AN INSIGHT INTO THE COSTS POST-JOBS ACT (2015), quoted in COFFEE, SALE & WHITEHEAD, *supra* note 38, at 149.
[292] Spotify, Registration Statement 186–87 (Form S-1) (Feb. 28, 2018).
[293] Slack Tech., Registration Statement II-1 (Form S-1) (Apr. 26, 2019). Other direct listings did not publish registration expenses in their last Amended Form S-1 or in accompanying Exhibits.
[294] Asana, Registration Statement F-42 (Form S-1) (Aug. 24, 2020).
[295] *See* Chen & Ritter, *supra* note 87, at 1108-12.
[296] As depicted in the table above, Spotify registered 55,731,480 and had a closing price of $149 on its first day of trading. Multiplying the total number of registered shares by the first day closing price equals approximately $8.3 billion.

In the PricewaterhouseCoopers illustration for IPOs, the costs were denominated as follows:

Item	**Amount**
SEC Registration Fee	$200,000
Listing Fee	$250,000
Printing Costs	$600,000
Auditors Fees	$1,700,000
Legal Fees and Expenses	$3,100,000
Transfer Agent/Registrar Fees	N/A
Underwriter's Fee	$37,000,000
Miscellaneous Fees/Expenses	$1,600,000
Total	**$44,350,000**

reduction in fees when foregoing traditional underwriting can be explained in part by the size of the offering, not its method. Large offerings typically involve lower underwriting fees and discounts. When, for example, Facebook registered $16 billion in its 2012 public offering, it negotiated a 1.1 percent fee.[297]

These lower negotiated rates are hardly surprising. The nonmarketing costs of a registered offering essentially are fixed. There will be SEC registration fees, listing fees, printing costs, auditor fees, legal fees and expenses, transfer agent and registrar fees and other miscellaneous fees in any event. The corporate board and specified officers and experts who certify parts of the registration statement must conduct due diligence whether the offering is a traditional IPO or direct listing.[298] One major law firm characterized the absence of underwriters' fees as a savings that "may marginally decrease a company's cost of capital, although the company will still incur significant fees to market makers or specialists, independent valuation agents, auditors and legal counsel."[299]

Another cost advantage of direct listings comes from dispensing with roadshows. Instead, direct listings use streamlined investor days and investor education, which do cost less than a traditional roadshow. But, compared to the overall magnitude of the direct listings, this cost savings is small.

A fourth and final purported advantage is greater flexibility in the issuing corporation's ability to provide guidance to investors in Selling Shareholder Direct Listings. The registration statement in such transactions is effective one or two weeks before trading begins. By the time trading occurs, corporations are eligible to make forecasts under §27A(b) of the Securities Act, which does not provide a safe harbor for a traditional IPO. When trading begins, the issuer will have an earnings call which can include forecasts for the next quarter or year. Underwriters in a traditional IPO almost invariably

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See supra note 291.

[297] Alistair Barr, Facebook Underwriters To Get 1.1 Percent Fee: Source, Reuters, March 19, 2012: 5:57 PM, https://www.reuters.com/article/us-facebook-ipo/facebook-underwriters-to-get-1-1-pct-fee-source-idUKBRE82I15N20120319.

[298] *See supra* Part II for description of due diligence process.

[299] GIBSON DUNN, A CURRENT GUIDE TO DIRECT LISTINGS 3 (Jan. 8, 2021).

prevent forecasts in a registration statement as one means to reduce their Section 11 liability risk.

D. Threats to Investor Protection

Whatever their purported advantages, direct listings render the application of Section 11 of the Securities Act uncertain and thereby weaken investor protection. Investment banks have diminished incentives for due diligence because they may not be underwriters under Section 11. Other transaction participants share in these diminished incentives, because plaintiffs may lack standing under Section 11. This is a risk in direct listings because, once trading begins, existing shareholders may sell either registered shares or unregistered shares exempt from registration.

We assess underwriter liability in more detail in Part E. For now, we note that to date, direct listings have been subject to limited judicial review. In *Pirani v. Slack,* the first case to address Section 11 in a direct listing, plaintiffs were held to have standing to sue to establish Section 11 liability.[300] There has been no judgment on the merits.

In the Ninth Circuit decision in *Pirani*[301] a majority of the court addressed a plaintiff who appeared incapable of tracing his unregistered shares in a direct listing. The Ninth Circuit nonetheless held that the unregistered shares were characterized as "such security[ies]" under Section 11(a) "because their public sale cannot occur without the only operative registration in existence." Judge Miller dissented,[302] writing that the majority decision contradicted Judge Friendly's decision in *Barnes v. Osofsky*,[303] which had limited tracing under Section 11 to a "narrow" reading, interpreting "acquiring such security" to mean "acquiring a security pursuant to the registration statement."[304] Miller emphasized, "Until today, every court of appeals to consider the issue, including ours, has done the same."[305]

Liability in Friendly's construct in *Barnes* was limited to purchasers of a registered offering or purchasers who can trace "the lineage of their shares to

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[300] Pirani v. Slack Tech., et al., 13 F.4th 940 (9th Cir. 2021).
[301] *Id*. at 946.
[302] *Id*. at 951-52 (Miller, J., dissenting).
[303] 373 F.2d 269 (2d Cir. 1967).
[304] *Id*. at 271-73 (emphasis added). *See also* supra notes 136-137.
[305] Pirani, 13 F.4th 940, at 952 Judge Miller cited:

> *Plumbers' Union Local No. 12 Pension Fund v. Nomura Asset Acceptance Corp.*, 632 F.3d 762, 768 & n.5 (1ST Cir. 2021); *Rosenzweig v. Azurix Corp.*, 332 F.3d 854, 873 (5th Cir. 2003); *Lee v. Ernst & Young, LLP*, 294 F.3d 969, 975-78 (8th Cir.

the new offering.[306] The burden of demonstrating tracing is on the plaintiffs.[307]

Pirani in any event does not effectively address investment banks serving as underwriters or providing gatekeeping and due diligence. *Pirani* does not require that there be an underwriter. A basic purpose of the Securities Act of 1933 was to create a gatekeeping system to provide an outside check on insiders.[308] Holding that insiders can be held liable does not ensure the robust due diligence envisioned under the Securities Act.

E. Assessment and Proposals

For the foreseeable future, use of direct listings will be limited to selling shareholders in a small number of companies able to overcome the relative weakness of a direct listing in marketing the company's securities. With a few exceptions, only companies with a well-known sponsor such as Peter Thiel of Palantir and Facebook fame[309] have undertaken direct listings, advised by top tier investment banks and top tier legal counsel.

Nevertheless, direct listings, like SPAC mergers, promise to weaken Section 11 liability for IPO-equivalent transactions, where the justification for underwriter liability has had its strongest force. Whether the courts will consider a financial advisor in a direct listing to be a statutory underwriter under §2(a)(11) of the Securities Act is uncertain. This provision reaches an investment bank in a traditional IPO "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" as well as any person who "participates or has a direct or indirect participation in any such undertaking." This means that, "no

2002); *Hertzberg v. Dignity Partners, Inc.*, 191 F.3d 1076, 1080 (9th Cir. 1999); *Joseph v. Wiles*, 223 F.3d 1155, 1159-60 (10th Cir. 2000), *abrogated on other grounds by California Pub. Emps.' Ret. Sys. v. ANZ Sec., Inc.*, 137 F. Ct. 2042 (2017); *APA Excelsior III L.P. v. Premiere Techs., Inc.,* 476 F.3d 1261, 1271 (11th Cir. 2007). In *Hertzberg*, we held that "such security" requires the plaintiff to "have purchased a security issued under that, rather than some other, registration statement." 191 F.3d at 1080. And in *In re Century Aluminum Co. Securities Litigation*, 729 F.3d 1104, 1106 (9th Cir. 2013), we reiterated that "such security" means that the shares were "issued under the allegedly false or misleading registration statement."

Id. (Miller, J., dissenting)

[306] 379 F.2d at 270.

[307] *Id.* at 273 n.2.

[308] *See supra* notes 33 - 71.

[309] *See, e.g.,* MAX CHAFKIN, THE CONTRARIAN: PETER THIEL AND SILICON VALLEY'S PURSUIT OF POWER (Penguin Press 2021).

distinction is made between professional investment bankers and amateurs. Any person who performs one of the specified functions in relation to the offering is a statutory underwriter even though he or she is not a broker or dealer."[310] As such, it is possible that a financial advisor in a direct listing would be characterized as an underwriter. Indeed, in the much-cited case *SEC v. Chinese Consol. Benevolent Ass'n, Inc.,*[311] the court took an expansive view of the underwriter's role, holding that a benevolent association whose motive was purely patriotic could be held to be a statutory underwriter when it received $600,000 from members of various Chinese communities during World War II for the purpose of acquiring Chinese "Liberty Bonds." The court did not require the Chinese Consolidated Benevolent Association to operate under a contract or to have received any compensation from China.

Commentators have argued on the basis of *Chinese Consolidated* and subsequent cases, most notably *Harden v. Raffensperger, Hughes & Co*.[312], that financial advisors should or could be considered statutory underwriters.[313] Nonetheless, there is as yet no precedent that clarifies firmly whether financial advisors are liable as underwriters under Section 11.

Aware of this concern, the SEC's December 2020 3-2 majority took the position that a "financial advisor to an issuer engaged in a Primary Direct Listing may, depending on the facts and circumstances including the nature and extent of the financial advisor's activities, be deemed a statutory underwriter with respect to the securities offering, with attendant underwriter liabilities."[314] We agree, although we note that financial advisors carefully structure their activities in direct listings to minimize the risk that they may

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[310] 2 SECURITIES REGULATION 6TH ED., *supra* note 30, at 1469.
[311] 120 F.2d 738 (2d Cir. 1941), *cert. denied*, 314 U.S. 618; *see* 1 SECURITIES REGULATION 6TH ED., *supra* note 1, at 1481–82. *See also id.* at 1445–98.
[312] 65 F.3d 1392 (7th Cir. 1995). In Harden, FirstMark under then applicable National Association of Securities Dealers rules was required to hire a qualified independent underwriter to perform due diligence in a registration statement. Raffensperger did not agree to buy, sell, distribute or solicit orders for the covered FirstMark notes. Because the court viewed Raffensperger's role as "necessary to the distribution of the FirstMark securities," the Seventh Circuit ruled that Raffensperger was an underwriter by participating in the securities issuance. *Id.* at 1401. *See also* SEC v. Platforms Wireless Int'l Corp., 617 F.3d 1072 (9th Cir. 2010) ("Any intermediary between the issuer and the investor that is an essential cog in the distribution process may be a statutory underwriter.")
[313] *See, e.g.,* John C. Coffee, Jr., *The Spotify Listing: Can an "Underwriter-less" IPO Attract Other Unicorns?,* THE CLS BLUE SKY BLOG (Jan. 16, 2018), https://clsbluesky.law.columbia.edu/2018/01/16/the-spotify-listing-can-an-underwriter-less-ipo-attract-other-unicorns/; Benjamin J. Nickerson, Note, *The Underlying Underwriter: An Analysis of the Spotify Direct Listing*, 86 U. CHI. L. REV. 985, 1014–24 (2019).
[314] *See supra* at 19, quoting Sec. Exchange Act Release No. 90,768 at 33.

be deemed statutory underwriters. We also agree with the dissenting Commissioners that "it is currently unclear what types of involvement would result in meeting the statutory definition" of an underwriter.[315]

This uncertainty makes investment banks potentially big beneficiaries of reforms allowing direct listings. Banks attempt to secure gains by participating in a direct listing as financial advisors and avoiding Section 11 liability. They take heart from the registration statement, according to which, "There are no underwriters."[316]

Proponents of direct listings nevertheless assert that selling shareholders and investment banks acting as financial advisors undertake "the exact same due diligence process" they do in a traditional IPO, given the risk of Section 11 liability.[317] In off-the-record interviews, many advisors repeated this view, insisting that financial advisors have an incentive to perform equivalent due diligence in case they are sued and found to be statutory underwriters.

This evidence frames an unanswered empirical question: Are financial advisors in direct listings conducting due diligence equivalent to underwriter due diligence in a traditional IPO? We are skeptical. First, investment banks do face a reduced risk of Section 11 liability in direct listings, diminishing their incentives to perform due diligence to assure the accuracy of corporate disclosures. Second, we doubt that financial advisors face reputational incentives equivalent to those faced by underwriters in traditional IPOs, even taking into account the apparent decline in investment banks' sensitivity to reputational damage.[318] Finally, the diligence taken in direct listings may well vary across transactions and not conform with IPO standards. Indeed, one prominent law firm advises its corporate clients that financial advisors "may want customary diligence" in a direct listing, suggesting that diligence practices vary.[319]

The SEC, in its approval of the NYSE direct listing rules, made an important policy decision when it rejected the initial NYSE proposal to permit direct listing simply on the basis of a Securities Exchange Act registration under §12(b) and the Stock Exchange's listing requirements. By

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[315] *See supra* at 20, quoting Sec. Exchange Act Release No. 90,768.
[316] *See supra* note 279 and accompanying text.
[317] FENWICK, *supra* note 256 (investment banks acting as financial advisors and their legal counsel "put companies through the exact same due diligence process as in a traditional IPO").
[318] As to which, see *supra* note 69 and accompanying text.
[319] Interview with Market Participant on October 7, 2021.

requiring a Securities Act registration as well, the Commission ensured that at least board members, senior executives, and the outside accountant who expertized parts of the registration statement would be subject to near strict liability under Section 11, provided that tracing can be established. The Commission urged that the higher \$100 million market value or \$250 million valuation requirements buttressed the greater investor protection extended by Section 11. The Commission could increase the number of new issues eligible to use direct listing by reducing market value and valuation requirements to, or nearer to, the current NYSE \$40 million level. At this time, no persuasive justification exists for doing so.

Other empirical questions about investment banks in direct listings also deserve further analysis. As noted, one company undertaking a direct listing engaged 13 financial advisors. Why do so if these advisors were not engaged in sales activities or equivalent activities? Many of the functions of a financial advisor, such as an independent valuation or consulting with the Designated Market Maker about the initial price or price range, could be performed by a single financial advisor. Proponents of direct listings argue that investment banks acting as financial advisors may not engage in any sales activity. But they also acknowledge that an advantage of multiple advisors is to help secure greater analyst coverage, which can only occur if the financial advisor becomes a market maker. How much compensation do financial advisors in the initial direct listings receive as market makers? Is this the equivalent of an underwriting spread? Do financial advisors receive compensation other than financial advisory fees?

While investment banks may benefit from direct listings, the major winners in the NYSE direct listing rules are selling shareholders, usually corporate insiders and sponsors, who have generally been able to sell their shares without limits from lock-ups.[320] Instant sales could drive prices down by dint of the law of supply and demand, but this does not appear to have been an issue in direct listings thus far.[321]

The biggest loser in a direct listing is investor protection. Without near-strict Section 11 liability on an underwriter, and without underwriter due diligence, the preparation of the Securities Act registration statement may be conducted by corporate insiders who include existing selling shareholders

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[320] Horton, *supra* note 256, at [12].

[321] If there had been an earlier private placement of securities, existing shareholders would be limited by Rule 144(e) in terms of the value of securities they could sell in any three months. In contrast, if there was no private placement, Rule 144(e) with its volume limits would not apply. *See* 3 SECURITIES REGULATION 6TH ED., *supra* note 77, at 648–61.

with an interest in securities sales at the highest price. Financial advisors, meanwhile, have diminished incentives for due diligence.

In determining whether underwriter liability is justified in this setting, it appears that the benefits of Section 11 liability for direct listings are at least as great as those for traditional IPOs. Although direct-listed companies tend to have strong name recognition, experience with direct listings is too brief to clarify whether these firms expose investors to lower risk; our initial assessment is that listed companies are little different from many high-tech companies that have recently pursued traditional IPOs.[322] Moreover, the benefits of underwriter liability may be even greater than for traditional IPOs because the absence of lockups magnifies insider incentives to overstate the corporation's prospects and thereby instantly capitalize on overpricing. Furthermore, investment banks may face weaker reputational incentives to verify corporate disclosures as financial advisors than as underwriters, a role in which they are closely associated with transactions. If the costs of underwriter liability are no greater in direct listings than in traditional IPOs, as we have little reason to doubt, the case for underwriter liability in direct listings is as strong as it is for traditional IPOs.

How to address this problematic state of affairs? Professor Horton concluded his article on direct listings with the observation, "Perhaps the most obvious solution is to deem a financial advisor to be an underwriter for the purposes of the Securities Act of 1933."[323]

There are other ways for the SEC to secure investor protection. Each direct listing could be required to have an underwriter, which could be achieved by statutory amendment or SEC rule. Another, potentially simpler, way to secure investor protection would be for the SEC to secure a stock exchange rule change requiring an underwriter in a direct listing. After all, a direct listing is only possible if the SEC approves an exchange rule, and the SEC can abrogate, add to and delete from the rules of an exchange.[324] The Commission's notice of a proposed rulemaking would also provide the Commission the opportunity to amplify its understanding of direct listings.

Such an exchange rule for direct listings would require a statutory underwriter to perform due diligence and provide an independent review of the material facts. The underwriter would be subject to the same near strict

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[322] *See supra* note 273-278 and accompanying text.
[323] Horton, *supra* note 256, at [30].
[324] Section 19(c) of the Securities Exchange Act, 15 U.S.C. §78s(c); *see also* 6 LOUIS LOSS, JOEL SELIGMAN & TROY PAREDES, SECURITIES REGULATION 86–96 (6th ed., 2021)..

Section 11 liability to which an underwriter in a traditional IPO is subjected. However, unlike a traditional IPO underwriter, the direct listing underwriter would not be required to buy shares in the direct listing or be expected to engage in stabilizing transactions. We anticipate that the underwriter in such a case would be an investment bank similar or identical to the investment banks serving as financial advisors in direct listings. The essence of this proposal would be to require traditional due diligence by imposing potential Section 11 liability.

If the SEC reopens the direct listing NYSE and Nasdaq rules, it could engage in rulemaking on a more fully informed basis, addressing the basic concerns expressed by the two SEC Commissioners who dissented from the 3-2 rule approval vote. On the other hand, failure to reopen the NYSE and Nasdaq rule approvals or otherwise review the need for underwriting in direct listings runs the risk of fortifying yet another exception to the 1933 Act's near strict liability requirements in public offerings.

V. Conclusion

In a 2019 Concept Release, the SEC sought to "simplify, harmonize and improve the exempt offering process to promote capital formation and expanded investment opportunities while maintaining appropriate investor protection."[325] The Commission's focus, "in light of the increased activity in exempt markets" was on whether the offering framework "is working effectively to provide access to capital for a variety of issuers, especially smaller issuers and access to investment opportunities for a variety of investors while maintaining investor protections."[326] The most important outcome of this review was the dramatic November 2020 expansion of several Securities Act exemptions described above.[327]

In our view the piecemeal nature of this review, emphasizing only exemptions, and the partisan outcome is exactly the wrong way to address the Securities Act in the 21st century. We urge the Commission to make a comprehensive review of the Act, systematically focusing on several core issues. Comprehensive reviews of the operation of the Securities Act have

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[325] SEC, Concept Release on Harmonization of Securities Offering Exemptions, Release No. 33-1064; 34-86129; IA 5256; IC 33512, File No. S7-08-19 at 1, https://www.sec.gov/rules/concept/2019/33-10649.pdf.
[326] *Id*. at 21.
[327] *See supra* notes 76-84 and accompanying text.

been conducted often in the past.[328] These studies cast a wide net in an effort to understand the contemporary dynamics of securities offerings as they evolved at the time.

Several issues call out for systematic review.

First is the number of public companies. Several SEC leaders, including SEC Chair Jay Clayton in 2017[329] and Commissioner Heather Peirce in November 2021,[330] have expressed concern that the number of public companies has declined from more than 7,000 in the 1990s to fewer than 4,000 in 2010. In our view a primary cause of this decline has been the substantial expansion of exemptions for securities trading and the growth of institutional investor trading in the parallel Rule 144A marketplace.[331] While the size of the decline alone may seem concerning, a new study should seriously examine additional question. Importantly, has there been harm to investor protection or capital formation? We have evolved in several steps toward a bifurcated securities market, dividing securities offerings into a registered category and an exempt category largely for the benefit of institutional investors. Is this as it should be, given the greater ability of institutions "to fend for themselves"?[332] Or do the less detailed disclosures in private securities markets and lesser liability exposure of issuers unduly cause investor protection risks? Answering this type of question requires an

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[328] *See, e.g*. SEC, Disclosure to Investors: A Reappraisal of Administrative Policies under the '33 and '34 Securities Acts (1969) (popularly known as the Wheat Report after its Chair, SEC Commissioner Francis Wheat); see 2 SECURITIES REGULATION 6TH ED., *supra* note 30, at 22-23; Report of the Advisory Committee on Corporate Disclosure to the SEC, House Comm. On Interstate & Foreign Commerce, 95th Cong., 1st Sess., Comm. Print 95-29 1977 (popularly known as the Sommer Report after its Chair, Commissioner A.A. Sommer), see 2 SECURITIES REGULATION 6TH ED., *supra* note 30, at 22-27; the 2005 Securities Offering Reform proposed a comprehensive revamping of the public offering process, see 1 SECURITIES REGULATION 6TH ED., *supra* note 1, at 765-779.

[329] Jay Clayton's Statement before Senate Comm. On banking, Housing & Urban Affairs (Mar. 23, 2017) (expressing concern that U.S.-listed public companies had decreased over 35 percent since 1997); SEC Chair Jay Clayton, Remarks to SEC Advisory Comm. (June 22, 2017) ("The substantial decline in the number of U.S. IPOs and publicly held companies in recent years is of great concern to me").

[330] Heather Peirce, *The Future of the SPAC Market*, HARV. L. SCH. F. ON CORP. GOV., (Nov. 1, 2021), https://corpgov.law.harvard.edu/2021/11/01/speech-by-commissioner-peirce-on-the-future-of-the-spac-market/.

[331] As to these developments, see *supra* notes 79-84 and accompanying text.

[332] Quoting SEC v. Howey, 328 U.S. 293 (1946), distinguishing which investors did not need the protection of a registered offering from those who do.

assessment of the greater speed of some exempt processes and the risk of fraud in these processes.[333]

A second issue is the effects of technology. The mechanics of complying with the Securities Act were last systematically reviewed in the 2005 Securities Offering Reform initiative. Much has changed since, such as the increased role of social media and computer technology in securities trading. Do concepts such as waiting periods or gun-jumping—that is, prohibition of premature disclosures—continue to make sense? We appear to have reached a time when a thorough revision of the public and private securities offering processes is in order. This would involve ending or modifying protections adopted at a time of more primitive communications and would entail a review of whether disclosure requirements should be based on real time disclosure and mark-to-market valuation concepts that are now feasible.[334]

Third, as we have stressed in this article, we believe the dramatic expansion of exemptions from the Securities Act and development of alternative means of complying with the Act deserves serious review.[335] Why do we have so many exemptions? Can the November 2020 expansion of exemptions be justified? In particular, the ability to comply with the private placement Regulation D was dramatically increased by expansion of Rule 501(a) and by raising dollar magnitudes of several exemptions.[336] Are the criteria for compliance with exemptions appropriately drawn given fraud risk?

Fourth, new registered securities offering techniques, most notably SPAC mergers and direct listings, should be reviewed. Such a review would be better informed against the backdrop of the comprehensive review we propose. Is underwriter liability justified in these settings, based on a comparison of their benefits and accompanying costs? Before the Commission permits new techniques for public offerings that weaken

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[333] As to the risk of fraud in private securities markets, see Renee M. Jones, *The Unicorn Governance Trap*, 166 U. PA. L. REV. ONLINE 165, 179-82 (2017); Elizabeth Pollman, *Private Company Lies*, 109 GEO. L. J. 353, 368-86 (2020); Matthew Wansley, *Taming Unicorns*, 97 IND. L.J. 35-48 (forthcoming 2022); Verity Winship, *Private Company Fraud*, 54 U.C. DAVIS L. REV. 663, 685-702(2020). Compare 3 SECURITIES REGULATION 6TH ED., *supra* note 77, at 250-56 (regarding fraud risk in offerings by small issuers). For a detailed examination of problems that may limit sophisticated actors' ability to self-protect, see William W. Clayton, *High-End Bargaining Problems*, 75 VAND. L. REV. 703 (2022).

[334] *See* generally 1 SECURITIES REGULATION 6TH ED., *supra* note 1, at 748-1138 regarding the mechanics of compliance with the Securities Act.

[335] *See* Pt 2.C.

[336] *See supra* notes 80-81 and accompanying text.

longstanding safeguards, it must do more than assert the adequacy of existing protections.[337]

The most difficult question if a systematic review is undertaken and the need for different standards is found will involve how to implement desired change. The Commission may seek legislative amendments, but this may prove politically infeasible at least in the short-to-medium term. Another option would be to proceed through rulemaking or modification of securities exchange rules or listing requirements, but in that case the Commission may well find itself tied up in litigation before the new standards can be implemented. These are the standard political considerations for the SEC.[338] They should not dissuade the Commission from proceeding if new standards are justified.

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[337] As an example of this approach, see *supra* note 271

[338] *See* generally SELIGMAN, *supra* note 26, describing history of SEC decision making.