HARVARD BUSINESS LAW REVIEW Online

SPACs AND THE JOBS ACT

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Public Inroads in Private Equity

The law has long confined the average investor to trading in public securities[1] while allowing wealthy—or "accredited"[2]—individual investors access to a panoply of private securities, including investment vehicles such as hedge funds and private equity funds. Nevertheless, pressure to let the general public into private equity has been growing. Two forces have contributed to this mounting pressure. First, public investors are eager to try their hand at investing in private enterprise. Second, private firms need capital. In the face of these forces, the sharp line that has long separated public and private firms has become increasingly blurred.[3]

Consider the story of the emerging growth company (EGC), or "Initial Public Offering (IPO) on-ramp," provision of the Jumpstart Our Business Startups Act (JOBS Act). In its first few months on the books, this provision had effects far different from what its drafters envisioned. The JOBS Act's IPO on-ramp was intended to ease regular

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[1] *See*, 15 U.S.C.A. § 77d (West 2009 & Supp. 2012) *amended by* Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012).

[2] Rule 501 of Regulation D describes several categories of accredited investors, including certain banks, charitable organizations, and certain high net worth individuals, who may invest in securities that are not registered. 17 C.F.R. § 230.501(a) (2012). Most notably, individuals with a net annual income of over $200,000 or a total net worth of over one million dollars may invest in securities that are not registered provided that those securities meet the general disclosure requirements of Rule 502. 17 C.F.R. § 230.502 (2012).

[3] For a few recent scholarly discussions of the public-private divide, see Donald C. Langevoort & Robert B. Thompson, *"Publicness" in Contemporary Securities Regulation After the JOBS Act* (Georgetown Law and Econ. Research Paper, No. 12-002, 2012) *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1984686; Adam C. Pritchard, *Revisiting* "Truth in Securities" Revisited*: Abolishing IPOs and Harnessing Private Markets in the Public Good* (Univ. of Mich. Law & Econ. Research Paper No. 12-010, 2012) *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2103246; Usha Rodrigues, *Securities Law's Dirty Little Secret*, 81 FORDHAM L. REV. (forthcoming 2013) (on file with the author).

companies' path to going public; instead, it has inadvertently made it easier for the average investor to get a taste of private equity via special purpose acquisition corporations (SPACs). This piece will briefly describe SPACs, the IPO on-ramp, and how shell companies have taken advantage of a legislative provision intended to bring cash-hungry young companies directly to market. This piece will close with a few thoughts on lessons the story of SPACs' interaction with the JOBS Act may offer regarding the increasingly indistinct line that divides public and private investment.

Introducing SPACs

A SPAC is a type of "blank-check" company that goes public to raise a pool of cash and then begins a hunt for a target.[4] The bulk of the IPO proceeds are locked up in a trust account, invested in government-backed securities, and kept safe from the interference of the managers.[5] Once a target is identified, the SPAC managers disclose material financial information about it to shareholders, who then have a say on whether the acquisition occurs by way of voting or opt-out rights.[6] If no suitable target is found, or if a shareholder is unhappy with the deal, she can receive most of her money back—an average of ninety-eight cents on the dollar—from the trust account.[7] But if a SPAC shareholder *does* like the deal, then she will end up having owned a piece of an acquisition vehicle—in essence, a one-off private equity fund.[8]

The beauty of the SPAC model is that it bifurcates the process of going public, making it faster and cheaper. When the SPAC itself goes public, it is basically an empty shell, so any disclosures required under the Securities Act of 1933 (1933 Act) are minimal and cheap.[9] The SPAC's Securities Exchange Act of 1934 (Exchange Act) filings are likewise minimal; in essence, they involve nothing more than reporting the rate of return generated in the trust account.[10] If and when the SPAC acquires a target—

[4] Usha Rodrigues & Mike Stegemoller, *Exit, Voice, and Reputation: The Evolution of SPACs*, 37 DEL. J. CORP. L. (forthcoming 2012).

[5] *Id.*

[6] *Id.*

[7] *Id.*

[8] *See* Steven M. Davidoff, *Black Market Capital*, 2008 COLUM. BUS. L. REV. 172, 225 (2008) ("SPACs are a species of private equity: these are capital pools organized to acquire individual businesses. But because of the general requirement that the initial acquisition comprise eighty percent of its assets, SPACs typically only acquire a single privately-held business. Despite these important distinctions, SPACs otherwise attempt to mimic private equity returns by employing comparable structures and practices. For example, SPACs utilize similar leverage to increase the size and potential returns of their acquisitions. The managers of SPACs are also typically provided twenty percent of the initial share offering at nominal amounts; ownership they are required to maintain until and after consummation of an acquisition.").

[9] Daniel S. Riemer, *Special Purpose Acquisition Companies: Spac and Span, or Blank Check Redux?*, 85 WASH. U.L. REV. 931, 950–51 (2007) (describing typical SPAC registration disclosure).

[10] Rodrigues & Stegemoller, *supra* note 4.

usually a private company—that target immediately becomes public without the hassle, disclosures, and delay that accompany a typical IPO.[11]

JOBS Act and SPACs

SPACs offered a rare chance for the average investor to participate in the rarified world of investing in private targets, while simultaneously offering those targets an easy route to an IPO. The JOBS Act took a decidedly different approach to blurring the line between public and private investment. Rather than letting the general public into private equity investments, the drafters tried the converse: encouraging more private firms to go public. Yet despite the JOBS Act's focus on making it easier to bring traditional operating companies to the public market, its provisions have proven unexpectedly appealing for SPACs. Thus, legislation intended to help conventional companies go public is also facilitating a form of private equity investment.

SPACs' business structure was in place long before the passage of the JOBS Act; indeed, they predated the Act by more than a decade.[12] The whole point of the JOBS Act's EGC provision was to coax small-cap companies into going public by reducing the burdens of public disclosure and ongoing federal regulation, thereby providing the benefit of access to the public capital markets previously unavailable to them. I thought surely the passage of the JOBS Act was bad news for SPACs. Why agree to be acquired by a SPAC when you can easily go public on your own? The JOBS Act, however, had an unanticipated effect on the SPAC market because the JOBS Act's IPO on-ramp provision makes it easier and cheaper for *any* small corporation to go public.[13]

As it turned out, the JOBS Act was not all bad news for SPACs because many SPACs *themselves* decided to go public using the IPO on-ramp. Indeed, in the eight weeks after the JOBS Act's passage, over a dozen of the companies taking advantage of the new on-ramp option were SPACs.[14] Four months after the JOBS Act's passage, one out of every nine EGCs was a SPAC.[15] The trend has not abated; in the first half of August 2012, one out of five firms that made use of the IPO on-ramp provision were SPACs.[16] To say the least, SPACs are making good use of the EGC option.

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[11] Some call SPACs back-door IPOs, but SPACs differ from the seedier reverse mergers that led to so many Chinese companies with questionable accounting practices going public. *Id.*

[12] Riemer, *supra* note 9, at 944–45.

[13] For example, emerging growth companies need to disclose only two years of audited financial information prior to going public. 15 U.S.C.A. 77g(a)(2)(A) (West 2009 & Supp. 2012) *amended by* Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012). They are not subject to Sarbanes-Oxley's dreaded internal controls provision. 15 U.S.C.A. § 7262(b) (West 2009& Supp. 2012) *amended by* Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012).

[14] Emily Chasan, *Meet the JOBS Act's Jobs-Free Companies*, WALL ST. J., June 4, 2012, at B1.

[15] Chris Hitt, *"I Am Shocked, Shocked": Blank Check Companies and the "Scandal" of the JOBS Act*, BLOGMOSAIC (Aug. 16, 2012), http://blogmosaic.knowledgemosaic.com/2012/08/16/spacs-as-egcs/.

[16] *Id.*

At first blush, SPACs' use of the JOBS Act's on-ramp seems counter-intuitive. It already was, and still is, easy for SPACs to go public under the conventional 1933 Act registration process. After all, SPACs' disclosures at the start-up phase are largely boilerplate, along the lines of "this is who we are, this is how much money we plan to raise, this is how much we are setting aside in trust."[17] If it is so easy for SPACs to register under the 1933 Act, why should they bother with the on-ramp provision offered by the JOBS Act?

The answer to this question stems from economic realities. As it turns out, *successful* SPACs—that is, SPACs that complete acquisitions—can save a lot of money in securities regulation compliance costs by making use of the IPO on-ramp. The payoff comes from greatly reduced ongoing reporting requirements imposed by the Exchange Act. In particular, EGC status under the JOBS Act lasts up to five years, as long as revenues, market capitalization, and debt issuances stay low,[18] and with that status come "scaled-back disclosures, certain exemptions to executive-compensation disclosures and attestation requirements for the auditors."[19] These features make EGC SPACs comparatively more attractive to potential targets. A private company looking to go public on the cheap (i.e., at even less expense than the JOBS Act's on-ramp promises) might well favor an EGC SPAC acquirer that promises lower disclosure burdens over a traditional public company acquirer—or, for that matter, a non-EGC SPAC—both of which would require the Exchange Act's more in-depth disclosure. Time will tell whether EGC SPACs prove to be more successful acquirers than traditional acquirers and non-EGC SPACs.

In sum, despite reformers' best intentions, many of the first companies to file as EGCs were *not* small operating companies rushing to access the capital markets as soon as regulatory barriers fell away. Instead, they were firms looking to *acquire* private firms down the road and take them public. Even so, the net effect may be what the JOBS Act's drafters intended: if these new EGC SPACs have their way, they will acquire private firms, and thus bring more small firms to the public markets. Yet the SPAC EGCs will accomplish this goal in a roundabout way. More small firms will go public, as the JOBS Act envisioned, but by way of shell companies that allow the general public to participate in the uniquely public form of private equity that SPACs offer. While successful EGC SPACs will thus bring more firms public, they will at the same time allow their own investors to participate in a species of private equity investment, a kind of investment traditionally reserved for accredited investors. All of this supports a telling conclusion: both regulators and the market itself are exerting pressure on the line separating public and private investment, and these two separate forces can combine to produce unanticipated results.

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[17] *See, e.g.*, Acquicor Tech. Inc., Registration Statement (Form S-1) (Sept. 2, 2005).

[18] 15 U.S.C.A. 77b(a) (West 2009 & Supp. 2012) *amended by* Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012).

[19] Chasan, *supra* note 14.

Blurring the Line Between Public and Private

In conclusion, SPACs and the JOBS Act, both considered singly and taken together, signal the mounting pressure building over the divide between public and private investment. SPACs are mechanisms that let the public make private equity-like investments. The IPO on-ramp is an attempt to entice private companies to the public markets. Yet even more tellingly, these separate phenomena have recently interacted in an unexpected way, revealing how difficult it can be for reformers to revise the public-private boundary with any degree of certainty.

SPACs and the JOBS Act's IPO on-ramp are but two examples of recent trends that suggest that the line separating the public and private investment spheres may be blurring. Another example, the CROWDFUND Act, applies pressure on the other side of the public-private line: rather than making it easier for more private companies to access the public markets, it allows unaccredited investors a chance to invest limited sums in private companies for the first time.[20]

Securities regulation ultimately involves a delicate balancing act, with investors' need for protection and firms' thirst for capital pulling in opposite directions. The traditional balance reserved robust investor protection for the public markets, and allowed wealthy investors exclusive access to more risky, and potentially more profitable, private firm investment.[21] But SPACs are a sign that the general public also desires to furnish capital to private firms in exchange for the chance to earn a higher rate of return. At the same time, the JOBS Act signals a desire on the part of regulators and firms alike to allow companies to enjoy the benefits of being public while reducing some of the burdens that have traditionally accompanied public status. Such examples thus, in different ways, indicate that the public-private boundary may be shifting dramatically.

[20] Title III of the JOBS Act, the CROWDFUND Act, allows issuers to sell up to one million dollars of securities in a twelve-month period without Securities Act of 1933 registration. Any investor can invest in these companies—they are not reserved for accredited investors only. If an investor's annual net worth or income is less than $100,000, she can invest no more than 5% of her net worth or annual income or $2,000, whichever is greater. Jumpstart Our Business Startups Act, Pub. L No. 112-106, sec. 302, § 4(a)(6)(B)(i), 126 Stat. 306, 315 (2012). If an investor's annual net worth or annual income is equal to or more than $100,000, then she can invest no more than the greater of 10% of her net worth or annual income and $100,000. *Id.*

[21] Individuals qualify as accredited investors by having a net annual income of over $200,000 or a total net worth of over one million dollars. 17 C.F.R. § 230.215 (2012). SEC regulations and industry practice dictates that only this special class of individual investors can invest in hedge funds, private equity funds, and venture capital funds. Thus, historically at least, ordinary investors have been shut out of the private market, except via pension funds that in effect pool the resources of many investors into an accredited-investor fund. No private market mutual funds currently exist.