

NOT GUILTY BY ASSOCIATION: WHY THE TAINT OF THEIR “BLANK CHECK” PREDECESSORS SHOULD NOT STUNT THE GROWTH OF MODERN SPECIAL PURPOSE ACQUISITION COMPANIES

Abstract: During the 1980s, “blank check” companies were prominent vehicles for fraud and abuse in the penny stock market. These companies largely disappeared as a result of regulatory backlash in the 1990s, but a new type of company with a similar structure has taken their place in the securities market: the Special Purpose Acquisition Company (“SPAC”). Much like their blank check predecessors, SPACs have no operations; they merely issue securities with the intent of using the proceeds for merging with or acquiring another company. Although SPACs have enjoyed increased prominence in the market, regulators continue to view them with considerable skepticism. In addition to promulgating regulations forcing SPACs to disclose more information to potential investors, the Securities and Exchange Commission deliberately moves slowly in processing SPAC deals, with the hope of curbing the pace of SPAC offerings. This Note argues that continuing to treat SPACs similarly to the blank check companies of the 1980s is a misguided strategy because the characteristics of the two, once one looks beyond their basic structure, differ significantly. This Note also emphasizes that SPACs may be the only method of raising capital for smaller emerging companies. It thus concludes that any efforts to thwart the SPAC structure itself reflect an erroneous attempt to protect investors, at the expense of allowing this latest Wall Street innovation to facilitate capital formation.

INTRODUCTION

On February 21, 2008, the Nasdaq Stock Market, Inc. (“Nasdaq”) announced that it was proposing a change to Securities and Exchange Commission (“SEC”) rules governing the listing of Special Purpose Acquisition Companies (“SPACs”).¹ Two weeks later, on March 6, the New

¹ Press Release, Nasdaq Stock Market, Inc., NASDAQ Proposes Listing Standards for Acquisition Vehicles: Move Will Enhance Protection and Transparency in This Active Market Segment (Feb. 21, 2008), *available at* <http://ir.nasdaq.com/releasedetail.cfm?ReleaseID=295473>. A SPAC, often referred to as a “blank check company,” is a public shell company with no operating assets and no business plan. David Smith et al., *Reverse Mergers and*

York Stock Exchange (“NYSE”) followed suit by applying to the SEC to change its rules for SPAC listings as well.² These announcements, coupled with the recent filing by Goldman Sachs for its first SPAC initial public offering (“IPO”), were perhaps the most striking endorsements of the potential for the modern-day SPAC, the arrival of which has received mixed reviews.³ Historically, SPACs only were allowed to trade on the Over-the-Counter Bulletin Board (“OTC-BB”).⁴ In 2005, however, much to the consternation of the SEC, the American Stock Exchange (“Amex”) surprised the industry by beginning to list SPACs.⁵

SPACs have been tainted in the minds of regulators because they evoke images of the “blank check” companies of the 1980s that thrived amidst a penny stock⁶ market dominated by fraudulent and manipulat-

Nanotechnology, 4 NANOTECHNOLOGY L. & BUS. 87, 91 (2007). A SPAC’s stated purpose when conducting an initial public offering (“IPO”) is to accumulate capital in order to identify and then acquire or merge with a suitable private operating company. *Id.* Nasdaq’s current rules only allow SPACs to list after they have completed an acquisition and become operating companies. See Helen Avery, *SPACs Take Aim for UK Presence*, EUROMONEY, June 2006, at 46, 82–87.

² Lynn Cowan, *NYSE to Welcome “Blank-Check Companies,”* WALL ST. J., Mar. 7, 2008, at C3. Generally, NYSE’s IPO rules require companies to have a financial history spanning at least three years before they may list on the exchange. *Id.* Because SPACs do not have an operating history or money on their balance sheets prior to going public, they cannot meet that standard. *Id.* NYSE Euronext has proposed an exception to these rules that will allow SPACs to list. *Id.*

³ See Ridgeway Barker & Randi-Jean Hedin, *SPACs—Continuing to Grow and Evolve*, METROPOLITAN CORP. COUNS., June 2007, at 38; Lynn Cowan, *Goldman Writes Out “Blank Check,”* WALL ST. J., Mar. 26, 2008, at C3; Jennifer Reingold, *The IPO Gets Edgy*, FORTUNE, Feb. 19, 2007, at 17; Press Release, Nasdaq Stock Market, Inc., *supra* note 1.

⁴ Penny Stock Reform Act of 1990, Pub. L. No. 101-429, §§ 501–510, 104 Stat. 931, 951–58 (codified as amended in scattered sections of 15 U.S.C.); H.R. REP. NO. 101-617, at 8 (1990), as reprinted in 1990 U.S.C.C.A.N. 1408, 1410–11.

⁵ See Steven Boehm et al., *A Primer on SPACs: An Explanation of the Purpose, Structure and Current Issues Affecting Special Purpose Acquisition Companies*, MONDAQ, Aug. 11, 2005, <http://www.mondaq.co.uk/article.asp?articleid=34272&latestnews=1>.

⁶ Section 503(a) of the Penny Stock Reform Act amended Section 3(a) of the Securities Exchange Act of 1934 by adding a definition for a “penny stock.” Penny Stock Reform Act § 503. The statute thus defines a “penny stock” as:

- [A]ny equity security other than a security that is—
- (i) registered or approved for registration and traded on a national securities exchange that meets such criteria as the [SEC] shall prescribe by rule or regulation . . . ;
 - (ii) authorized for quotation on an automated quotation system sponsored by a registered securities association . . . ;
 - (iii) issued by an investment company registered under the Investment Company Act of 1940;
 - (iv) excluded on the basis of exceeding a minimum price, net tangible assets of the issuer, or other relevant criteria, from the definition of such term by rule or regulation which the [SEC] shall prescribe . . . ; or

ive trading practices.⁷ As a result of “pump and dump” schemes, investors, during one period, lost an estimated \$2 billion per year on penny stocks.⁸ Perpetrators of penny stock fraud orchestrated their schemes through the marketing of public shell corporations, often referred to as “blank check” companies.⁹ These “blank checks” had no operating history, few employees, few or no discernible assets, and often no legitimate likelihood of future success.¹⁰ Because their only stated purpose was to merge with an unidentified private operating company, investors had little material information on which to evaluate an investment in such a company.¹¹

In the ensuing decade, Congress and the SEC responded to the widespread fraud in the penny stock market by passing laws and promulgating regulations requiring enhanced disclosure about blank check companies, reducing the recidivist criminal elements in the penny stock market, and providing specific protections for investors in blank check schemes.¹² As a result of this regulatory backlash, the blank check company largely disappeared from the market during the late 1990s.¹³

In the wake of the bursting of the dot-com bubble, however, blank check companies reemerged under the title of the Special Purpose Acquisition Company.¹⁴ SPACs present an attractive opportunity for many

(v) exempted, in whole or in part, conditionally or unconditionally, from the definition of such term by rule, regulation, or order prescribed by the SEC.

15 U.S.C. § 78c(a)(51)(A) (2006).

⁷ See Penny Stock Reform Act § 502; H.R. REP. NO. 101-617, at 10–13; Gregory A. Robb, *Fraud Cited in Penny Stocks*, N.Y. TIMES, Sept. 7, 1989, at D5.

⁸ Robb, *supra* note 7. Brokers controlling large blocks of thinly traded securities manipulated the share price of those securities by trading shares back and forth between nominee accounts and touting the investments’ limitless potential to customers (the “pump”). Randolph Beatty & Padma Kadiyala, *Impact of the Penny Stock Reform Act of 1990 on the Initial Public Offering Market*, 46 J.L. & ECON. 517, 517 (2003); Thomas L. James, *Use of Reverse Mergers to Bypass IPOs: A New Trend for Nanotech Companies*, 4 NANOTECHNOLOGY L. & BUS. 95, 97 (2007). Brokers would then sell their large block at an artificially inflated price, resulting in a financial windfall to the brokers and a plummeting share price for investors (the “dump”). Beatty & Kadiyala, *supra*, at 517; James, *supra*, at 96.

⁹ Joris M. Hogan, *Corporate Governance Update: Real Time Disclosure Becomes a Reality and the SEC Nixes Shell Company Schemes*, 32 SEC. REG. L.J. 1, 13 (2004); *see also* H.R. REP. NO. 101-617, at 10–13.

¹⁰ Hogan, *supra* note 9, at 13; *see also* H.R. REP. NO. 101-617, at 10–13.

¹¹ Hogan, *supra* note 9, at 13; *see also* H.R. REP. NO. 101-617, at 10–13.

¹² See Penny Stock Reform Act §§ 501–510; H.R. REP. NO. 101-617, at 7–10, 20–23.

¹³ See Boehm et al., *supra* note 5.

¹⁴ *Id.*; Noah Klaris, *Planting Pearls in Shells: Evaluating the Possibilities of a Reverse Merger*, BUS. L. TODAY, Jan.-Feb. 2003, at 41, 44.

private companies seeking to reap the benefits of “going public,”¹⁵ while avoiding the costs inherent in the IPO process.¹⁶ Rather than face the prospect of selling itself to a new investing public, a private company can engage in a reverse merger with a SPAC, thereby accessing an already-established investor base in addition to the advantages of the capital markets.¹⁷ Aside from the costs of an IPO, SPACs may present the only opportunity for emerging companies to “go public” because investment banks typically favor larger private companies with high revenues and strong operating histories.¹⁸ With leveraged buyouts

¹⁵ Smith et al., *supra* note 1; Klaris, *supra* note 14, at 41, 44; Boehm et al., *supra* note 5. Stockholders of a public company have instant liquidity because they can sell their shares on the open market. See William K. Sjoström, Jr., *The Truth About Reverse Mergers*, 2 ENTREPRENEURIAL BUS. L.J., 753, 758 (2008). This liquidity may increase the value of the shares themselves. See *id.* Moreover, shares of stock in a public company may be used as currency to fund strategic acquisitions or collaborative partnering with other companies. See *id.*

In addition to the advantages of liquidity, public companies and their management are generally held in higher esteem by prospective investors, customers, and suppliers. Smith et al., *supra* note 1, at 88–91; Klaris, *supra* note 14, at 41; Boehm et al., *supra* note 5. This prestige, in turn, enables public companies to attract top-notch management personnel. Smith et al., *supra* note 1, at 88–91; Klaris, *supra* note 14, at 41; Boehm et al., *supra* note 5. A public company is also better suited to attract and retain such personnel by offering attractive stock-based compensation plans because these shares can be sold on the open market. Smith et al., *supra* note 1, at 88–91; Klaris, *supra* note 14, at 41; Boehm et al., *supra* note 5.

Going public also provides a company with greater flexibility in its financing. Smith et al., *supra* note 1, at 88–91; Klaris, *supra* note 14, at 41; Boehm et al., *supra* note 5. It provides access to the public markets through stock or debt offerings. Smith et al., *supra* note 1, at 88–91; Klaris, *supra* note 14, at 41; Boehm et al., *supra* note 5. It also enables the company to undergo alternative financing such as a private investment in public equity (“PIPE”) transaction. Finally, public companies generally have greater access to bank financing on more favorable terms. Smith et al., *supra* note 1, at 88–91; Klaris, *supra* note 14, at 41; Boehm et al., *supra* note 5.

¹⁶ Smith et al., *supra* note 1, at 88; Klaris, *supra* note 14, at 41, 44.

¹⁷ Sjoström, *supra* note 15, at 758. In a typical reverse merger, a private operating company works with a “shell promoter” to locate suitable non-operating or public shell companies. Smith et al., *supra* note 1; Klaris, *supra* note 14, at 41, 44. The private company then either merges with the shell or a newly formed subsidiary of the shell company (a “reverse triangular merger”). Smith et al., *supra* note 1, at 88; Klaris, *supra* note 14, at 41, 44.

Post-merger, the shell company contains the assets and liabilities of the operating company and is controlled by the former operating company shareholders. Smith et al., *supra* note 1, at 88; Klaris, *supra* note 14, at 41, 44. The shell company’s name is then changed to the name of the operating company, and its shares continue to trade on the stock market that they were trading on before the merger. Smith et al., *supra* note 1, at 88; Klaris, *supra* note 14, at 41, 44. The operating company’s business is generally still controlled by the same group of shareholders and managed by the same directors and officers. Smith et al., *supra* note 1, at 88; Klaris, *supra* note 14, at 41, 44. Essentially, the private operating company succeeds to the shell’s public status. Smith et al., *supra* note 1, at 88; Klaris, *supra* note 14, at 41, 44.

¹⁸ Smith et al., *supra* note 1, at 88; Klaris, *supra* note 14, at 41, 44.

(“LBOs”) lagging in large part due to the subprime mortgage crisis and resulting credit crunch, SPAC deals have picked up the slack.¹⁹ These transactions are lightly leveraged, enabling private companies to garner large cash infusions in equity rather than debt.²⁰

Despite this ever-increasing growth and acceptance on the market, however, the SEC’s ongoing distaste for SPACs “is no secret.”²¹ In 2005, the SEC passed several new regulations geared toward mandating enhanced disclosure from public shell companies.²² By requiring private operating companies merging with public shells to provide the same level of disclosure required in a traditional IPO, the new rules effectively removed some of the incentive for “going public” through a SPAC.²³ In addition to such formal regulations, the SEC has continued to review SPAC registration statements and proxy materials with greater scrutiny.²⁴ Many bankers and lawyers have suggested that the SEC is deliberately spending considerable time vetting deals, hoping to slow down the pace of SPAC offerings.²⁵

This Note analyzes current formal and informal regulatory practices with regard to the formation of SPACs, as well as their use as a vehicle by private companies seeking to “go public.”²⁶ Part I of this Note discusses the history of congressional and SEC regulation of public

¹⁹ Elizabeth Hester, *Wall Street Peddles Blank-Check IPOs as Returns Trail S&P 500*, BLOOMBERG.COM, Jan. 6, 2008, <http://www.bloomberg.com/apps/news?pid=20601109&sid=aLgaESfbEyhs&refer=home>; Richard Pinto, *Stocked Market: US Lawyers Still Have Enough to Survive*, IFLRLEGALWIRE, Apr. 28, 2008, <http://www.iflrlegalwire.com/Article.aspx?ArticleID=1922683&LS=EMS177315>. The term “leverage” refers to the use of debt to acquire assets. Lartease Tiffith, *Hedge Fund Regulation: What the FSA Is Doing Right and Why the SEC Should Follow the FSA’s Lead*, 27 NW. J. INT’L L. & BUS. 497, 509–14 (2007). This enables different investment vehicles to invest significantly larger sums of money than their total amount of capital. *Id.*

²⁰ See Tiffith, *supra* note 19, at 509–14.

²¹ Barker & Hedin, *supra* note 3, at 38; see also Reingold, *supra* note 3, at 17 (identifying the enhanced scrutiny that the SEC applies in its review of SPAC offerings and proxy materials for SPAC transactions).

²² Use of Form S-8, Form 8-K, and Form 20-F by Shell Companies, 70 Fed. Reg. 42,234 (July 21, 2005) (codified at 17 C.F.R. §§ 230.419; 239.16b; 240.12b-2; 249.308 (2008)).

²³ See *id.*

²⁴ Paul Broude, *Should You Sell to a SPAC?*, MERGERS & ACQUISITIONS: THE DEAL-MAKER’S J., May 1, 2007, at 76–79.

²⁵ Barker & Hedin, *supra* note 3, at 38; Reingold, *supra* note 3, at 17. The SEC has considerable discretion during this review process. See William B. Barker, *SEC Registration of Public Offerings Under the Securities Act of 1933*, BUS. L. TODAY, at 65, 73 (1996). One example of such discretion occurs at the outset of the process, when the staff “screens” registration statements to determine the appropriate level of review: deferred review, monitor, no review, or full review. *Id.*

²⁶ See *infra* notes 210–323 and accompanying text.

shell companies.²⁷ It also summarizes the more recent wave of public shell company regulation.²⁸ Part II discusses the use of SPACs as vehicles through which private companies may “go public” without undergoing the increasingly burdensome IPO process.²⁹ It details the various restrictions that SPACs have imposed on themselves in order to enhance investor protection, as well as the natural evolution of SPACs.³⁰

Finally, Part III argues that the concerns underlying the regulation of public shell companies in the late 1980s are not present with SPACs.³¹ It argues further that increased regulation of SPACs, as well as the SEC’s alleged use of the review process to thwart SPAC transactions, is thus misguided for numerous reasons.³² First, the SEC’s disclosure requirements for public shell companies, as well as SPACs’ self-imposed restrictive measures, provide sufficient protection for investors.³³ Second, the rapidly increasing growth of SPACs, as well as the participation of high-end investment banks acting as underwriters both undercut the notion that SPACs will devolve into the fraud-prone blank checks of the 1980s.³⁴ Finally, increased competition among different SPACs, private equity funds, and hedge funds for high-profile private companies will lead to higher-quality SPAC managers and perhaps even more self-imposed measures ensuring investor quality.³⁵

Moving beyond any potential dangers to investors, SPACs provide a vehicle for “going public,” enabling potentially revolutionary emerging companies that might not be suitable IPO candidates to access the capital markets.³⁶ Enabling such companies to attain rapid growth could, in turn, stimulate job growth and support the overall strength of the market.³⁷ The current level of regulatory scrutiny has led several SPACs to leave the United States for the greener pastures of foreign markets, potentially diminishing the positive effects that they could have on the American economy.³⁸ For all of these reasons, this Note argues that the

²⁷ See *infra* notes 42–126 and accompanying text.

²⁸ See *infra* notes 118–126 and accompanying text.

²⁹ See *infra* notes 127–209 and accompanying text.

³⁰ See *infra* notes 131–154 and accompanying text.

³¹ See *infra* notes 210–323 and accompanying text.

³² See *infra* notes 210–323 and accompanying text.

³³ See *infra* notes 215–232 and accompanying text.

³⁴ See *infra* notes 233–298 and accompanying text.

³⁵ See *infra* notes 299–323 and accompanying text.

³⁶ See *infra* notes 299–323 and accompanying text.

³⁷ See *infra* notes 299–323 and accompanying text.

³⁸ See Avery, *supra* note 1, at 82–87 (explaining that more SPAC listings are on the way as the industry becomes frustrated with the regulations put in place by the SEC and legislation like the Sarbanes-Oxley Act); see also Nicholas Pettifer, *European SPACs Don't Need*

SEC should be working to facilitate the growth of the SPAC structure.³⁹ Such a regulatory approach would not represent an abandonment of its traditional duty to protect investors from unscrupulous brokers.⁴⁰ Rather, by working with exchanges such as Nasdaq and NYSE to help promote the growth of this investment vehicle, the SEC can fulfill its three-part mission: to protect investors; maintain fair, orderly and efficient markets; and facilitate capital formation.⁴¹

I. REGULATION OF PUBLIC SHELL COMPANIES

According to former SEC Chairman David Ruder, during the 1980s, penny stock fraud was “one of the most menacing problems facing investors, regulators, and the legitimate securities industry.”⁴² The North American Securities Administrators Association (“NASAA”) had likewise concluded that penny stock swindles were the chief threat of fraud and abuse facing small investors.⁴³ Increased regulation of public shell companies was thus initiated with the hope of curbing these widespread manipulative and fraudulent trading practices.⁴⁴ This Part describes the fraudulent practices dominating the penny stock market in the 1980s.⁴⁵ Then it summarizes the efforts of Congress and the SEC to protect investors from these predatory market practices.⁴⁶ Finally, it describes the recent SEC rulemaking that mandates enhanced disclosure for public shell companies.⁴⁷

Formal Regulation, IFLRLEGALWIRE, Apr. 22, 2008, <http://www.iflr.com/Article/1982935/European-Spacs-don39t-need-formal-regulation.html> (highlighting a viewpoint in Europe that SPACs “are so transparent that market forces will be enough to regulate them”).

³⁹ See *infra* notes 299–323 and accompanying text.

⁴⁰ See *infra* notes 299–323 and accompanying text.

⁴¹ See *Encouraging Small Business Growth and Access to Capital: Hearing Before the Subcomm. on Oversight and Investigations of the H. Comm. on Financial Servs.*, 108th Cong. 3–16 (2004) [hereinafter *Encouraging Small Business*] (statement of Alan Beller, Director, Division of Corporate Finance, SEC), available at <http://www.sec.gov/news/testimony/ts092304alb.htm>.

⁴² H.R. REP. NO. 101-617, at 7 (1990), as reprinted in 1990 U.S.C.C.A.N. 1408, 1409.

⁴³ *Id.*; Robb, *supra* note 7.

⁴⁴ See John M. Doyle, *SEC Proposal Aims at Penny Stock Fraud*, S.F. EXAMINER, Apr. 12, 1991, at B3; Diana B. Henriques, *Wall Street: Cleaning Up Penny-Stock Fraud*, N.Y. TIMES, Apr. 15, 1990, at F15; *Penny Stock Rules Asked*, N.Y. TIMES, Apr. 12, 1991, at D5; Gregory A. Robb, *House Panel Approves Measure on Penny Stocks*, N.Y. TIMES, June 21, 1990, at D20.

⁴⁵ See *infra* notes 53–97 and accompanying text.

⁴⁶ See *infra* notes 98–127 and accompanying text.

⁴⁷ See *infra* notes 128–139 and accompanying text.

A. *The 1980s: Fraud Dominates the Penny Stock Market*

Until 1983, the penny stock industry was primarily regional in nature.⁴⁸ The majority of penny stock brokerages were headquartered in Denver, Colorado; Salt Lake City, Utah; and Spokane, Washington.⁴⁹ Although thousands of investors had already lost millions of dollars at the hands of fraudulent penny stock schemes, most regulators regarded such abuses as a mountain state problem unworthy of national concern.⁵⁰

During the 1980s, the nature of the penny stock market fundamentally changed as numerous brokerage firms moved away from the initial public offering of "hot issues" as the forum for market manipulation and toward the secondary markets.⁵¹ The growth of technology, as well as the ability to purchase phone lists enabled penny stock manipulators to operate globally.⁵² In 1988, 12.5 percent of all substantive investor complaints received by the SEC concerned brokers at penny stock firms.⁵³ By 1989, penny stock firms comprised 22 percent of that total.⁵⁴ In addition to the rising level of complaints related to penny stock brokerages, the number of penny stock brokerages increased from a total of fifty-five, headquartered in six states in 1983, to 325 with headquarters in twenty-nine states and branch offices throughout the country only six years later.⁵⁵ Moreover, over that same time period, the estimated costs of penny stock fraud rose to approximately \$2 billion dollar per year.⁵⁶

⁴⁸ H.R. REP. NO. 101-617, at 9; Barbara Arsteinsen, *High-Risk "Pennies" for the Bold*, N.Y. TIMES, Nov. 17, 1985, at FP24; Nathaniel C. Nash, *S.E.C. Upgrades Its Regulation of Penny Stock Market*, N.Y. TIMES, Oct. 24, 1988, at D2.

⁴⁹ H.R. REP. NO. 101-617, at 9; Arsteinsen, *supra* note 48; Nash, *supra* note 48.

⁵⁰ H.R. REP. NO. 101-617, at 9.

⁵¹ *Id.* "Hot issues" are IPOs of small, new companies with "bright and profitable futures[,] such as energy and mining concerns, or high tech and health-related innovations. *Id.* Although brokerages dealing in penny stocks were beholden to the unpredictable nature of these "hot issues," it would be difficult to develop large and diverse investor bases necessary for the creation of a large, national penny stock brokerage firm. *Id.* The secondary market is the market for a security after the IPO. *Id.*

⁵² *Id.*

⁵³ *Id.*

⁵⁴ *Id.*

⁵⁵ H.R. REP. NO. 101-617, at 9; Robb, *supra* note 7.

⁵⁶ Doyle, *supra* note 44; *Penny Stock Rules Asked*, *supra* note 44; Robb, *supra* note 7. A list of the complaints filed against F.D. Roberts Securities, Inc., provides another illustration of the pervasiveness of fraud in penny stock brokerages. H.R. REP. NO. 101-617, at 13-15. In December 1988, the SEC filed a civil injunctive action against F.D. Roberts alleging that the firm had engaged in a scheme to manipulate the price of Hughes Capital securities. *Id.* A second SEC action was filed in November 1989 against eight individuals for two blind

These rising numbers put Congress on notice of the problem of penny stock fraud.⁵⁷ Congress identified two characteristics of the penny stock market that facilitated fraud: (1) an information gap in which investors were given little useful information on which to base an investment decision, thus allowing for easy manipulation by a few insiders; and (2) an extraordinary number of market participants who were either repeat offenders of state or federal securities laws, convicted felons, or persons with ties to organized crime.⁵⁸

The architects of penny stock schemes often sold the IPO to a collection of friendly brokerage firms in order to maintain tight control of the market.⁵⁹ These stocks were generally thinly traded, with only one, or possibly a few brokers in the stock.⁶⁰ This made it easier to manipulate prices than with typical listed securities with numerous buyers and sellers and an active market to set the price.⁶¹

After the IPO, penny stock brokers manipulated the share price.⁶² Often, the stock was given to other insiders at a very low price and then repurchased.⁶³ At this stage, nominee accounts traded the stock back and forth until the price reached a certain level.⁶⁴ Then the stock was sold to the public at an artificially inflated value, sometimes with undisclosed excessive markups as large as 1000 percent.⁶⁵

pool offerings underwritten by F.D. Roberts. *Id.* In May 1989, the former national sales manager, branch manager, and two brokers from F.D. Roberts pleaded guilty to conspiracy to use of fraudulent sales techniques to sell penny stocks and to manipulate the prices of those stocks. *Id.* The U.S. Attorney for the District of New Jersey stated that the fraudulent activities of these co-conspirators cost the investing public \$67 million and that the co-conspirators made illegal profits of as much as 400 percent by trading in nominee accounts and lining up secondary-market sales before the IPO had even taken place. *Id.*

An administrative action was also filed in May 1989 to revoke the licenses of thirty-five former agents of F.D. Roberts for engaging in a particular scheme to manipulate penny stock. H.R. REP. NO. 101-617, at 14–15. These agents had allegedly garnered one-day profits exceeding \$754,000 by purchasing preferred stock at \$1 per share and reselling it later that day for between \$3 and \$3.50 per share. *Id.* Such sales were allegedly effected through the use of deceptive sales practices and high pressure telephone solicitations. *Id.*

⁵⁷ H.R. REP. NO. 101-617, at 14–15.

⁵⁸ *Id.*; see also Doyle, *supra* note 44; Henriques, *supra* note 44; Penny Stock Rules Asked, *supra* note 44.

⁵⁹ Nash, *supra* note 48.

⁶⁰ H.R. REP. NO. 101-617, at 10–12; Nash, *supra* note 48.

⁶¹ Nash, *supra* note 48; David S. Ruder, Chairman, SEC, Lunch Address at the SEC/NASAA Section 19(c) Conference (Apr. 26, 1989) (transcript on file with author).

⁶² H.R. REP. NO. 101-617, at 10–12.

⁶³ *Id.*

⁶⁴ *Id.*

⁶⁵ *Id.* These markups were often obtained through the arrangement of “buy and sell” campaigns. *Id.* In a “buy and sell” campaign, one group of investors was encouraged to sell its shares of a particular stock, while another group was encouraged to buy shares at a

Many penny stock brokers furthered their manipulative practices by implementing coercive sales tactics.⁶⁶ Penny stock sales were often conducted out of “boiler room” operations where inexperienced sales people solicited prospective investors by cold calling them and then pressuring them into acting quickly so as to not miss out on any potential profit.⁶⁷ In addition to lacking experience and knowledge, these salespeople would often provide false or misleading information about a stock’s performance, the company itself and its growth prospects, and the market for the securities.⁶⁸ These cold calls generally targeted inexperienced investors who did not have the knowledge to make accurate analyses of the risks involved.⁶⁹

The most notorious method for committing penny stock fraud, however, was through the marketing of blank check companies.⁷⁰ These public shells had no operating history, few employees, few or no discernible assets, and no legitimate likelihood of future success.⁷¹ Because their only stated business purpose was to engage in some form of business combination with an unidentified private operating company, there was little material information included in their registration statements.⁷²

Approximately 70 percent of all penny stock issues offered between the beginning of 1988 through the third quarter of 1989 were blank check companies.⁷³ In the typical blank check scheme, most of

higher price. *Id.* When the investor wished to sell her stock and collect her own profit, the broker could not conventionally move the stock to another buyer, and the investor was told there were no buyers at that time. *Id.* Alternatively, the investor might have been coerced into using his “profit” to purchase another penny stock recommended by the broker. *Id.* Brokers often engaged in other manipulative practices, including refusing to accept sell orders or to deliver securities to customers. *Id.*

⁶⁶ Henriques, *supra* note 44; Nash, *supra* note 48; *Penny Stock Rules Asked*, *supra* note 44; Leonard Sloane, *Many Dangers of Blind Offers*, N.Y. TIMES, May 9, 1987, at 38.

⁶⁷ H.R. REP. NO. 101-617, at 10–12; Sloane, *supra* note 66; *see also* BOILER ROOM (New Line Cinema 2001).

⁶⁸ H.R. REP. NO. 101-617, at 10–12; Nash, *supra* note 48.

⁶⁹ H.R. REP. NO. 101-617, at 10–12. Penny stock brokerage firms commonly employed the “three-call approach.” *Id.* In the first call, the broker introduced himself and informed prospective investors that he often received “hot” stock tips. *Id.* The broker would then call potential investors who appeared interested a second time, to let them know that he would keep them in mind the next time a “hot” stock became available. *Id.* With the third call, the broker would pitch an “irresistible deal.” *Id.*

⁷⁰ Henriques, *supra* note 44; Nash, *supra* note 48; Robb, *supra* note 44; Sloane, *supra* note 66.

⁷¹ Henriques, *supra* note 44; Nash, *supra* note 48; Robb, *supra* note 44; Sloane, *supra* note 66.

⁷² H.R. REP. NO. 101-617, at 10–12.

⁷³ *Id.* at 19.

the company's stock was distributed to the underwriting broker and his business associates and friends.⁷⁴ The brokerage would then circulate false rumors about a possible merger and the profitability of the alleged target, thereby triggering increases in stock prices.⁷⁵ Insiders would then call potential investors, depicting the blank check as having just merged with an emerging growth company with incredible upside.⁷⁶ The stock prices would then climb precipitously until the insiders decided to sell their shares, causing the price to plummet.⁷⁷

Blinder, Robinson & Co., one of the most active players in the penny stock market of the 1980s, frequently benefited from such blank check offerings.⁷⁸ For example, on January 15, 1985, Meyer Blinder, Arnold L. Kimmes, and Michael D. Wright entered into an agreement with Blinder's securities brokerage whereby Kimmes and Wright agreed to provide substantially all of the securities for its blind pool corporations upon demand and at pre-fixed prices.⁷⁹ Kimmes and Wright created and secretly controlled several blind pool corporations, using figurehead officers and false registration statements to disguise their actual control.⁸⁰ Blinder, Robinson & Co. subsequently acquired 100 percent of the securities of two blank check corporations, Onnix Financial Group, Inc. and Executive Capital, Inc.⁸¹

The firm proceeded to sell these securities to its customers without disclosing to them that the purported IPO was a sham.⁸² It further failed to provide the purchasers of the blind pool stock with prospectuses.⁸³ Blinder, Robinson's secret unlimited access to the securities effectively created a rigged market.⁸⁴ This enabled Blinder to profit through risk-free transactions featuring arbitrarily established prices.⁸⁵ Blinder, Rob-

⁷⁴ *Id.*

⁷⁵ *Id.*

⁷⁶ *Id.*

⁷⁷ H.R. REP. NO. 101-617, at 19.

⁷⁸ See *United States v. Blinder*, 10 F.3d 1468, 1471 (9th Cir. 1993); *Blinder Files for Bankruptcy*, N.Y. TIMES, Aug. 1, 1990, at D5; *Florida Moves Against Blinder, Robinson*, N.Y. TIMES, May 18, 1989, at D17; *Investors Sue Penny Broker*, N.Y. TIMES, May 6, 1989, at 45.

⁷⁹ *Blinder*, 10 F.3d at 1471. Blind pools are arrangements by which companies sell securities, generally through an IPO, without stating specifically how the proceeds will be used. Sloane, *supra* note 66. Blank checks are one version of a blind pool. *Id.* Instead of identifying their proposed investment, blank checks assert an intention to search for promising private operating companies. *Id.*

⁸⁰ *Blinder*, 10 F.3d at 1471.

⁸¹ *Id.*

⁸² *Id.*

⁸³ *Id.*

⁸⁴ *Id.*

⁸⁵ *Blinder*, 10 F.3d at 1471.

inson sold Onnix shares at substantial markups.⁸⁶ Seeking to further capitalize on vulnerable investors, it allegedly sold 42,000 nonexistent shares, generating gross profits of \$1,384,000 for its brokers.⁸⁷

B. *The Solution? The Penny Stock Reform Act*

On July 20, 1990, the Securities Enforcement Remedies and Penny Stock Reform Act (the "PSRA" or the "Act") was introduced.⁸⁸ The Act represented Congress's response to the rampant fraud and manipulation of investors incident to participation in the penny stock market.⁸⁹ In the PSRA, Congress focused its legislative powers on three primary issues within the penny stock market: (1) an overall lack of information about companies and transactions; (2) the participation of repeat criminals as brokers and dealers; and (3) fraud and manipulation through blank check offerings.⁹⁰ The PSRA, however, did not seek to ban blank check offerings.⁹¹ Rather, it sought to equip investors with the tools to make better choices and to better monitor their investment opportunities.⁹²

⁸⁶ H.R. REP. NO. 101-617, at 13-14.

⁸⁷ *Id.* On July 2, 1992, a jury found Blinder guilty of racketeering conspiracy, racketeering, securities fraud, and unlawful distribution of securities. *Blinder*, 10 F.3d at 1471. He was sentenced to 46 months incarceration and fined \$100,000. *Id.* The United States Court of Appeals for the Ninth Circuit affirmed the district court's denial of Blinder's motions for dismissal as well as the denial of motions for judgment of acquittal or a new trial, the fine, and cost of incarceration. *Id.*

On August 1, 1990, Blinder, Robinson & Co., once the largest penny-stock brokerage in the world, filed for protection from its creditors under Chapter 11 of federal bankruptcy laws. *Blinder Files for Bankruptcy*, *supra* note 44. The company had shrunk to one-third of its former size during investigations by regulators and investor lawsuits. *Id.* It suffered losses of \$14.8 million in 1988 and \$11.7 million in 1989. *Id.* It owed its customers \$4.8 million and other brokerage firms \$400,000 in cash. *Id.* Additionally, the filing said Blinder, Robinson owed its customers and other brokerage firms \$70 million in securities. *Id.*

⁸⁸ Penny Stock Reform Act of 1990, Pub. L. 101-429, §§ 501-510, 104 Stat. 931, 951-58 (codified as amended in scattered sections of 15 U.S.C.); H.R. REP. NO. 101-617, at 7-10.

⁸⁹ H.R. REP. NO. 101-617, at 7-10; Beatty & Kadiyala, *supra* note 8, at 517; James, *supra* note 8, at 98; Doyle, *supra* note 44; Henriques, *supra* note 44; *Penny Stock Rules Asked*, *supra* note 44; Robb, *supra* note 44; Kelvin G. Salwen, *SEC Broadens Disclosure Rules on Small Stocks*, WALL ST. J., Apr. 13, 1992, at C14.

⁹⁰ Penny Stock Reform Act §§ 506-510; Doyle, *supra* note 44; Henriques, *supra* note 44; Nash, *supra* note 48; *Penny Stock Rules Asked*, *supra* note 44; Robb, *supra* note 44; Sloane, *supra* note 66.

⁹¹ *Cutting Penny Stock Fraud: SEC Proposes New Rules to Arm Unsuspecting Investors*, NEWS-DAY (New York City), Apr. 12, 1991, at 47; Robb, *supra* note 44.

⁹² *Cutting Penny Stock Fraud*, *supra* note 91, at 47; Robb, *supra* note 44. The Act, as originally proposed by Rep. Edward J. Markey, would have prohibited blank check companies from registering with the SEC and selling their shares publicly. Henriques, *supra* note 44. The proposal represented a departure from the notion that adequate, truthful disclo-

The PSRA added a new paragraph to Section 3(a) of the Securities Exchange Act of 1934 (“Exchange Act”) that defines “penny stock,” thereby determining the scope of securities covered by the new legislation.⁹³ In defining penny stock, Congress sought to include within the definition securities trading in the over-the-counter market that were not registered on an exchange or authorized on the Nasdaq market.⁹⁴

The PSRA also amended Section 15(b)(6) of the Exchange Act to expand the scope of the SEC’s authority to bar individuals from the securities business.⁹⁵ The amendment sought to lessen the role played in the penny stock market by former violators of federal and state securities laws, convicted felons, and persons with ties to organized crime.⁹⁶ Congress thereby granted the SEC the authority to suspend, bar, or place limitations on the activities or functions of any person associated or striving to become associated with a broker or dealer or to bar such person from even participating in the distribution of penny stocks.⁹⁷ Finally, the amendment prohibited any broker from participating in distribution of any penny stock without SEC consent, if the reasonably acting broker was aware of, or should have been aware of, the participation of a barred person.⁹⁸

sure was a sufficient antidote to stock fraud. *Id.* Rather, the bill envisioned a standard for registration and trading that suggested that some companies should not be permitted to sell shares to the public, regardless of how candid their paperwork might be. *Id.* Both the SEC and the National Association of Securities Dealers (“NASD”), however, balked at Markey’s proposal. *Cutting Penny Stock Fraud*, *supra* note 91; Henriques, *supra* note 44; Robb, *supra* note 44. The SEC thought that a flat ban of blank-check companies would have prevented legitimate capital raising by small companies. *Cutting Penny Stock Fraud*, *supra* note 91; Robb, *supra* note 44. Opposed to such a ban, the SEC sought the power to require increased disclosure. Robb, *supra* note 44. Sarah B. Ackerson, Chief of the Commission’s Penny Stock Task Force, explained that the SEC’s rules promulgated in response to the PSRA “really open the door for investor information They’re very consumer oriented and hopefully will arm investors with the kind of information that they need to make better choices and to monitor their own investment opportunities.” *Cutting Penny Stock Fraud*, *supra* note 91, at 47.

⁹³ Penny Stock Reform Act § 503; H.R. REP. NO. 101-617, at 16–19.

⁹⁴ H.R. REP. NO. 101-617, at 26.

⁹⁵ Penny Stock Reform Act § 504; H.R. REP. NO. 101-617, at 28.

⁹⁶ Penny Stock Reform Act § 504; Doyle, *supra* note 44; Henriques, *supra* note 44; *Penny Stock Rules Asked*, *supra* note 44.

⁹⁷ Penny Stock Reform Act § 504. Any person subject to such an SEC order barring or suspending participation in distribution of penny stock was forbidden to associate or seek to become associated with a broker or dealer, or participate in distribution of penny stock without the SEC’s consent. *Id.*

⁹⁸ *Id.*

Congress also took direct aim at blank check companies in particular.⁹⁹ Section 7 of the Securities Act of 1933 (“Securities Act”) was amended to require the SEC to adopt rules restricting blank check companies from registering within one year of the law’s enactment.¹⁰⁰

C. SEC Rulemaking in Response to the PSRA

In response to the PSRA, the SEC issued Rule 419, which applies to every registration statement filed under the Securities Act relating to blank check offerings.¹⁰¹ The SEC defined a blank check company as “a company in its development stage, offering penny stock either (1) where the company has no specific business plan or purpose, or (2) where the company has indicated that its business purpose is to merge with an unidentified company (or companies) issuing penny stock.”¹⁰² Although Rule 419 only applies to offerings registered under the Securities Act, blank check offerings have been effectively excluded from the registration exemption provided for in Regulation A and Rule 504 under Regulation D.¹⁰³

⁹⁹ *Id.* § 508; Henriques, *supra* note 44; *Penny Stock Rules Asked*, *supra* note 44; Robb, *supra* note 44.

¹⁰⁰ Penny Stock Reform Act § 508; H.R. REP. NO. 101-617, at 34. Several other measures were taken in the PSRA in order to combat fraud in the penny stock market. *See* Penny Stock Reform Act §§ 505, 508; H.R. REP. NO. 101-617, at 34. The PSRA added a new paragraph to Section 15 of the Exchange Act to establish a system for comprehensive disclosure in the penny stock market. Penny Stock Reform Act § 505. It required the SEC to adopt rules requiring brokers and dealers to provide customers with a specific “risk disclosure” document before effecting any penny stock transactions. *Id.* The amendment required that the document contain numerous statements regarding the nature of the risk involved in the penny stock market, information about the broker or dealer and her duties to the investor, information about the stock itself, and the means with which to receive additional information on broker-dealer disciplinary histories. *Id.*

Subsection 7(a) required the SEC to conduct a comprehensive review of the enforcement and oversight activities of the self-regulatory organizations monitoring the penny stock market. *Id.* § 510; H.R. REP. NO. 101-617, at 33.

¹⁰¹ 17 C.F.R. § 230.419 (2008); THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* § 3.4[7], at 132 (5th ed. 2005).

¹⁰² 17 C.F.R. § 230.419; HAZEN, *supra* note 101, § 3.4[7], at 132.

¹⁰³ 17 C.F.R. §§ 230.419, 230.501; 69 AM. JUR. 2D *Securities Regulation—Federal* § 233 (2008). Regulation A provides for a conditional small issues exemption from registration under the Securities Act of 1933. 17 C.F.R. §§ 230.251–263. Section 230.51 of the Code of Federal Regulations, which governs the scope of the exemption, eliminates development stage companies with no specific business plan or purpose, or whose business plan is to merge with an unidentified company or companies from the exemption. *Id.* § 230.251(a)(1). Rule 504 under Regulation D details an exemption for limited offerings and sales of securities not exceeding \$1,000,000. *Id.* § 230.504. Subsection (a)(3) specifically disqualifies any “development stage company that either has no specific business plan or purpose or has indicated that its business plan is to engage in a merger or acquisition with an unidentified

In addition, Rule 419 requires that proceeds garnered in a blank check offering be deposited into an escrow account maintained by an insured depository institution or a separate bank account created by a broker or dealer acting as a trustee.¹⁰⁴ This includes securities issued in connection with the offering to underwriters, promoters, or others as compensation or otherwise.¹⁰⁵ Such funds, including interest or dividends, must be held for the sole benefit of purchasers during the offering.¹⁰⁶

After the initial sale of the blank check company's securities, Exchange Act Rule 15g-8 prohibits any sale of deposited securities or interests until the securities are released from the Rule 419 account.¹⁰⁷ A blank check company may only release funds and securities from the account if several conditions are met.¹⁰⁸ First, the blank check company must enter into a business acquisition in which the fair market value of the target equals at least 80 percent of the IPO proceeds.¹⁰⁹ The company must then file a post-effective amendment to its registration statement, which must disclose information concerning the acquisition pursuant to Rule 419(e).¹¹⁰

Within five business days of the effective date of the post-effective amendment, the registrant must send each purchaser a copy of the prospectus contained in this post-effective amendment, as well as any other supplements or amendments.¹¹¹ Next, the registrant must pro-

company or companies, or other entity or person." *Id.* Rule 419 does not apply to offerings by small businesses that are not blank check companies, such as limited partnerships, where a detailed plan of business is developed, but specific investment properties are unidentified. Similarly, start-up companies with specific business plans did not fall within the Rule's purview, even if operations have not commenced before the initial offering. *Id.* § 230.419; HAZEN, *supra* note 101, § 3.4[7], at 132.

¹⁰⁴ 17 C.F.R. § 230.419; 69 AM. JUR. 2D *Securities Regulation—Federal* § 233.

¹⁰⁵ 17 C.F.R. § 230.419; 69 AM. JUR. 2D *Securities Regulation—Federal* § 233.

¹⁰⁶ 17 C.F.R. § 230.419(b); 69 AM. JUR. 2D *Securities Regulation—Federal* § 233. Persons may not lawfully sell or offer to sell any security deposited and held in escrow pursuant to Rule 419, or any interest in or related to such security, unless it is pursuant to a qualified domestic relations order as defined by the Internal Revenue Code or Title I of the Employee Retirement Income Security Act and its subsequent rules. *See* 17 C.F.R. § 240.15g-8.

¹⁰⁷ 17 C.F.R. § 230.15g-8. Rule 15g-8 further prohibits the sale of any other interests based on the deposited security, regardless of whether delivery is required. *Id.*

¹⁰⁸ *See id.* § 230.419(e).

¹⁰⁹ *See id.* § 230.419(e)(1); HAZEN, *supra* note 101, § 3.4[7], at 132. This calculation includes any funds received or to be received upon exercise or conversion of securities offered, but excluding underwriting commissions, underwriting expenses and dealer allowances payable to non-affiliates. 17 C.F.R. § 230.419(e)(1); HAZEN, *supra* note 101, § 3.4[7], at 132.

¹¹⁰ 17 C.F.R. § 230.419(e)(1); HAZEN, *supra* note 101, § 3.4[7], at 132.

¹¹¹ 17 C.F.R. § 230.419(e)(2)(i).

vide purchasers at least twenty, but no more than forty-five business days from the effective date of the post-effective amendment to notify the registrant of their desire to remain an investor.¹¹² If such purchaser notification is not received within the allotted time, the purchaser's deposit must be refunded.¹¹³ Finally, the registrant must consummate the acquisition meeting the criteria set forth above.¹¹⁴

Once the transaction has been consummated, and the escrow agent or trustee has received a signed representation from the registrant that the above conditions have been met, the funds may be released.¹¹⁵ When purchasers of the offering receive this post-acquisition information, they must be granted the opportunity to withdraw their deposit funds.¹¹⁶ Furthermore, if the acquisition does not occur within eighteen months of the effective date of the initial registration statement, the offering's proceeds must be returned to its purchasers.¹¹⁷

D. *The Latest Round of Public Shell Regulation*

On August 22, 2005, the SEC issued new provisions intended to deter fraud and abuse in securities markets through the use of reporting shell companies.¹¹⁸ These new rules and amendments address the use of Form S-8, Form 8-K, and Form 20-F by public shell companies.¹¹⁹ In its final rule, the SEC defined a shell company as a registrant with no or nominal operations and no or nominal assets, assets consisting solely of cash and cash equivalents, or cash and only nomi-

¹¹² *Id.* § 230.419(e)(2)(ii).

¹¹³ *Id.*

¹¹⁴ *Id.* § 230.419(e)(2)(iii).

¹¹⁵ *Id.* § 230.419(e)(3).

¹¹⁶ 17 C.F.R. § 230.419; HAZEN, *supra* note 101, § 3.4[7], at 132.

¹¹⁷ 17 C.F.R. § 230.419; HAZEN, *supra* note 101, § 3.4[7], at 132.

¹¹⁸ See 17 C.F.R. § 230.419; Use of Form S-8, Form 8-K, and Form 20-F by Shell Companies, 70 Fed. Reg. 42,234 (July 21, 2005); Hogan, *supra* note 9, at 13.

¹¹⁹ See 17 C.F.R. §§ 230.419; 239.16b; 249.308; Use of Form S-8, Form 8-K, and Form 20-F by Shell Companies, 70 Fed. Reg. 42,234; Hogan, *supra* note 9, at 12. Form S-8 is used by public companies to register securities for sale under the Securities Act of 1933 in connection with employee benefit plans. See 17 C.F.R. § 239.16b; Use of Form S-8, Form 8-K, and Form 20-F by Shell Companies, 70 Fed. Reg. 42,234; Hogan, *supra* note 9, at 12. Form 8-K is used to disclose certain corporate events on a current basis under the Securities Exchange Act of 1934. See 17 C.F.R. § 249.308; Use of Form S-8, Form 8-K, and Form 20-F by Shell Companies, 70 Fed. Reg. 42,234; Hogan, *supra* note 9, at 12. Form 20-F is a form under the Exchange Act for foreign private issuers. See 17 C.F.R. § 249.220; Use of Form S-8, Form 8-K, and Form 20-F by Shell Companies, 70 Fed. Reg. 42,234; Hogan, *supra* note 9, at 12.

nal other assets.¹²⁰ The rules and amendments prohibit public shell companies from using Form S-8 until they have become operating companies and until sixty days have passed from the filing of the information required for filing of a registration statement.¹²¹ This particular rule seeks to address the use of Form S-8 registration statements by reporting shell companies to circumvent the registration and prospectus delivery requirements of the Exchange Act.¹²²

On November 7, 2005, Section 5.06 of Form 8-K became effective.¹²³ Section 5.06 requires a shell company that is reporting an event that causes it to cease being a shell company to disclose the same type of information it would be required to provide in registering a class of securities under the Exchange Act within four business days after the completion of the transaction.¹²⁴ This forces private companies attempting to go public through a public shell reverse merger or reverse triangular merger transaction to disclose the same level of information required by a traditional IPO.¹²⁵ The goal was to provide the requisite information useful to investors in making informed decisions about investing in a company.¹²⁶

II. MODERN-DAY SPACS

Modern-day SPACs present an attractive alternative to the traditional IPO.¹²⁷ This Part begins with a discussion of several protective measures that SPACs voluntarily include within their bylaws that diminish some of the risks investors may have faced in previous blank check

¹²⁰ See 17 C.F.R. § 240.12b-2; Use of Form S-8, Form 8-K, and Form 20-F by Shell Companies, 70 Fed. Reg. 42,234; Hogan, *supra* note 9, at 13. The SEC declined to define the term “nominal,” arguing that the term was not inappropriately vague or ambiguous. Use of Form S-8, Form 8-K, and Form 20-F by Shell Companies, 70 Fed. Reg. 42,234. It reasoned that quantitative thresholds would present a serious potential problem because they could be more easily circumvented. *Id.*

¹²¹ See 17 C.F.R. § 239.16b; Use of Form S-8, Form 8-K, and Form 20-F by Shell Companies, 70 Fed. Reg. 42,234; Hogan, *supra* note 9, at 13.

¹²² See 17 C.F.R. § 239.16b; Use of Form S-8, Form 8-K, and Form 20-F by Shell Companies, 70 Fed. Reg. 42,234; Hogan, *supra* note 9, at 13.

¹²³ See 17 C.F.R. § 249.308; Use of Form S-8, Form 8-K, and Form 20-F by Shell Companies, 70 Fed. Reg. 42,234; Hogan, *supra* note 9, at 13.

¹²⁴ See 17 C.F.R. § 249.308; Use of Form S-8, Form 8-K, and Form 20-F by Shell Companies, 70 Fed. Reg. 42,234; Hogan, *supra* note 9, at 13.

¹²⁵ See 17 C.F.R. § 249.308; Use of Form S-8, Form 8-K, and Form 20-F by Shell Companies, 70 Fed. Reg. 42,234; Hogan, *supra* note 9, at 13.

¹²⁶ See 17 C.F.R. § 249.308; Use of Form S-8, Form 8-K, and Form 20-F by Shell Companies, 70 Fed. Reg. 42,234; Hogan, *supra* note 9, at 13.

¹²⁷ Smith et al., *supra* note 1; Klaris, *supra* note 14, at 41, 44.

offerings.¹²⁸ It continues by summarizing the relative merits of gaining access to the capital markets through a SPAC merger.¹²⁹ Finally, this Part describes the general evolution of SPACs within the market.¹³⁰

A. *Self-Imposed SPAC Restrictions*

The restrictions of Rule 419 are generally not applicable to SPACs, which fit beneath an exception provided in Rule 3a51-1 of the Exchange Act for issuers with less than three years of operations who have a minimum of \$5 million in net assets.¹³¹ To the extent that an issuer promptly files a Current Report on Form 8-K upon consummation of an IPO showing that net assets are in excess of \$5 million, the SEC will not deem the issuer a blank check company subject to Rule 419.¹³² Accordingly, SPACs typically file such a report upon consummation of the IPO, thereby avoiding the restrictions Rule 419 would otherwise impose.¹³³

Despite the limited applicability of Rule 419, SPACs restrict their own activities in an effort to provide a certain degree of investor protection.¹³⁴ Many of these measures mirror the recently proposed criteria for SPAC listing on the Nasdaq.¹³⁵ The current trend is for SPACs to incorporate these provisions in their organizational documents.¹³⁶

Similar to the requirements of Rule 419, the proceeds generated from a SPAC IPO are deposited in escrow and are not released until

¹²⁸ See *infra* notes 131–154 and accompanying text.

¹²⁹ See *infra* notes 155–180 and accompanying text.

¹³⁰ See *infra* notes 181–209 and accompanying text.

¹³¹ Boehm et al., *supra* note 5; see 17 C.F.R. § 240.3a51-1(g)(1) (2005).

¹³² Boehm et al., *supra* note 5; see 17 C.F.R. § 240.3a51-1(g)(1). For an argument against extending Rule 419 to SPACs, see generally Daniel S. Riemer, *Special Purpose Acquisition Companies: SPAC and SPAN, or Blank Check Redux?*, 85 WASH. U. L. REV. 931 (2007). For an article discussing whether to regulate the market in the context of trading financial assets, see David E. Van Zandt, *The Market as a Property Institution: Rules for the Trading of Financial Assets*, 32 B.C. L. REV. 967, 1025 (1991). Van Zandt identifies the important issue as “not whether some idealized notion of a ‘free market’ is superior to some idealized notion of ‘regulation’”; but whether “a particular market structure ‘economizes’ most thoroughly given the nature of the assets, the demand for transacting and the available cost-reducing technology.” *Id.* He concludes that, when market structures are faced with difficult commons problems, it may be that government regulation is the best “economizing” technology. *Id.*

¹³³ Van Zandt, *supra* note 132, at 1025.

¹³⁴ Matthew S. Town & John Niedernhoffer, *Attack of the SPACs*, SAN DIEGO DAILY TRANSCRIPT, Sept. 26, 2005, available at <http://www.sddt.com/reports/article.cfm?RID=355&SourceCode=20050926rb>; see also Boehm et al., *supra* note 5.

¹³⁵ See Press Release, Nasdaq Stock Market, Inc., *supra* note 1.

¹³⁶ Boehm et al., *supra* note 5.

either a business combination occurs or the SPAC liquidates.¹³⁷ The remaining 20 percent is used to enable management to seek out a suitable target, to conduct thorough due diligence on any potential target, to cover any other miscellaneous operating expenses, and to reimburse management for out-of-pocket expenses.¹³⁸ Beyond such reimbursements, the SPAC's initial stockholders receive no compensation for their services unless and until they have effected a business combination.¹³⁹

If a combination is not effected within the self-imposed deadline, which usually spans between twelve and eighteen months, the SPAC liquidates.¹⁴⁰ Most SPACs, however, provide for an extension of the initial deadline (up to twenty-four months) if management has reached an agreement in principle with a prospective target.¹⁴¹ Upon liquidation, pro rata shares of the escrowed funds are distributed to the SPAC's shareholders.¹⁴² Initial stockholders are generally excluded from receiving any distribution of escrowed funds with respect to any shares they acquired prior to the IPO.¹⁴³

In addition to meeting this timing requirement, the company acquired in a SPAC's initial transaction must have a fair market value in excess of 80 percent of net assets.¹⁴⁴ Further protecting its shareholders, SPAC transactions require majority approval from investors before any business combination.¹⁴⁵ Even upon obtaining majority approval, SPACs may be prevented from completing a business combination if more than 20 percent of disapproving shareholders seek to convert their shares.¹⁴⁶

Some SPACs have included additional safeguards as a result of market expectations or of agreements between the initial stockholders and underwriters.¹⁴⁷ SPACs often require initial stockholders to agree to lock-up provisions to ensure that those stockholders retain their

¹³⁷ *Id.*; see also Town & Niedernhoffer, *supra* note 134.

¹³⁸ Boehm et al., *supra* note 5.

¹³⁹ *Id.*

¹⁴⁰ *Id.*; see also Town & Niedernhoffer, *supra* note 134.

¹⁴¹ Town & Niedernhoffer, *supra* note 134; Boehm et al., *supra* note 5.

¹⁴² Town & Niedernhoffer, *supra* note 134; Boehm et al., *supra* note 5. Despite this return of funds to stockholders, investors generally do not fully recover the cost of their investment upon liquidation. Town & Niedernhoffer, *supra* note 134; Boehm et al., *supra* note 5.

¹⁴³ Boehm et al., *supra* note 5.

¹⁴⁴ *Id.*; see also Town & Niedernhoffer, *supra* note 134.

¹⁴⁵ Town & Niedernhoffer, *supra* note 134; Boehm et al., *supra* note 5.

¹⁴⁶ Town & Niedernhoffer, *supra* note 134; Boehm et al., *supra* note 5.

¹⁴⁷ Boehm et al., *supra* note 5.

ownership interests in the company until a designated period after a business combination.¹⁴⁸ This period generally spans anywhere from six months to three years.¹⁴⁹ This may help discourage directors from making a bad investment decision because of an impending liquidation deadline, especially because the initial stockholders do not receive a pro rata share of a pre-combination liquidation distribution.¹⁵⁰

In order to further align the interests of the initial stockholders with investors purchasing in the IPO, a SPAC may also require that the initial stockholders purchase a fixed dollar amount of warrants in the public markets.¹⁵¹ These warrants will be subject to a lock-up period until the SPAC enters into a business combination.¹⁵² Finally, some SPACs sell their lead underwriter an option to purchase additional units at a nominal cost.¹⁵³ These units typically have comparable terms as the units issued in the IPO; however, the unit purchase price and the warrant exercise price are higher.¹⁵⁴

B. *An Alternative Route to Going Public*

SPACs, as well as other public shells, often present an attractive opportunity for private operating companies seeking the advantages of becoming a public company while avoiding the costs inherent in the IPO process.¹⁵⁵ This enables private companies to access the capital markets through either a reverse merger or reverse triangular merger with a public shell.¹⁵⁶ SPACs can be particularly attractive to private companies seeking an alternative to the traditional IPO precisely because they have not conducted any business and thus should be free of any contingent liabilities.¹⁵⁷

Aside from the costs of an IPO, these shells may present the only opportunity for emerging companies to gain access to the capital markets.¹⁵⁸ Investment banks favor larger private companies with high revenues and a strong operating history because they are more attrac-

¹⁴⁸ *Id.*

¹⁴⁹ *Id.*

¹⁵⁰ *See id.*

¹⁵¹ *Id.*

¹⁵² Boehm et al., *supra* note 5.

¹⁵³ *Id.*

¹⁵⁴ *Id.*

¹⁵⁵ *See* Klaris, *supra* note 14, at 41, 44; Boehm et al., *supra* note 5.

¹⁵⁶ Smith et al., *supra* note 1; Klaris, *supra* note 14, at 41, 44.

¹⁵⁷ Town & Niedernhoffer, *supra* note 134.

¹⁵⁸ William K. Sjostrom, Jr., *Carving a New Path to Equity Capital and Share Liquidity*, 50 B.C. L. REV. (forthcoming May 2009); Smith et al., *supra* note 1, at 88.

tive to investors.¹⁵⁹ In 2004, there were 249 IPOs, only eleven of which raised less than \$25 million.¹⁶⁰

For emerging enterprises, where the process, service, or product is new and untested, a successful IPO can be difficult even if a company successfully attracts an investment bank to underwrite its offering.¹⁶¹ In addition to “selling” itself to an investment bank, the company must “sell” itself to the investing public.¹⁶² A private company can never be certain how the investing public will react to its offering.¹⁶³ This uncertainty, combined with the general instability of the market, yields the very real threat that the time and money private companies spend towards preparing an IPO could be completely wasted if the transaction is not consummated.¹⁶⁴

A reverse merger with a SPAC provides the private operating company with a large infusion of cash from the proceeds of the SPAC’s IPO.¹⁶⁵ Because a SPAC already has an existing trading market in its securities, the private company also enjoys immediate share liquidity.¹⁶⁶ This liquidity, which may increase the value of the shares themselves, is furthered by the vested interest of the relevant underwriter(s) in supporting the market after a reverse merger.¹⁶⁷ The experience of a SPAC’s management team in ensuring compliance with the Securities Act,¹⁶⁸ the Exchange Act¹⁶⁹, and the Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley”)¹⁷⁰ may also ease the operating company’s transition into fulfilling the regulatory requirements of a public company.¹⁷¹

In addition to their use for acquiring and going public with individual companies, SPACs are now being formed as a way to purchase asset managers.¹⁷² This offers managers new routes to public capital,

¹⁵⁹ *Id.*

¹⁶⁰ *Id.*

¹⁶¹ *Id.* at 90.

¹⁶² *Id.*

¹⁶³ Smith et al., *supra* note 1, at 90.

¹⁶⁴ *Id.*

¹⁶⁵ *Id.* at 91.

¹⁶⁶ Sjoström, *supra* note 15, at 758.

¹⁶⁷ *Id.* An investment becomes more attractive when potential investors know they would have the ability to quickly sell their shares. Smith et al., *supra* note 1, 88–91; Klaris, *supra* note 14, at 41; Boehm et al., *supra* note 5.

¹⁶⁸ 15 U.S.C. §§ 77a–77aa (2006).

¹⁶⁹ *Id.* §§ 78a–78oo.

¹⁷⁰ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 15 U.S.C., 18 U.S.C., and 28 U.S.C.).

¹⁷¹ See, e.g., Oakmont Acquisition Corp., Prospectus (Form S-1/A) (July 11, 2005).

¹⁷² Jay Cooper, *Money Managers Target of “Blank-Check” Firms; SPACs Offer Firms New Way to Gain Capital Without IPO*, PENSIONS & INVESTMENTS, Jan. 21, 2008, at 2. For example, on

thereby enabling them to obtain currency to grow without the hassle and risk of an IPO.¹⁷³ It further allows staff to focus on the business rather than spend a significant period of time on an IPO road show.¹⁷⁴ Although there are currently no publicly listed venture capital vehicles on American exchanges, developments on London's Alternative Investment Market ("AIM") seem to indicate that such a development remains another plausible use for SPACs.¹⁷⁵

Potential downsides regarding use of SPACs as a vehicle for going public include the requirement that the SPAC investors vote in favor of the merger, coupled with the concept that less than 20 percent of stockholders opposing the merger can exercise their right to convert.¹⁷⁶ This requires considerable time and expense in order to solicit the stockholder vote and hold the stockholder meeting.¹⁷⁷ Furthermore, a private company entering into a business combination with a SPAC will likely have to live with a much larger retained equity stake by stockholders of the SPAC.¹⁷⁸ Private companies may, however, be able to take advantage of the small time period in which individual SPACs

November 7, 2007, Freedom Acquisition Holdings, Inc., took public London-based hedge fund manager, GLG Partners, Inc., in a \$3.4 billion dollar deal. *Id.* This transaction came one year after a SPAC created by the founders of Berkshire Capital Securities LLC, Highbury Financial, acquired the U.S. mutual fund business of ABN AMRO for \$38.6 million. *Id.* New York-based Grail Partners is quickly following suit with its filing of a registration statement with the SEC to form Grail Investment Corp., another SPAC. *Id.* Although it cannot identify any prospective targets prior to its offering, Grail is expected to acquire a firm from the asset management industry. *Id.*

¹⁷³ *Id.*

¹⁷⁴ *Id.*

¹⁷⁵ See Arleen Jacobius, *A Different Way to Fund Venture Cap; LSE Public Fund Listings Create Permanent Capital, Extend Investment Cycle by Years*, PENSIONS & INVESTMENTS, Dec. 10, 2007, at 2. According to Jacobius, a "wave of pioneers" has developed a method for funding venture capital firms by listing public funds on the AIM instead of raising money privately. *Id.* This provides permanent capital, thus lengthening the typical investment period for venture capital firms from the typical three to six years to eight years. *Id.* By lengthening the investment period, the executives of publicly listed venture capital funds gain time to hold on to their best-performing portfolio companies longer, so that they may grow to their full potential. *Id.* It also allows them to nurture slower-growing, promising companies. *Id.* As a result, this new model "has the potential of making these funds perpetual fundraising machines." *Id.*

¹⁷⁶ Town & Niedernhoffer, *supra* note 134; Boehm et al., *supra* note 5.

¹⁷⁷ Town & Niedernhoffer, *supra* note 134; Boehm et al., *supra* note 5.

¹⁷⁸ Smith et al., *supra* note 1, at 91. It is important to note, however, that private company ownership generally retains more control over the general direction of their companies than if they had obtained venture or private equity funding. Broude, *supra* note 24, at 76–79. Private company ownership has also pointed to their ability to postpone the required "sale" of their vision to public stockholders until after the merger, as opposed to prior to the issuance of shares. Barker & Hedin, *supra* note 3, at 38.

must enter into a business combination, using the timeline as leverage to bargain for a sweeter deal.¹⁷⁹ Private companies must thus balance all of these potential upsides against the cost of compliance with SEC regulations of public companies, as well as the value of the company's increased vulnerability to changes in economic or market conditions.¹⁸⁰

C. *The Rise of the SPAC*

In the wake of the slowdown of the IPO market, there has been a recent surge in SPAC transactions.¹⁸¹ As recently as 2005, most SPAC

¹⁷⁹ Barker & Hedin, *supra* note 3, at 38. Conversely, this is one drawback of investing in a SPAC pre-acquisition. *See id.*

¹⁸⁰ James, *supra* note 8, at 98; Smith et al., *supra* note 1, 88–91; Klaris, *supra* note 14, at 41; Boehm et al., *supra* note 5.

¹⁸¹ Boehm et al., *supra* note 5. Because SPACs are merely a vehicle for pooling capital in an effort to acquire an unidentified operating company (from any market sector, despite any previously identified focus), investors who purchase shares in the IPO invest primarily in the expertise of a SPAC's management team. Such teams are generally comprised of private equity and hedge fund operators, current and former mutual fund managers and Wall Street analysts, and various current and former politicians and corporate executives. Smith et al., *supra* note 1, at 91; Town & Niedernhoffer, *supra* note 134. Consequently, in many ways, investors' hopes that management will enter into a lucrative merger, yielding a profit for everyone, is largely "on faith." Karen Richardson & Peter Lattman, *Financiers Now Say "Trust Us"—Like the Blank-Check Offerings of Yore, SPAC Investors Are Asked to Buy In—on Faith*, WALL ST. J., Feb. 1, 2007, at C1.

Hedge funds, venture capital firms, and other institutional investors have been a significant factor in the surge of SPAC IPOs. Smith et al., *supra* note 1, at 91; Town & Niedernhoffer, *supra* note 134. In fact, investment by parties not deemed to be institutional investors is often limited to a specified number of states. Smith et al., *supra* note 1, at 91; Town & Niedernhoffer, *supra* note 134. SPACs are attractive investment vehicles for these sophisticated investors because they can capitalize on a SPAC's unique securities structure. Smith et al., *supra* note 1, at 91; Town & Niedernhoffer, *supra* note 134. SPACs are listed through both shares and warrants, which trade at different prices until an acquisition is announced. Smith et al., *supra* note 1, at 91; Town & Niedernhoffer, *supra* note 134. Hedge funds often employ arbitrage strategies to profit from these price differences. Steven M. Davidoff, *The Unseen Mergers Boom: SPACs*, N.Y. TIMES DEALBOOK, Jan. 6, 2008, <http://dealbook.blogs.nytimes.com/2008/01/06/the-unseen-mergers-boom-spacs/>. The approval of SPAC transactions often occurs several months after announcement. *Id.* Although the proxy statement to approve the transaction, which includes relevant financial and other information, is not immediately filed after announcement, investors may trade the SPAC shares in the interim in anticipation of the acquisition. *Id.* Such activity avoids the gun-jumping provisions normally imposed on IPOs, thus creating short-term trading opportunities for hedge funds to take advantage of information deficits. *Id.*

In addition to the opportunities presented by their securities structure, SPACs provide an opportunity to participate in a private-equity style investment in a publicly traded security. Richardson & Lattman, *supra*; Kit R. Roane, *Business Buffet: When Hungry Investors Want to Make a Meal of a Company, They Can Pool Their Millions in Something Called a SPAC*, U.S. NEWS & WORLD REP., Jan. 22, 2006, at 1, available at <http://www.usnews.com/usnews/biztech/articles/060130/30spacs.htm>; Town & Niedernhoffer, *supra* note 134. Experienced

underwriters were second and third tier securities firms, but larger securities firms, including Goldman Sachs Group, Deutsche Bank AG, and Citigroup, Inc., are beginning to participate.¹⁸² In 2007 alone, sixty-six SPAC offerings raised over \$12 billion, and SPAC offerings comprised 25 percent of all IPOs and 20 percent of aggregate money raised.¹⁸³ For the first three quarters of 2008, they amounted to 53 percent of all IPOs within the United States, and 75 percent of aggregate money raised.¹⁸⁴

Several SPAC IPOs and business combinations in the past year indicate that this growth in the SPAC market is likely to continue.¹⁸⁵ Apollo Management L.P. raised \$300 million for Marathon Acquisition Corp., another SPAC.¹⁸⁶ Freedom Acquisition Corp.'s IPO in December, which was underwritten by Citigroup, raised \$520 million.¹⁸⁷ SPACs are also beginning to acquire higher-profile private companies.¹⁸⁸ American Apparel, a nationwide clothing retailer, recently agreed to combine with Endeavor Acquisition Corp., a SPAC that raised \$130 million in 2005.¹⁸⁹ On March 13, 2006, Services Acquisition Corp., a publicly traded SPAC listed on AMEX, announced its planned acquisition of Jamba Juice for \$265 million.¹⁹⁰ In November 2007, the IPO of Liberty Acquisition Holdings Corp. became the first SPAC to break the \$1 billion mark when it listed on AMEX.¹⁹¹

In addition to the recent surge in deal flow and size, AMEX granted the SPAC structure some level of credibility by beginning to

financial players can thus identify private companies with great potential that could be tapped through either more effective management, large infusions of cash, or access to the capital markets. Richardson & Lattman, *supra*. They present an upside inherent in the deal if the management team identifies a good undervalued private company to take public. *See id.* They also grant institutional investors the flexibility to continue owning the shares after the initial business combination, as well as protection if those investors vote against a business combination and exercise their right to convert. Smith et al., *supra* note 1, at 91; Richardson & Lattman, *supra*; Roane, *supra*; Town & Niedernhoffer, *supra* note 134.

¹⁸² Cowan, *supra* note 3; Eric J. Savitz, *The New Blind Pool*, BARRON'S, Dec. 21, 2005, at 22; Town & Niedernhoffer, *supra* note 134; Nicholas Pettifer, *2008: Year of the Spacs?*, IFLRLEGALWIRE, Feb. 14, 2008, <http://www.iflr.com/Article/1983123/2008-year-of-the-Spacs.html>.

¹⁸³ Davidoff, *supra* note 181.

¹⁸⁴ *Id.*

¹⁸⁵ *See* Richardson & Lattman, *supra* note 181; Roane, *supra* note 181.

¹⁸⁶ Richardson & Lattman, *supra* note 181.

¹⁸⁷ *Id.*

¹⁸⁸ *Id.*

¹⁸⁹ *Id.*

¹⁹⁰ *Id.*

¹⁹¹ *Blank-Check Liberty Acquisition IPO Tops \$1 Bln*, REUTERS, Dec. 12, 2007, <http://www.reuters.com/article/newIssuesNews/idUSN1261457920071212>.

list SPACS in 2005.¹⁹² As of early 2007, it listed twenty-three SPACs.¹⁹³ In perhaps the most striking sign of the growing acceptance of SPACs in the market, Nasdaq and the NYSE announced that they would propose a rule change to the SEC for the listing of SPACs in February and March 2008, respectively.¹⁹⁴ According to Bob McCooey, senior vice president of Nasdaq Stock Market, Inc., his exchange believes that “listing [SPACs] on NASDAQ, subject to . . . important investor protections, [would] benefit investors and issuers alike.”¹⁹⁵

Beyond having to satisfy all applicable initial listing standards, the Nasdaq proposal would require SPACs to meet several more stringent listing standards.¹⁹⁶ First, gross proceeds from the IPO of a SPAC offering must be deposited in an escrow account maintained by an insurance depository institution as defined by the Federal Deposit Insurance Act or in a separate bank account established by a registered broker or dealer.¹⁹⁷ Second, the company must complete one or more business combinations using an aggregate cash consideration equal to at least 80 percent of the value of the escrow account at the time of the IPO within 36 months of the effectiveness of its IPO registration statement.¹⁹⁸ Finally, while a SPAC is in the acquisition stage, each business combination must be approved both by the company’s shareholders and by a majority of the company’s independent directors.¹⁹⁹ Following each business combination, the combined company must meet all of the requirements for initial listing.²⁰⁰

The response to Nasdaq’s proposal thus far, as with any other SPAC-related matter, has been mixed.²⁰¹ The thirty-six month deadline that Nasdaq would impose has already been pointed to as doubling the time period specified in Rule 419.²⁰² Others have hinted that Nasdaq has only retreated from its objection to listing SPACs be-

¹⁹² Richardson & Lattman, *supra* note 181.

¹⁹³ *Id.*

¹⁹⁴ Cowan, *supra* note 2; Press Release, Nasdaq Stock Market, Inc., *supra* note 1.

¹⁹⁵ Cowan, *supra* note 2; Press Release, Nasdaq Stock Market, Inc., *supra* note 1.

¹⁹⁶ Press Release, Nasdaq Stock Market, Inc., *supra* note 1.

¹⁹⁷ *Id.*

¹⁹⁸ *Id.*

¹⁹⁹ *Id.*

²⁰⁰ *Id.*

²⁰¹ See Davidoff, *supra* note 181; Posting of Zac Bissonnette to Blogging Stocks, <http://www.bloggingstocks.com/2008/02/24/nasdaq-lightens-up-on-blank-check-ipos/> (Feb. 24, 2008, 10:10 EST); Posting of Douglas A. McIntyre to Inmoney, <http://www.inmoneytoday.com/2008/02/22/nasdaq-ndaq-wants-to-list-blank-check-companies/> (Feb. 22, 2008, 17:20 EST).

²⁰² Davidoff, *supra* note 181.

cause the amount of money generated from SPAC offerings has become too prominent to ignore.²⁰³ Another commentator has argued that trading in SPACs on stock markets before they engage in a business combination with an actual operating company is mistaken because trading in a SPAC is trading in a “phantom.”²⁰⁴

On March 6, 2008, NYSE followed Nasdaq’s lead with its proposal to the SEC to create an exception that would allow SPACs to list.²⁰⁵ Generally, NYSE’s IPO rules require companies to have a financial history spanning up to three years.²⁰⁶ That rule has prevented SPACs, which do not have any operating history or money on their balance sheets prior to going public, from listing.²⁰⁷ The SEC could use these announcements to attempt to implement its own regulation of SPACs, potentially triggering a longer public review of SPACs.²⁰⁸ Although the SEC is expected to approve any rules Nasdaq and NYSE propose because Amex already permits these listings, such an approval would not likely represent a departure from the SEC’s policy of subjecting SPAC filings to greater scrutiny.²⁰⁹

III. THE CASE FOR MODERN-DAY SPACs

Regulation of blank check companies represented the reaction of Congress and the SEC to widespread fraud and manipulation permeating the penny stock market.²¹⁰ As one of the most prominent vehicles for enacting such penny stock schemes, blank check companies received especially close scrutiny during this wave of lawmaking.²¹¹ Although this reaction was based on several legitimate concerns regarding public shell companies, many of the underlying issues that motivated this wary treatment of public shells no longer exist.²¹² This Part argues that the changing nature of SPACs warrants an attitude adjustment from the SEC during its reviews of SPAC offerings and transactions.²¹³ Instead of viewing

²⁰³ Posting of Zac Bissonnette, *supra* note 201.

²⁰⁴ Posting of Douglas McIntyre, *supra* note 201.

²⁰⁵ Cowan, *supra* note 2.

²⁰⁶ *Id.*

²⁰⁷ *Id.*

²⁰⁸ Posting of Douglas McIntyre, *supra* note 201.

²⁰⁹ *See id.*

²¹⁰ Penny Stock Reform Act of 1990, Pub. L. No. 101-429, § 502, 104 Stat. 931, 951; H.R. REP. NO. 101-617, at 10–13 (1990), *as reprinted in* 1990 U.S.C.C.A.N. 1408, 1411–15.

²¹¹ H.R. REP. NO. 101-617, at 10–13, 22–23.

²¹² *See id.* at 22–23; Richardson & Lattman, *supra* note 181; Roane, *supra* note 181; Savitz, *supra* note 182, at 22; Town & Niedernhoffer, *supra* note 134.

²¹³ *See infra* notes 233–323 and accompanying text.

them merely as potential vehicles for fraud and manipulation, the SEC should recognize their potential as an alternative vehicle enabling private companies to access the capital markets.²¹⁴

A. *Natural Market Forces Have Been More Successful Than the PSRA and Subsequent SEC Rules*

One consistent, fundamental notion of free-market governance is that expanding the powers of government over the affairs of business remains a dangerous proposition.²¹⁵ Although the PSRA and the restrictions of Rule 419 were intended to keep fraudulent issuers out of the IPO market, at least one empirical study has indicated that some issuers have circumvented the PSRA by simply offering securities at a higher price.²¹⁶ That is, promoters and broker-dealers have adjusted their schemes by offering securities that do not meet the technical definition of “penny stocks.”²¹⁷ As opposed to improving issuer quality, the period following the passage of the PSRA thus provides evidence that speculative issuers could have migrated to the “non-penny” range.²¹⁸ These unintended effects of the PSRA emphasize the difficulty of crafting legislation geared toward reducing undesirable behavior in a securities market.²¹⁹ Because the method of limiting such activity can be easily circumvented (for example, by simply offering securities at a higher price), the PSRA has proven to be largely ineffective.²²⁰

Other commentators have argued that the problems of the PSRA extend beyond merely providing easy loopholes for fraudulent brokers and dealers to exploit.²²¹ Although it provides investors in penny stock enhanced disclosure, the PSRA imposes substantial costs on issuers, brokers, dealers, and investors of penny stock.²²² Liability imposed through the Act would tend to deter honest penny stock bro-

²¹⁴ See Jenny Anderson, *Crave Huge Risk? This Investment May Be for You*, N.Y. TIMES, Sept. 23, 2005, at 7; cf. Sjöstrom, *supra* note 158.

²¹⁵ See ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS (Modern Library 2000) (1776); see also Monte E. Wetzler, *A Remedy Worse Than the Problem*, N.Y. TIMES, July 23, 1989, at F2 (arguing against the expansion of SEC power in the wake of insider-trading scandals).

²¹⁶ Beatty & Kadiyala, *supra* note 8, at 518.

²¹⁷ *Id.*

²¹⁸ *Id.* at 532.

²¹⁹ *Id.* at 538.

²²⁰ *Id.*

²²¹ Carolyn E. Lampe, *The Penny Stock Reform Act of 1990: A Costly Solution to a Serious Problem*, 13 GEO. MASON L. REV. 779, 801 (1991).

²²² *Id.*

kers and dealers from the market, without encouraging fraudulent brokers from doing the same.²²³ The costs of increased disclosure may also prevent some small businesses from entering the market if fewer brokers are able to trade their stock.²²⁴

Similar to the requirements of the PSRA, the SEC's Rule 419 regarding blank-check offerings has been easily circumvented.²²⁵ The restrictions of Rule 419 are generally not applicable to SPACs, which rely on an exception provided in Rule 3a51-1 of the Exchange Act for issuers with less than three years of operations who have a minimum of \$5 million in net assets.²²⁶ To the extent an issuer files a Current Report on Form 8-K promptly upon consummation of an IPO showing that net assets are in excess of \$5 million, the SEC will not deem the issuer a blank check company subject to Rule 419.²²⁷ Accordingly, SPACs avoid the dictates of Rule 419 merely by filing a Current Report upon consummation of the IPO.²²⁸

In spite of the apparent failures of the PSRA and subsequent SEC rulemaking, SPAC issuer quality has continued to improve due to natural market forces.²²⁹ As more SPACs begin flooding the market, SPACs have become forced to differentiate themselves from other SPACs, as well as other investment vehicles such as hedge funds and private equity funds.²³⁰ Because they have recognized the potential of SPACs, prominent underwriters such as Goldman Sachs, Deutsche Bank, and Citigroup are getting involved and taking financial stakes in SPAC deals.²³¹ This combination of issuer quality with the increased level of competition for both investors as well as private operating companies has thus provided tangible results, whereas governmental intrusion at best has produced no results, and at worst has yielded unanticipated collateral damage.²³²

²²³ *Id.*

²²⁴ *Id.*

²²⁵ Boehm et al., *supra* note 5; see 17 C.F.R. § 240.3a51-1(g)(1) (2005).

²²⁶ Boehm et al., *supra* note 5; see 17 C.F.R. § 240.3a51-1(g)(1).

²²⁷ Boehm et al., *supra* note 5; see 17 C.F.R. § 240.3a51-1(g)(1).

²²⁸ Boehm et al., *supra* note 5; see 17 C.F.R. § 240.3a51-1(g)(1).

²²⁹ See *supra* notes 181–209 and accompanying text.

²³⁰ See *supra* notes 181–209 and accompanying text.

²³¹ Cowan, *supra* note 3; Matthew Goldstein, *Company Man Draws Blank*, THESTREET.COM, July 27, 2006, <http://www.thestreet.com/story/10299584/1/company-man-draws-blank.html>.

²³² See Wetzler, *supra* note 215 (arguing against the expansion of SEC power in the wake of insider-trading scandals).

B. *A Far Cry from the '80s*

The fact that previous legislation and SEC rulemaking have failed to achieve their desired results does not alone call for a less antagonistic SEC review of SPAC offerings.²³³ A simple qualitative comparison between current SPACs and the blank checks of yore, however, demonstrates that the legitimate concerns motivating the PSRA and subsequent rulemaking have in large part been addressed through the natural evolution of the SPAC form.²³⁴ The parties involved, the level of information available to investors, and the amount of disclosure required have all reduced the level of manipulation, fraud, and exploitation of the market.²³⁵

1. A Changing Cast of Characters Has Reduced the Level of Manipulation, Fraud, and Exploitation in the Market

During the 1980s, the penny stock market was dominated by numerous brokerages dealing strictly in penny stocks throughout the country.²³⁶ These penny stock brokerages hired sales staff with almost no industry knowledge or experience, and they targeted small, unsophisticated investors with false information and intense pressure to immediately buy or sell.²³⁷ Because they were dealing in penny stocks, penny stock brokers were able to control the flow of information about the companies that they sold investors as well as the price investors paid for those companies.²³⁸ In addition to the proliferation of speculative underwriters in the penny stock market, many of the key players within penny stock brokerages, as well as blank check companies, were former violators of federal and state securities laws, former convicted felons, and persons with strong ties to organized crime.²³⁹

In contrast to the blank check companies of the 1980s, modern-day SPACs involve a very different set of players.²⁴⁰ People responsible

²³³ See *infra* notes 236–323 and accompanying text.

²³⁴ See *infra* notes 236–323 and accompanying text.

²³⁵ See *infra* notes 236–323 and accompanying text.

²³⁶ H.R. REP. NO. 101-617, at 9–12.

²³⁷ *Id.*; see Henriques, *supra* note 44; Nash, *supra* note 48; *Penny Stock Rules Asked*, *supra* note 44; Leonard Sloane, *Many Dangers of Blind Offers*, N.Y. TIMES, May 9, 1987, at 38.

²³⁸ H.R. REP. NO. 101-617, at 9–12.

²³⁹ Doyle, *supra* note 44; Henriques, *supra* note 44; *Penny Stock Rules Asked*, *supra* note 44.

²⁴⁰ See H.R. REP. NO. 101-617, at 9–12; Doyle, *supra* note 44; Henriques, *supra* note 44; *Penny Stock Rules Asked*, *supra* note 44; Richardson & Lattman, *supra* note 181; Roane, *supra* note 181; Savitz, *supra* note 182, at 22; Town & Niedernhoffer, *supra* note 134.

for the formation of SPACs have typically been professionals involved in the private equity and hedge fund industry.²⁴¹ Recent prominent founders of SPACs have included three former Apple executives, a former adviser to Presidents Clinton and Bush, a former congressman, an owner of two professional sports teams, and a former hedge fund manager.²⁴² These individuals have already displayed their financial acumen through other investment vehicles, such that they have earned sufficient market credibility to attract investors who invest chiefly in their ability to choose and ultimately manage the “right” private operating company.²⁴³

Moreover, unlike blank check investors, who were selected primarily due to their vulnerability to boiler room tactics, hedge funds and various institutional investors are now the most common investors in SPACs.²⁴⁴ These highly sophisticated parties have both the market power and financial savvy to evaluate the unique risks of investing in such companies.²⁴⁵ Similarly, the speculative underwriters that used to dominate the blank check industry appear to have lost their hold on the SPAC market.²⁴⁶ Upon initial emergence in the twenty-first century, SPAC transactions primarily attracted second and third-tier underwriters.²⁴⁷ In recent years, however, some of the world’s most prestigious underwriters, such as Goldman Sachs, Citibank, and Deutsche Bank have entered the SPAC market.²⁴⁸

Finally, the target companies with which recent SPACs have merged have very little in common with the private companies identi-

²⁴¹ See Doyle, *supra* note 44; Henriques, *supra* note 44; *Penny Stock Rules Asked*, *supra* note 44; Richardson & Lattman, *supra* note 181; Roane, *supra* note 181; Savitz, *supra* note 182, at 22; Town & Niedernhoffer, *supra* note 134.

²⁴² Avery, *supra* note 1, at 82–87; Hester, *supra* note 19.

²⁴³ See Richardson & Lattman, *supra* note 181; Roane, *supra* note 181; Savitz, *supra* note 182, at 22; Town & Niedernhoffer, *supra* note 134.

²⁴⁴ See Avery, *supra* note 1, at 82–87; Goldstein, *supra* note 231.

²⁴⁵ See Avery, *supra* note 1, at 82–87. Like any other investment vehicle, there are several risks attendant to investing in a SPAC. See, e.g., Endeavor Acquisition Corp., Registration Statement (Form S-1), at 9–19 (Sept. 20, 2005). Such factors include, but are not limited to, an investor’s inability to evaluate management’s ability to achieve its business objective; the potential for forced liquidation; the fact that many of the SPAC’s officers and directors may have conflicts of interest in connection with business opportunities; and the reality that, because its initial business combination must utilize at least 80 percent of its assets, the success of the investment is likely to be solely dependent on a single business and a limited number of products or services. See *id.*

²⁴⁶ See Avery, *supra* note 1, at 82–87.

²⁴⁷ See Cowan, *supra* note 3; Goldstein, *supra* note 231.

²⁴⁸ Cowan, *supra* note 3; Goldstein, *supra* note 231.

fied in the blank check schemes of the 1980s.²⁴⁹ Then, penny stock brokers were able to control the flow of information regarding the typical target company.²⁵⁰ Because of this monopoly of information, investors had little to no hope of verifying the purported “incredible upside” of these “emerging companies.”²⁵¹ The modern SPAC market, however, has featured increasingly prominent private companies going public via SPAC transactions.²⁵² SPAC managers cannot wield the same level of control when merging with nationally recognized brands such as American Apparel and Jamba Juice.²⁵³ Rather than being victimized by this monopoly on information, the public easily tracks the details of these private companies and their SPAC transactions, which are now closely followed in numerous news mediums throughout the country.²⁵⁴

2. The Modern Character of the SPAC Market Has Yielded Greater Competition and Greater Quality

This new cast of characters has yielded a changing market characterized by inner competition.²⁵⁵ The architects of blank check schemes in the 1980s targeted individual investors with little experience and little to no chance of effectively evaluating the risks involved.²⁵⁶ Finding potential customers was thus as easy as opening a phone book and dialing.²⁵⁷ Furthermore, because the private companies targeted by blank check managers were often the product of their imagination, finding a suitable emerging company with “limitless potential” was no more difficult than identifying prospective investors.²⁵⁸

²⁴⁹ See Richardson & Lattman, *supra* note 181; Roane, *supra* note 181; Savitz, *supra* note 182, at 22; Town & Niedernhoffer, *supra* note 134.

²⁵⁰ H.R. REP. NO. 101-617, at 10–13.

²⁵¹ *Id.* at 9–12.

²⁵² See Ken MacFadyen, *SPAC Invaders: While Blackstone Stole the Headlines, Hedge Fund GLG Partners Used a Back Door Method to Achieve a Public Listing*, MERGERS & ACQUISITIONS: THE DEALMAKER'S J., Aug. 1, 2007, at 26–27.

²⁵³ See *id.*

²⁵⁴ See, e.g., Stephanie Kang, *American Apparel Seeks Growth Through an Unusual Deal*, WALL ST. J., Dec. 19, 2006, at B1.

²⁵⁵ See Kelly Holman, *The New Deal Club: As Bulge Brackets Line Up Behind SPACs, Should PE Firms Start to Sweat?*, INVESTMENT DEALERS DIG., Dec. 17, 2007, at 22–26; Lina Saigol, *Need for Safety Helps Growth of SPACs*, FIN. TIMES, Dec. 17, 2007, at 21.

²⁵⁶ H.R. REP. NO. 101-617, at 9–12.

²⁵⁷ *Id.* at 10–12.

²⁵⁸ *Id.*

Conversely, the SPAC market has become increasingly competitive as this investment vehicle continues gaining market credibility.²⁵⁹ Instead of picking up a phone book and instituting pressure campaigns rife with misinformation in order to manipulate inexperienced investors, today's SPACs must attract extremely sophisticated institutional investors and hedge funds in order to generate sufficient proceeds in the initial offering.²⁶⁰ Accordingly, SPACs are forced to take measures to make themselves an attractive investment.²⁶¹ After evaluating the SPAC during the initial offering period, stockholders are given a second chance to evaluate their investment once management has identified a target company.²⁶² When investors find prospective targets unattractive, for whatever reason, they have the automatic right to convert their shares to cash.²⁶³

Within this competitive market, SPACs have also had to differentiate themselves from other investment vehicles.²⁶⁴ A SPAC is often a more attractive investment opportunity than other public shell companies because it has been formed precisely for the purpose of taking a private company public.²⁶⁵ As such, it has no operating history, and likely no contingent liabilities.²⁶⁶ In addition to competing with other investment vehicles, the recent proliferation of SPACs has led to increased competition among SPACs themselves.²⁶⁷

Furthermore, the competition does not end after the IPO.²⁶⁸ In addition to competing for investors at this initial stage, so as to garner sufficient capital to engage in a business combination, SPACs must also compete for target companies.²⁶⁹ In order to remain viable, a SPAC has to present an attractive alternative to going public through the tradi-

²⁵⁹ See Richardson & Lattman, *supra* note 181; Roane, *supra* note 181; Savitz, *supra* note 182, at 22; Town & Niedernhoffer, *supra* note 134.

²⁶⁰ See Avery, *supra* note 1, at 82–87.

²⁶¹ See Richardson & Lattman, *supra* note 181; Roane, *supra* note 181; Savitz, *supra* note 182, at 22; Town & Niedernhoffer, *supra* note 134.

²⁶² See Anderson, *supra* note 214.

²⁶³ See Richardson & Lattman, *supra* note 181; Roane, *supra* note 181; Savitz, *supra* note 182, at 22; Town & Niedernhoffer, *supra* note 134.

²⁶⁴ See Holman, *supra* note 255, at 22–26; Saigol, *supra* note 255.

²⁶⁵ See Richardson & Lattman, *supra* note 181; Roane, *supra* note 181; Savitz, *supra* note 182, at 22; Town & Niedernhoffer, *supra* note 134.

²⁶⁶ See Richardson & Lattman, *supra* note 181; Roane, *supra* note 181; Savitz, *supra* note 182, at 22; Town & Niedernhoffer, *supra* note 134.

²⁶⁷ See Davidoff, *supra* note 181.

²⁶⁸ See Richardson & Lattman, *supra* note 181; Roane, *supra* note 181; Savitz, *supra* note 182, at 22; Town & Niedernhoffer, *supra* note 134.

²⁶⁹ See Richardson & Lattman, *supra* note 181; Roane, *supra* note 181; Savitz, *supra* note 182, at 22; Town & Niedernhoffer, *supra* note 134.

tional IPO process.²⁷⁰ Once a private company has made the decision to go public through either a reverse merger or reverse triangular merger with a public shell, a SPAC must differentiate itself from other public shells and from other SPACs.²⁷¹

This increased competition with other investment vehicles, other public shells, and other SPACs at both the initial offering and business combination stage has led to greater investor protection in SPAC transactions.²⁷² As part of this effort, SPACs have voluntarily self-imposed many of the Rule 419 restrictions that technically do not apply.²⁷³ In recent deals, SPACs have even put away as much as 95 percent of funds garnered in the initial offering into an escrow account.²⁷⁴ In some instances, the underwriter has put a portion of its fees into the same account until an acquisition has been made.²⁷⁵ Unlike a private equity investment, SPAC shareholders thus have the ability to help determine whether a particular business combination takes place, and they have immediate share liquidity.²⁷⁶

Although Nasdaq's current proposal would extend the typical lifespan of a SPAC from eighteen to twenty-four months to a period of thirty-six months prior to liquidation, it promises greater investor protection as well.²⁷⁷ In addition to the regulatory scrutiny of the SEC and perhaps Congress, as SPACs begin listing on more prominent exchanges, they would have to meet the listing standards of the respective exchanges.²⁷⁸ Also, providing a SPAC with a longer period in which it may seek out and come to terms with a suitable target may be better for its investors.²⁷⁹ It may take longer for them to see the returns on their investment, but it could also reduce the bargaining leverage of targets using the deadline to strike a rather favorable deal.²⁸⁰ If investors lose patience, they can always take advantage of the liquidity attendant to any public company and sell their shares.²⁸¹

²⁷⁰ See Klaris, *supra* note 14 at 41, 44; Boehm et al., *supra* note 5.

²⁷¹ See Davidoff, *supra* note 181.

²⁷² See Holman, *supra* note 255; Richardson & Lattman, *supra* note 181; Roane, *supra* note 181; Saigol, *supra* note 255; Savitz, *supra* note 182, at 22; Town & Niedernhoffer, *supra* note 134.

²⁷³ See 17 C.F.R. § 230.419 (2008).

²⁷⁴ Avery, *supra* note 1, at 82–87.

²⁷⁵ *Id.*

²⁷⁶ See Sjostrom, *supra* note 15, at 758.

²⁷⁷ See Press Release, Nasdaq Stock Market, Inc., *supra* note 1.

²⁷⁸ See *id.*

²⁷⁹ See Broude, *supra* note 24, at 76–79.

²⁸⁰ See *id.*

²⁸¹ See Sjostrom, *supra* note 15, at 758.

3. Sufficient Safeguards Exist for Investors

Section 5.06 of Form 8-K, which became effective November 7, 2005, requires a shell company reporting an event that causes it to cease being a shell company to disclose the same type of information it would be required to provide in registering a class of securities under the Exchange Act.²⁸² Effectively, this means that private companies that are going public through a SPAC merger must disclose the same level of information required by an IPO.²⁸³ Accordingly, investors are presented with the same level of information as in any other offering when making the decision whether to purchase or sell shares in the new public operating company.²⁸⁴ Investors thus have sufficient information to evaluate the relative risks and rewards in making such a decision.²⁸⁵

A recent trend is that hedge fund managers are forming SPACs instead of hedge funds.²⁸⁶ Assuming a limited pool of investment managers who would form any of these kinds of vehicles, this may result in enhanced disclosure within the alternative investment industry as investors in such investments are migrated to investment vehicles with disclosure requirements.²⁸⁷ Generally, hedge funds have been viewed as secretive in nature, in large part because of certain provisions in the Securities Act, the Exchange Act, the Investment Company Act of 1940, and the Investment Advisers Act of 1940, which have exempted the majority of hedge funds and their advisers from registering with the SEC.²⁸⁸ SPACs, however, must immediately comply with the Securities Act, the Exchange Act and Sarbanes-Oxley.²⁸⁹

Although an investment in a SPAC, like any other investment, carries with it a potentially high degree of risk, the safeguards built into the bylaws of these corporations provide investors with considerably more protection than other investment vehicles.²⁹⁰ First, SPACs keep at least 80 percent of IPO proceeds in an escrow account, thereby protecting

²⁸² See 17 C.F.R. § 249.308 (2008); Use of Form S-8, Form 8-K, and Form 20-F by Shell Companies, 70 Fed. Reg. 42,234 (July 21, 2005); Hogan, *supra* note 9, at 13.

²⁸³ See 17 C.F.R. § 249.308; Use of Form S-8, Form 8-K, and Form 20-F by Shell Companies, 70 Fed. Reg. 42,234; Hogan, *supra* note 9, at 13.

²⁸⁴ See 17 C.F.R. § 249.308; Use of Form S-8, Form 8-K, and Form 20-F by Shell Companies, 70 Fed. Reg. 42,234; Hogan, *supra* note 9, at 13.

²⁸⁵ See 17 C.F.R. § 249.308; Use of Form S-8, Form 8-K, and Form 20-F by Shell Companies, 70 Fed. Reg. 42,234; Hogan, *supra* note 9, at 13.

²⁸⁶ See Tiffith, *supra* note 19, at 509-14.

²⁸⁷ See *id.*

²⁸⁸ See *id.*

²⁸⁹ See Broude, *supra* note 24, at 76-79.

²⁹⁰ See Macfadyen, *supra* note 252, at 26-27.

against inappropriate uses of the publicly raised funds.²⁹¹ Second, unlike investors in private equity funds or hedge funds, investors in SPACs have immediate liquidity.²⁹² This enables them to sell their shares at a moment's notice, whereas private equity and hedge fund investments are normally subjected to minimum commitment periods as long as ten years.²⁹³ Third, investors in a SPAC have a say over whether a business combination takes place.²⁹⁴ Unlike other investment vehicles, the board of directors of a SPAC must disclose a significant amount of information in its proxy materials, making its business decisions considerably more transparent.²⁹⁵ If shareholders harbor any doubt over a proposal, they can vote against a transaction or convert their shares to cash.²⁹⁶ Finally, if, at the end of the day, the SPAC goes south, shareholders at least get a pro rata share upon liquidation.²⁹⁷ This pro rata share generally does not equal the initial investment; however, unlike other investment vehicles, it helps to cap potential for loss.²⁹⁸

C. SPACs Facilitate Capital Formation

In addition to the large increase in quality, modern-day SPACs could positively impact the economy.²⁹⁹ The cost of going public through an IPO has become more and more expensive, contributing to an overall slowdown in the IPO market.³⁰⁰ In addition to the costs of regulatory compliance, private companies evaluating the risks of an IPO often determine that these potential hazards outweigh the possible benefits of becoming a public company.³⁰¹ For some emerging companies, going through the IPO-process is not even an option because they are incapable of finding an underwriter willing to conduct the offering.³⁰² Although the SEC must play some sort of formal and informal gatekeeping role with regard to becoming a public company, sound

²⁹¹ Town & Niedernhoffer, *supra* note 134; Boehm et al., *supra* note 5.

²⁹² See Sjostrom, *supra* note 15, at 758.

²⁹³ *Id.*

²⁹⁴ Town & Niedernhoffer, *supra* note 134; Boehm, et. al, *supra* note 5.

²⁹⁵ See Michael Delaney, *SPACtacular: Resurgence of the Blank-Check Company*, MERGERS & ACQUISITIONS J., June 1, 2006, available at 2006 WLNR 9392913.

²⁹⁶ Town & Niedernhoffer, *supra* note 134; Boehm et al., *supra* note 5.

²⁹⁷ Town & Niedernhoffer, *supra* note 134; Boehm et al., *supra* note 5.

²⁹⁸ See Hester, *supra* note 19; Lina Saigol, *Need for Safety Helps Growth of SPACs*, FIN. TIMES, Dec. 17, 2007, at 21.

²⁹⁹ See *infra* notes 300–323 and accompanying text.

³⁰⁰ Smith et al., *supra* note 1; Klaris, *supra* note 14, at 41, 44; Boehm et al., *supra* note 5.

³⁰¹ Smith et al., *supra* note 1; Klaris, *supra* note 14, at 41, 44; Boehm et al., *supra* note 5.

³⁰² Sjostrom, *supra* note 15, at 758.

policy would promote alternative methods by which emerging companies may access the capital markets.³⁰³

As the subprime mortgage crisis brings talk of an imminent recession, the SEC should be acting to facilitate capital formation instead of singularly fixating on the protection of investors.³⁰⁴ Some commentators have pointed to the incredibly high amount of leverage in the market as the basis for the current credit crunch.³⁰⁵ Massive levels of debt underlying the world economy system are unwinding, leading some analysts to predict an impending bear market of “epic proportions.”³⁰⁶ As a result, leveraged buyouts (“LBOs”) have “all but disappeared,” as borrowing costs nearly doubled from June 2007 to December 2007.³⁰⁷ LBOs in the United States fell from \$322.4 billion in the first six months of 2007 to \$103.2 billion in the second half of the year as the subprime mortgage market collapsed.³⁰⁸

SPACs present an opportunity for private companies to infuse themselves with large amounts of cash in equity as opposed to debt.³⁰⁹ Enabling private companies to access these infusions of cash outside of private investment could help them expand rapidly.³¹⁰ Such entities have the ability to continue growing both internally and through ac-

³⁰³ See Hester, *supra* note 19.

³⁰⁴ The SEC’s mission statement is threefold: to protect investors; to maintain fair, orderly and efficient markets; and to facilitate capital formation. *Encouraging Small Business*, *supra* note 41. SEC chairman Christopher Cox has recognized that the securities markets and its participants have been markedly impacted from the widespread packaging and selling of residential mortgages as securities issued by special purpose trusts that qualify for off-balance sheet treatment. *The State of the United States Economy and Financial Markets: Hearing Before S. Comm. on Banking, Housing, and Urban Affairs*, 110th Cong. (2008) (statement of Christopher Cox, Chairman, SEC), available at <http://sec.gov/news/testimony/2008/ts021408cc.htm>. As mortgage delinquencies have risen, other financial instruments tied to the value of those mortgages have declined in value. *Id.* Cox has acknowledged that

[t]he resulting large losses for some market participants, the concern in the markets about the future performance of a range of complex structured finance instruments, and the more generalized concern about the effects on credit markets overall have led to a more risk-averse environment, and have contributed to a slowdown in the rate of the nation’s economic growth.

Id.

³⁰⁵ John Markman, *Are We Headed for an Epic Bear Market?*, MSN MONEY, Sept. 20, 2007, <http://articles.moneycentral.msn.com/Investing/SuperModels/AreWeHeadedForAnEpicBearMarket.aspx>.

³⁰⁶ *Id.*

³⁰⁷ Hester, *supra* note 19.

³⁰⁸ *Id.*

³⁰⁹ *See id.*

³¹⁰ *See id.*

quisitions because they will be lightly leveraged compared to LBOs.³¹¹ If these cash infusions had come from bank borrowing rather than from equity, the companies involved would have substantial annual interest expenses.³¹² This ability to thrive in such a credit-poor environment has helped SPACs become one of Wall Street's only positive performers in an otherwise dismal year.³¹³

The immediate growth that SPACs facilitate in certain private companies may also sustain gains in employment.³¹⁴ Several studies suggest that fast-growing companies account for a very large portion of employment growth.³¹⁵ As much as 50 percent of employment growth may come from fast-growing new companies like Google.³¹⁶ In addition to creating job growth, enabling more companies to access the capital markets helps support the market itself.³¹⁷ In 2007, Wall Street earned \$770 million from the sale of shares in sixty-four SPACs, and SPAC offerings accounted for 25 percent of all IPOs and 20 percent of the aggregate money raised.³¹⁸ This helped counter the overall reduction of earnings for IPOs.³¹⁹ The importance of maintaining potential revenue-generators for Wall Street during IPO-slowdowns has recently been illustrated rather dramatically by the "fire sale" of Bear Stearns, the demise of Lehman Brothers, the sale of Merrill

³¹¹ *Id.* The outlook for LBOs in the private equity industry is even more dismal for 2008, in large part because of the credit crunch, which has "siphoned off the fuel that makes the private equity machine run." Andrew R. Sorkin, *Live From Germany: Super Return 2008*, N.Y. TIMES DEALBOOK, Feb. 26, 2008, <http://dealbook.blogs.nytimes.com/2008/02/26/live-from-germany-super-return-2008/index.html?hp>. The industry seems to expect an increase in equity deals with minority stakes, and few, if any, LBOs. *Id.*

³¹² Richard C. Breeden, Chairman, SEC, Remarks at the International Organization of Securities Commissions (Sept. 24, 1991).

³¹³ Holman, *supra* note 255.

³¹⁴ See Edmund Andrews, *Where Do the Jobs Come From?*, N.Y. TIMES, Sept. 21, 2004, at G11. During the second week of March 2008, the number of newly laid-off workers filing for unemployment benefits rose to its highest level in nearly two months, providing more evidence that the faltering economy is adversely impacting the labor market. Martin Crutsinger, *Jobless Claims Jump More Than Expected*, DETROIT FREE PRESS, Mar. 20, 2008, available at <http://www.freep.com/apps/pbcs.dll/article?AID=/20080320/07/80320025>.

³¹⁵ Crutsinger, *supra* note 314.

³¹⁶ *Id.* Some analysts have referred to such companies as "gazelle" companies—"young enterprises with pioneering ideas that quickly grow into big companies." *Id.*; see also Rebecca Buckman & Kara Scannell, *Venture Capital: Do U.S. Regulations Drive Away Start-Ups?*, WALL ST. J., Apr. 27, 2006, at C5 ("Promising young companies that can't go public could expand more slowly and create fewer jobs If large U.S. companies such as Dell Inc. or Google Inc. hadn't pursued initial public offerings, they likely wouldn't have contributed so much to the U.S. economy.").

³¹⁷ See Davidoff, *supra* note 181.

³¹⁸ *Id.*

³¹⁹ *Id.*

Lynch & Co., and the government bailout of the U.S. financial system.³²⁰

Finally, because SPACs generally do not rely on significant amounts of leverage to finance transactions, their potential economic benefits are not offset by any considerable dangers imploding SPACs could cause to the global financial market.³²¹ The SEC has recently emphasized the havoc that the collapse of highly leveraged hedge funds could reek on the financial community in its latest attempts to modify regulation of that industry.³²² As such, the recent decisions of hedge funds to utilize SPACs to accumulate capital, as opposed to continuing to use significant levels of debt, should come as a relief.³²³

CONCLUSION

The PSRA and subsequent SEC regulations regarding blank-check companies came in response to a national crisis within the penny stock market. At the time, stringent regulation of such entities was appropriate to curb systemic manipulative and fraudulent practices. Modern-day SPACs, however, do not display the alarming characteristics that made the blank-check companies of the 1980s so devastating to the credibility of the U.S. markets. Rather, the recent upsurge in SPAC transactions displays a trend towards increased quality within the SPAC market.

On their own, SPAC transactions have replaced second- and third-tier underwriters with reputable international powerhouses like Goldman Sachs, Citigroup, and Deutsche Bank. Such increased issuer quality was a primary goal of blank-check company regulation; however, where the market has achieved such a result, Congressional and SEC regulations have failed. Moreover, inexperienced private investors have been replaced with highly sophisticated institutional investors and hedge funds, and largely obscure targets are beginning to be replaced by rather prominent private companies.

³²⁰ See Emergency Economic Stabilization Act of 2008, Pub. L. 110-343, 122 Stat. 3765; *Bear Stearns Fire Sale Hammers Stock Futures*, REUTERS, Mar. 17, 2008, <http://in.reuters.com/article/companyNews/idINN1755682020080317>; Carrick Mollenkamp et al., *Crisis on Wall Street as Lehman Totters, Merrill Is Sold, AIG Seeks to Raise Cash*, WALL ST. J., Sept. 15, 2008, at A1.

³²¹ See Tiffith, *supra* note 19, at 531.

³²² See *Goldstein v. Sec. & Exch. Comm'n*, 451 F.3d 873, 874 (D.C. Cir. 2006) (identifying the SEC's concern with potential impacts of failed hedge funds on the global financial markets before striking down the Hedge Fund Rule).

³²³ See *id.*; Daniel Sargon, *Hedge Fund Registration: Yesterday's Regulatory Schemes for Today's Investment Vehicles*, 2007 COLUM. BUS. L. REV. 247, 251; Tiffith, *supra* note 19, at 509-14.

The slowdown in both the IPO market and the economy at large suggests that alternative routes for emerging companies to access the capital markets should be promoted. Consequently, when considering regulatory issues involving public shell companies, the SEC should reconsider its apparent distaste of SPACs. Even in the wake of the penny stock fraud of the 1980s, the authors of the PSRA were careful to avoid delegitimizing the blank check structure itself, instead emphasizing the necessity of providing individual investors with sufficient information to thoroughly evaluate their investment decisions. Continuing to curb the pace of SPAC offerings thus reflects a misguided attempt to protect investors at the expense of allowing this latest Wall Street innovation to facilitate capital formation.

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