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WALL STREET SPAC BUBBLE: LEARNING TO INDIAN SECURITIES MARKET

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SPACs: AN INTRODUCTION

Special Purpose Acquisition Companies (SPACs) have been around for decades in the US and now gaining popularity in Asian financial markets such as Hong Kong, Singapore and India. The SPACs have proved to be a better alternative of traditional IPOs as it is functionally beneficial to all the parties involved in it i.e., sponsors; investors; and target companies. Sponsors are the initiator of SPAC who bear the maximum risk as a non-refundable investment for operating expenses- fee to lawyers, bankers, accountants. People investing in the entity when offered to public are the investors of the SPAC. The private companies that are going to be acquired by the sponsors through the listed SPAC are known as Targets.

These shell companies are publicly traded corporations, set up to raise money through IPO to eventually acquire a private entity that needs capital for growth. SPACs have no assets, no products or services (business model) of their own, as a matter of fact the capital raised in the IPO is the only asset it has.

Target private entities prefer SPACs to go public because they often get better valuations and terms; and pose lesser regulatory demands than a traditional IPO. It also de-risks and shrinks the process of getting listed.

This article aims to propose regulatory measures by identifying the problems that caused bubble in US.

SPAC BUBBLE IN WALL STREET

Generally, the dynamics of a bubble goes like this- initially the high popularity of a controversial financial innovation- Incorporation of SPACs in this case- sets in motion the imitation of it; increasing adoption of practice makes the investors and media skeptical; the skepticism gets sharpen as relatively low-grade firms transact increasingly; it discourages the reputed firms to transact in the practice because of negative media coverage and poor market valuations; and it gets further discouraged by the regulator by providing warning.

In the recent past years SPACs proliferated in the US market and grew at such an exponential rate that it outperformed its previous year data[1] of no. of listing and gross proceeds till its burst.

Critics noted the dynamics of bubble in the SPACs market and published numerous remarks and papers prior to the burst. David Solomon, chief executive officer of Goldman Sachs, a major underwriter of many of the SPAC deals, apprised[2] in January 2021, that the boom is not "sustainable in the medium term." And it was evident by the frenzied growth of the no of the SPAC IPOs in the market.

[1] *SPAC IPO Transactions Statistics - by SPACInsider*. (n.d.). SPACInsider.

[2] Goldman chief executive says Spac boom is unsustainable. (2021, January 19). *Financial Times*.

Officials such as regulatory board members, bankers, legal consultants and academics have often asserted negative and cautionary statements publicly. Even the SEC chairman, Jay Clayton[3], in September 2020 said that SEC is vetting to guarantee that SPAC shareholders "are getting the same rigorous disclosure that you get in connection with bringing an IPO to market."

Poor quality players fueled the market bubble as they had nothing to offer to public in terms of business plan. It makes people more exposed to the risk of losing capital because they had bet only on the name of investor and now the target is also functionally weak. Stock prices of public companies listed through SPAC like Nikola[4], an electric truck manufacturer and ATI Physical Therapy Inc.[5] have plummeted multifold after flying high in initial days; invited law suits from shareholders accusing fraud & irrational forecast of company's future; and have lost considerable capital of investors.

And with only limited quality targets to acquire within the time limit, the SPAC sponsors had to complete the acquisition even at the cost of shareholders value. A SPAC bubble got fueled by these negative loop of bad transactions/stricter regulations/negative market sentiment.
The boom of SPAC IPOs, in-fact, planted the seed of its own demise. The rapid proliferation of the practice plagued by bad market players, negative media remarks and regulatory concerns deflated the bubble of illegitimate practice, though gradually. The SEC[6] realized that the SPACs are going to be in the market for long; hence it came up with new set of rules for better regulation.

WHAT CAUSED BUBBLE

1. **Easy-going regulations:** The regulatory environment of SPAC was far more lenient as compared to traditional IPOs. Underwriter liabilities were less imposed on them. SPACs were protected from the liabilities arising out of future centric statements and projections under the Private Securities litigation Reform Act, 1995[7]. The process of going-public of SPAC was regulated as per merger rules[8] and not public offering rules, this substantially lowered the risk of litigation against the sponsors because it did not impose as strict liabilities related to the misinformation & misstatement in the offer document as imposed on Merchant banks in case of traditional IPOs. In fact, SPAC got popular because of its features of taking capital seeking entities public by surpassing the regulatory checks. Such provisions led to some serious issues such as loss of investor's capital, law suits mainly from long-term investors accusing irrational projections of future.

[3] Naumovska, I. (2021, February 18). The SPAC Bubble Is About to Burst. *Harvard Business Review*.
[4] Dec 21, A. /, 2021, & Ist, 20:40. (n.d.). *EV start-up Nikola settles with US for USD 125 million - Times of India*. The Times of India. Retrieved October 19, 2022
[5] *SPAC-Backed ATI Physical Therapy Stock Drop Sparks Investor Suit*. (n.d.). News.bloomberglaw.com. Retrieved October 19, 2022
[6] Franck, T. (n.d.). *SEC targets SPACs with rules on inflated business forecasts, merger disclosures*. CNBC. Retrieved October 19, 2022
[7] (2022). Govinfo.gov.
[8] Bai, J., Ma, A., Zheng, M., Baker, M., Bernstein, S., Greenwood, R., Hanson, S., Hoberg, G., Lerner, J., Mathews, R., Ravid, A., Shleifer, A., Sunderam, A., Vallée, B., Viceira, L., Wallen, J., & Ye, M. (n.d.). *Segmented Going-Public Markets and the Demand for SPACs*. Retrieved October 19, 2022

2. **Compensation Structure:** Unlike the traditional public offering market where Merchant banks get fixed proportion of capital from IPO, the SPAC sponsors get equity-based compensation and get a snippet of equity in target firm, known as “founder share”. The high anticipation of litigation cost induces the merchant banks to take only safer entities to public. So, the market of inherently risky and value-creating firms seeking public capital was catered by SPAC, as they were less constrained by the expected litigation costs. SPACs have a limited life span, usually 24 months, to effect a merger with target entity. So, considering the compensation structure; involvement of risky deals and that to in a limited period, it would make more sense for a SPAC sponsor to close deals rather than liquidating the listed entity. It corrupted the whole system with fraudulent/inefficient deals at the cost of retail investor’s capital.

3. **Existing bad practices:** The recent[9] public listings of the unicorn startups were pre-mature and alleged to be a secure way out to the existing shareholders -venture capital firms, hedge funds managers, private equity firms- through offer for sale. Most of these are still loss-making companies; have uncertain futures; and constantly facing negative governmental intervention in their way to be profitable. The regulators must impose stringent rules to curb these practices and ensure that no one is making profit on the cost of other investors. The regulators must impose stricter rules such as lock-in period, pre-IPO investor’s contribution, and negative covenants to ensure the shares are not disposed of in any other manner. These rules are imperative to shield the public investors from the unethical benefit to the pre-IPO investors.

4. **Other issues:** A typical SPAC deal has more complex issues than one might think. It is known that going public by way of SPAC merger provides better valuation to the target than traditional way of public offering; however, the sponsor plays the role to rationalize this decision -paying more money in the deal- to the investor.

SPAC sponsors have an upper hand over investors in terms of information of the acquired entity; as SPACs do not have to adhere to such strict disclosure requirements as the IPOs. This creates an asymmetry between sponsors and investors in terms of information and power which eventually might lead to unfair advantages to the sponsors.

Sponsors of a SPAC earn on the basis of listed firm’s long-term outcome. When the firm earns projected returns, sponsors sell off the shares to book profits. The provision of lock up period, provisionally 1 year, develops a short-term mindset among sponsors. This can potentially smash up the whole system with sponsors exploiting their role of being a certification intermediary, letting the poor firms in the market, and keeping the unfavorable news quiet and only letting it out after their exit.

LESSONS TO INDIAN MARKET

Though SPACs were stifled by the corrupt market activities initially; but its potential to

[9]Groh, A. P., Proelss, J., Sannajust, A., & Schweizer, D. (2022). Leave no Money on the Table: Venture Capitalists’ SPAC Exits. *SSRN Electronic Journal*.

encourage entrepreneurial & innovative activities- ushering the risky, value creating firms to the public market- helped realizing its long-term goals by overcoming the hurdles.

SPAC sponsors perform the non-bank certification intermediary role to serve the market of small, value creating and risky firms turned down by the Merchant banks. These firms are mainly capital seeking, later stage startups. Such pressing economic role[10] also rationalizes the persistent existence of the SPACs.

But the riskiness of firms coalesced with the potential problems of agency in SPACs could lead to inordinate risk taking. Hence, to promote financial stability and protect investors it is exigent to identify and attenuate these sources of conflict. A hopeful prospect here is that Indian market can very well learn and thrive on the mistakes of west. Some propositions pertaining to the regulation could be.

1. **Disclosure requirements:** The regulator must impose strict disclosure rules on both the private firm and the listed SPAC. A SPAC, BowX Acquisition Corp.[11], which was initially listed "to focus our search on target businesses in the technology, media and telecommunications industries," got merged with a startup, WeWork, of real estate sector. This indicates the failure of regulatory institution to rein back the listed entities. An impartial disclosure of information alleviates asymmetric information between sponsors and investors & thus substantially subside the agency issues in the market.

2. **Regulating entry in the market by imposing strict liabilities:** The sponsors of a SPAC though perform similar functions as merchant banks but are less exposed to the liabilities. SPAC sponsors act as non-bank certification intermediary and match the potentially value-creating firm with investors of matching risk appetite. Since the diligence is not that rigorous and does not impose much litigation cost post-merger, it opens the market for bad firms on the cost of investor's capital. So SPAC sponsors must be imposed with underwriter liabilities similar to the merchant banks to govern the entry of firms in public market and listing of SPACs.

3. **Consideration of Indian startup ecosystem:** Indian startup ecosystem is not mature enough. Later stage startups are still on a long way to profitability; even the listed new age companies like Zomato[12], Paytm[13] are incurring huge losses. Moreover, as compared to US, the no. of private entities in India is very less to be able to go public. This can create an imbalance in the demand and supply of targets; and if the demand increases it might lead to the acquisition of poor firms by the sponsors due to some misaligned incentives. It results in the erosion of capital of the investors. The regulators must secure third-party (investors) concerns by making proper rules for eligibility requirement such

[10] Bazerman, M. H., & Patel, P. (2021, July 1). *SPACs: What You Need to Know*. Harvard Business Review.

[11] *FORM S-1 REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933*. (2020). Sec.gov.

[12] Finology ventures private ltd. (2022). *Finology Ticker*. Https://Ticker.finology.in/; Finology Ticker - Stock Screener.

[13] Finology Ventures Private Ltd. (n.d.). *One97 Communications Share Price, Financials and Stock Analysis*. Https://Ticker.finology.in/. Retrieved October 19, 2022

as percentage of anchor investor, profit making threshold amongst others.

The market regulator must establish better governance by making additional set of rules such as- mitigating the cost to target company by regulating the irrational offering of shares to SPAC sponsors, leniency as to the time constraint for acquisition, not let the existing shareholders to treat IPO as a safe exit from the company.

The national market regulator- SEBI- is still considering the entry of SPACs and is in the process[14] of formulating the guidelines to govern it. But International Financial Services Centers Authority (IFSCA) has published guidelines[15], though not exhaustive, for SPAC market in the IFSC. Governance of SPAC market is still based on some vague and discretionary rules subjected to the Authority.

CONCLUSION

The failure of the US financial market to regulate the SPACs has proved beneficial for Indian market. A bubble was experienced in the SPAC market of US because of incompetency of the market regulators. The practice, however, did not go out of market due to its indispensable economic role. SPACs are a revolution in the public and private capital markets. It provides a capital raising opportunity to wider universe of startups; and fuel innovation & growth. Since a perspective has developed that SPACs are a legitimate way of seeking capital from public, it is imperative for leaders and regulators to know how the game is played.

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[14] SHAH, P. (2022, May 19). *SEBI readies framework for SPAC listing in India*. Www.thehindubusinessline.com.
[15] IFSCA. (2021a). *International Financial Services Centres Authority*. Ifsca.gov.in.