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## 3 Financial Market Areas That Need Better Disclosure Regimes

By **Adam Hollander and Thomas Sperber** (May 4, 2022, 5:10 PM EDT)

Over the past two years, following the extreme volatility and declines that characterized the early days of the COVID-19 pandemic in March 2020, capital markets and the investors who feed them have exhibited substantial growth and activity.

Major stock market indices such as the Dow Jones Industrial Average are trading well above pre-pandemic highs. Prices and trading volumes of digital assets including cryptocurrencies are far higher than historical levels. In 2020 and 2021, investors poured money into special-purpose acquisition companies, with SPAC initial public offering proceeds topping \$160 billion in 2021 alone.

Whether considering traditional equities, emergent digital asset classes or SPACs' — often false — promise of rapid growth, investors increasingly find themselves reliant on inadequate and incomplete information. The present need for robust disclosures to help avoid or mitigate investor harms ranging from volatility and uncertainty to outright fraud and abuse is particularly glaring.

It is axiomatic that disclosure helps investors make better investment decisions, because knowledge about how a company operates, or a security performs, in the present is one of the few indicators of what it will do in the future. Digital asset and SPAC markets are rife with risk, but frequently lack the key disclosures that public investors have relied on to make informed investment decisions.

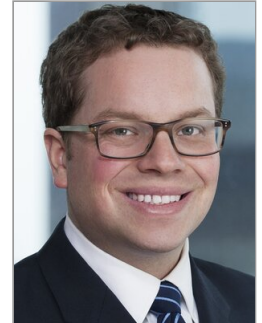
At the same time, the SEC's recently proposed environmental, social and governance, or ESG, disclosure rules reflect the need for flexible requirements that can accommodate ever-shifting sets of both on-the-ground realities and investor concerns.

### Digital Assets: Protecting Against Volatility and Abuse

Estimates of the aggregate market capitalization of all digital assets have skyrocketed over the last two years, growing from about \$150 billion in mid-March 2020 to close to \$2 trillion currently. And that market has been characterized by extreme volatility, with that aggregate market cap approaching a peak of \$3 trillion as recently as last November, after a valley of about \$1.2 trillion last July, and substantial fluctuations throughout.

Yet as investors pour money into this highly speculative asset class, fundamental questions persist for particular coins and tokens and for crypto as a whole:

- Are these securities, commodities or currencies?
- Are they — and should they be — subject to oversight by the U.S. Securities and Exchange Commission, the U.S. Commodity Futures Trading Commission or some other body?



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- Are existing regulatory rules and legal frameworks sufficient, or do Congress, regulators and the courts need to develop new rules and understandings to govern crypto investments?

Many of the same ostensible benefits crypto advocates tout — including that they allow for investing and anonymized transactions outside of traditional governmental and financial ecosystems — underscore the risks investors face. Particularly for coins or tokens that are not tethered to any thing of tangible or intrinsic value, future value and performance is exceedingly hard to predict, and volatility may be driven not by any underlying fundamentals but rather by whims and manipulation.

Bitcoin, the largest cryptocurrency, has seen unprecedented growth since late 2020, but it is still subject to massive swings in value — plunging 30% in one day in May 2021. Many of dogecoin's greatest spikes and dips have been attributed to memes and jokes tweeted by Tesla Inc. CEO Elon Musk.

The decentralized nature of cryptocurrency also makes it ripe for fraud. In 2021 alone, online scammers stole \$14 billion in cryptocurrency. Federal prosecutors are pursuing charges against a husband and wife allegedly responsible for the 2016 hack of crypto exchange Bitfinex, in which hackers stole digital assets presently valued at more than \$4.5 billion.

Other examples abound; although fraud and abuse are not unique to digital assets, investors' vulnerability and inability to hold wrongdoers accountable is particularly acute in that class.

Whether considered as stores of value, assets to transact akin to cash, or otherwise, the long-term sustainability and usefulness of digital assets will rely in large part on investors' ability to make informed decisions about capital allocation, enabling greater accountability through the regulation, oversight, and enforcement that robust disclosures enable.

The outcome of certain disputes, including the SEC's current litigation against Ripple Labs Inc. over whether digital asset XRP is — and will be regulated as — a security or a commodity, may create an easier path to more protected, better informed, investors.

Likewise, digital asset exchanges that proactively and carefully vet their products and impose rigorous listing requirements, should enable broad protection while preserving the benefits that draw investors to digital assets.

Those protections, alongside a robust disclosure regime for cryptocurrency, would help ensure that investors were better educated about the risks associated with decentralized currency, and give victims of cybercurrency fraud a straightforward avenue to prosecute scammers.

### **SPACs: Drawing a Blank (Check)**

By design, SPACs — so-called blank-check companies that go public and subsequently seek a merger or similar transaction with a private entity, allowing that entity to go public — lack the requisite disclosures associated with traditional IPOs. Absent their own operations, financial projections, or track record, SPAC investors are left with little to evaluate any particular SPAC, and may instead be swayed by the presence of a celebrity sponsor or some other alluring, but ultimately inconsequential, factor.

Like cryptocurrencies, SPACs were not considered mainstream investments until relatively recently. But in the past two years SPACs exploded in popularity, representing 59% of all IPOs in 2021, which saw twice as many SPAC IPOs as 2020, itself a record year at the time.

While the COVID-19 pandemic likely contributed to SPACs' banner year, commentators have also attributed SPACs' recent meteoric rise to the fact that SPACs are largely unregulated and had dramatically less onerous disclosure requirements as compared to traditional IPOs.

The same lack of regulation, particularly in the area of disclosure, that made SPACs so appealing to some made others wary. SPACs are structured as a win-win for insiders.

Hedge funds that invest early have a surefire path to a handsome profit by selling prior to the

business combination, and the SPAC's sponsors receive valuable warrants for a fraction of their worth while their shares convert to an automatic, substantial stake in the combined company. Even if the post-merger entity is a loser for retail investors, the insiders win, creating adverse incentives for sponsors and hedge funds to build up hype and then get out fast.

Sure enough, the bottom fell out of the SPAC boom early this year. Over 600 SPACs have failed to find a merger target, and many of those that did manage to eke out a business combination since 2020 have performed underwhelmingly. The number of public company restatements more than quadrupled from 336 in 2020 to 1,441 in 2021, largely driven by the increased accounting scrutiny and compliance obligations that apply once the previously private SPAC target goes public.

Investors are redeeming their SPAC shares rather than continuing to invest in the post-deSPAC entities at record pace, and SPAC IPOs are down more than 80% the first quarter of 2022, as compared to last year. While it's clear that retail investors have suffered from the SPAC boom and bust, it's not at all clear that insiders suffered the same fate.

Potential changes to SEC regulations for SPACs could restore investors' collective faith in the model. If SPACs become more transparent — resulting in investors learning about what the insiders stand to gain, and what the outsiders stand to lose — they might just regain footing in the IPO market.

Likewise, more stringent auditing requirements before de-SPAC transactions close will allow investors to consider the soundness of their SPAC investments.

To make up the ground SPACs have lost, their proponents will need to win over investors with credibility and security, as opposed to glitz, glamour and bullish expectations. Better disclosures are critical to achieving this goal.

### **Doing Well by Doing Good**

Investor demands for greater corporate responsibility — and the very real exposure companies face from environmental damage, poor governance, and other high-profile malfeasance — highlight the growing importance of corporate disclosures that focus on a broader set of concerns beyond primarily financial reporting and related information.

Yet investors have largely been left to navigate corporate disclosures on these important items on their own in the absence of universal ESG disclosure standards. Only half of S&P 100 companies produce a sustainability report, and even those companies that have voluntarily reported on ESG rarely include such disclosures in their SEC filings.

The SEC's recently proposed ESG disclosure rules, including changes to require issuers to include climate-related disclosures in their public filings, are a step in the right direction.

More standardized disclosures about both the present and future environmental impacts of a company's operations, as well as the company's present and future exposure to the effects climate change, will enable investors to better assess whether their investment activity is consistent with their investment strategies and values.

And to be clear, enhanced and uniform ESG disclosure rules are about much more than feeling good; they are crucial to investors' ability to make informed decisions about the related financial upsides and downsides of their investment decisions.

### **Conclusion**

Disclosures are not a panacea. Certainly, as public and private enforcement of securities issuers makes clear, fraud and abuse are a constant regardless of what is going on broadly in the world and in the capital markets. But more robust disclosures would provide investors and regulators alike with critical information to guard against manipulation and abuse, as well as powerful tools to police misconduct when it arises.

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