

'Blank Check' IPOs Alarm NASD Amid Resurgence of Unnamed Deals

By Elizabeth Hester

Sept. 5 (Bloomberg) -- A type of initial public offering that vanished in the 1990s in a wave of scandals is making a comeback, and regulators say they are concerned investors may be defrauded again.

NASD, which polices more than 5,000 U.S. brokerage firms, says it is investigating the resurgence of "blank checks" -- shell companies that raise money in public markets without saying what they will spend it on.

This year, blank-check companies have sold \$2.2 billion of stock in 28 offerings, and \$4.3 billion more in new issues is planned with help from some of Wall Street's best-known banks and underwriters, including Citigroup Inc. and Merrill Lynch & Co., according to data compiled by Bloomberg. The data from filings show that firms have earned fees averaging 6.4 percent, generating a potential \$417 million.

"I'm not sure that all that's going on with these securities is above-board," says James Shorris, head of enforcement for the Washington-based NASD, formerly known as the National Association of Securities Dealers Inc.

Shorris says he is troubled by the possibility that the renewed trust in blank-check deals will trigger new abuses. NASD is examining whether anyone is trying to artificially create or inflate demand for the shares.

"Several" firms have been queried, Shorris says, declining to name them.

One -- EarlyBirdCapital Inc. -- says it has been contacted by NASD. The Melville, New York-based company has underwritten at least 14 blank-check IPOs since 2004, raising more than \$840 million, according to Bloomberg data.

"We've gotten an inquiry, as have another dozen underwriters, for basic, fact-finding information from them, and we are complying fully," Chairman David Nussbaum says, declining to elaborate.

Unidentified Target

Blank-check companies, also known as special-purpose acquisition companies, or SPACs, sell shares to the public in anticipation of merging with or acquiring an existing business they have not yet identified. Investors bet on the prowess of the shell company's executives, who have 18 months to find a suitable target or return investors' money.

Prospectuses, which spell out terms of an IPO and are filed with the Securities and Exchange Commission, are short on specifics because principals are barred from talking to potential targets before the offering. The most they will do is name an industry or geographic region.

The investments, sometimes called "blind pools," are attracting some big names.

Wozniak, Tenet

Apple Computer Inc. co-founder Steve Wozniak and former White House national security adviser Richard Clarke founded blank-check companies this year that raised more than \$200 million, according to SEC filings.

Former CIA Director George Tenet sits on the board of Granahan McCourt Acquisition Corp., a Hopewell, New Jersey-based company targeting the media and telecommunications industries.

Michael Gross, founder of New York private-equity firm Apollo Management LP, raised \$300 million for Marathon Acquisition Corp. in an offering underwritten by Ladenburg Thalmann & Co. Inc., UBS AG, and Citigroup, the biggest U.S. bank.

Nicolas Berggruen, who used to run a \$1 billion hedge fund, filed Aug. 2 for a New York-based \$330 million blank check called Freedom Acquisition Holdings Inc. to be handled by Citigroup.

Merrill Lynch, which has the world's largest brokerage force, and Deutsche Bank AG, Germany's No. 1 bank, have worked on blank-check IPOs of more than \$100 million each since last year, according to SEC filings.

So far, NASD has not accused anyone of wrongdoing. Merrill Lynch spokeswoman Jessica Oppenheim, Citigroup spokeswoman Danielle Romero-Apsilos and Deutsche Bank spokesman Ted Meyer declined to comment on their firms' deals.

Bank Interest

The larger investment banks are getting involved because they can make money during several steps in the process, including underwriting the initial sale, advising on the subsequent acquisition and helping arrange bank loans, says Mitchell Littman, a lawyer at Littman Krooks LLP in New York who has worked on half a dozen blank-check offerings.

Underwriters for New York-based Marathon Acquisition made \$21 million, according to an Aug. 23 SEC filing.

'Rigged Market'

In the late 1980s and early 1990s, blank checks run by Michael Studer and Meyer Blinder cheated investors out of tens of thousands of dollars by illegally inflating share prices.

Studer used Freeport, New York-based Castle Securities Corp. to create Windfall Capital Corp. in 1989. Windfall then merged with U.S. Environmental Inc., and Castle Securities fraudulently pushed the share price of the new company higher, SEC documents showed.

Castle Securities earned at least \$170,000 in trading fees, according to a September 2004 SEC opinion, while most investors lost money. Studer was barred from the securities industry.

Blinder, former president of Denver-based brokerage Blinder Robinson & Co., spent 40 months in prison for fraud after selling blind-pool shares and then creating what the 9th U.S. Circuit Court of Appeals called a "'rigged market" for the securities, SEC documents say.

EarlyBirdCapital's Nussbaum brought about a dozen blank-check offerings to market during the 1990s while heading GKN Securities Corp. In 1997, NASD fined Nussbaum \$50,000 and suspended him for 30 days for charging "'excessive markups and unfair prices" and controlling as much as 99 percent of the trading in some companies. Nussbaum didn't admit wrongdoing.

SEC Safeguards

Investors stopped putting money into blank-check companies amid the criminal prosecutions and regulatory sanctions. In 1993, the SEC imposed tighter safeguards, including a requirement that funds be held in escrow until an acquisition is complete.

If that doesn't happen within 18 months of the IPO, all the money except for about 5 percent in underwriting fees is returned to investors.

Also, blank-check shareholders now vote on an acquisition. If they don't like it, the managers have to find another target by the deadline or dissolve the company.

Blank check filings started to increase in 2003.

``They've made a comeback because enough time has gone by, in terms of the taint of what those 'blind pools' used to be," says Littman, the lawyer.

Wozniak's Acquicor Technology Inc. said in a May 15 filing that it plans to use its approximately \$164 million trust to buy a technology, multimedia or networking business. Officers of the Newport Beach, California-based firm include former Apple CEO Gilbert Amelio.

Video Surveillance

Good Harbor Partners Acquisition Corp. held about \$54 million in trust as of June 30, according to a quarterly statement. Clarke, chairman of the Arlington, Virginia-based firm, plans to invest in security-related technologies, including video surveillance.

Wozniak declined in an e-mail to comment, and Clarke did not return calls seeking comment.

Besides the potential for fraud, NASD also is looking for any conflicts of interest that might arise from an investment bank underwriting a blank-check deal and then advising the company on acquisitions, Shorris says.

``The extent to which these entities are kind of on multiple sides of these transactions could also raise some issues that we're looking at," he says.

The SEC, which is responsible for overseeing securities filings, said in an April 2004 rule proposal: ``Neither blind pool offerings nor blank check offerings are inherently fraudulent." It also said the tighter safeguards have been ``successful in deterring fraud and abuse."

SEC spokesman John Nester declined to elaborate.

'Temporary Fad'

Some who track the industry say they believe the NASD scrutiny might cool investor interest.

The current boom is ``a temporary fad that will fade after investors have had their fingers burned," says Jay Ritter, a finance professor at the University of Florida in Gainesville.

``There were regulatory changes that gave investors some protection, but I think it's just the triumph of hope over experience."

The deals appeal to institutional investors and hedge funds because they are sold in units including one share of common stock plus one or two warrants to buy shares, creating more opportunities to trade the securities.

Warrants are company-issued certificates giving the holder the option to buy or sell a certain number of shares at a specific price before a predetermined date.

After a set period, usually 90 days, the shares and warrants split and trade separately.

``The principal market at this point seems to be hedge funds," Shorris says.

Services Acquisition

None of the latest blank checks has folded, according to the Reverse Merger Report, a publication tracking the offerings. Since 2003, 30 of more than 100 blank checks have closed mergers or announced deals, according to the Petaluma, California-based quarterly.

They include Services Acquisition Corp. International, led by Steven Berrard, the former CEO of Blockbuster Inc. and AutoNation Inc. Berrard staged a \$138 million IPO for the Fort Lauderdale, Florida-based shell in June 2005, saying he did not have an industry focus and planned to find a service business.

In March, he agreed to buy closely held Jamba Juice Co., the San Francisco-based smoothie franchiser with more than 550 stores in 26 states. Fidelity Investments, the world's largest mutual fund manager, acquired more than 8 percent of the shares, according to Bloomberg data.

Management Expertise

Winslow Management Co., a Boston-based hedge fund, held 539,250 shares of Services Acquisition as of June 30, according to Bloomberg data.

``It's really totally management," portfolio manager Matthew Patsky says in explaining the fund's investment with the Berrard-run company. ``We want to see a fairly narrow industry expertise and have some level of confidence there are opportunities out there."

Even as investors flock to the deal, the merger has been delayed. Berrard's company, prodded by SEC questions, said Aug. 1 it had not accounted for its warrants properly and had to restate its annual financial report for 2005 and reports for the third quarter of 2005 and the first quarter of 2006. The company filed the new statements Aug. 3, according to SEC documents.

Shares Gain

Services Acquisition units, including the shares and warrants, gained 67 percent since its IPO on the American Stock Exchange as of Sept. 1, according to Bloomberg data. Shares have returned 27 percent since trading separately from the warrants, which have returned 253 percent.

``That was a good example of what happens when the stars align," says Littman, who represented Services Acquisition's underwriter, New York-based Broadband Capital Management LLC. ``You've got a guy with a great track record, who's got the experience, who's respected out there, who used the money in an intelligent way."

Broadband Capital earned \$8.4 million in the deal, regulatory filings show.

As the number of companies filing has increased, the fees banks charge are down from 7.2 percent last year and 9.8 percent in 2004, to 6.3 percent so far this year, according to Bloomberg data.

`Regulators Should Poke'

The decline can be attributed to more competition for underwriting as well as investors' demand that banks defer some fees until after an acquisition is complete, says Brett Goetschius, Reverse Merger Report's editor and publisher.

That deferment helps underwriters convince investors the IPO is not a black hole.

``The regulators should poke," Littman says. ``It's a good thing for the industry. This is the world we now live in, unfortunately. It keeps people honest."

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