

Recommendations of the Investor Advisory Committee regarding Special Purpose Acquisition Companies

The following recommendations relate to the recent rise in the registration of Special Purpose Acquisition Companies (“SPACs”) and the corresponding investor protection issues which have emerged from the popularity of such investment vehicles in 2020 and 2021 in the United States. The Securities and Exchange Commission (“SEC” or “Commission”) and its staff have already taken steps to address SPAC regulatory and investor protection issues,¹ and the SEC’s 2021 [regulatory agenda](#) includes a topic on SPACs. Given the dynamic nature of the SPAC market in recent months, the Investor Advisory Committee (“IAC”) offers these preliminary recommendations for consideration, focusing on the practical challenges SPAC investors face in fully assessing the risks and opportunities associated with these investment vehicles. As more data emerges, the IAC intends to revisit the issue of SPAC governance in future and may offer additional suggestions for reform in that area.

RECOMMENDATIONS

The IAC makes the following two recommendations to the Commission:

A. *Disclosure:* The IAC recommends that the Commission regulate SPACs more intensively by exercising enhanced focus and stricter enforcement of existing disclosure rules under the Securities Exchange Act of 1934 (“Exchange Act” or “‘34 Act”) in relation to the adequacy of disclosure around the following areas:

1. Disclosure of the role of the SPAC sponsor (and/or insiders or affiliates such as celebrity sponsors/advisors), including disclosure of the sponsor’s appropriateness, expertise, and capital contributions, as well as an overview of any potential conflicts of interest on the part of the sponsor and other insiders or affiliates, and any divergence of the sponsor’s financial interest relative to that of the retail investors in the SPAC.²

¹ On December 22, 2020, the Division of Corporation Finance issued [CF Disclosure Guidance Topic No. 11](#). Also in December 2020, the SEC’s Office of Investor Education and Advocacy (“OIEA”) issued an Investor Bulletin, [What You Need to Know About SPACs](#). OIEA followed this up with an Investor Alert, [Celebrity Involvement with SPACs](#), just the day before the IAC meeting in March 2021. At the end of March 2021, the Office of the Chief Accountant issued a statement entitled [Financial Reporting and Auditing Considerations of Companies Merging with SPACs](#), and the Division of Corporation Finance issued a [Staff Statement on Select Issues Pertaining to Special Purpose Acquisition Companies](#). In April 2021, additional SEC documents on the topic of SPACs were issued: [SPACs, IPOs and Liability Risk under the Securities Laws](#) and [Staff Statement on Accounting and Reporting Considerations for Warrants Issued by SPACs](#). In May 2021, OIEA updated its Investor Bulletin, [What You Need to Know About SPACs](#). The SEC, through Investor.Gov, has an [introductory page](#) on SPACs. In July 2021, the Commission [announced an enforcement action](#) associated with a SPAC merger.

² The Commission has addressed the SPAC conflicts of interest issue – [SEC Issues Guidance in Light of Ongoing Surge in SPAC IPOs](#). (<https://corp.gov.law.harvard.edu/2021/02/07/sec-issues-guidance-in-light-of-ongoing-surge-in-spac-ipos/>)

2. Plain English disclosure in the SPAC registration statement (beyond mere financial footnotes) around the economics of the various participants in a SPAC process, including the “promote” (e.g. “founder shares”) paid and their impact on dilution sufficient to enable a retail investor to make a meaningful comparison of the upside potential and downside risks of a SPAC transaction compared to other SPACs as well as other types of investment opportunities. To the extent particulars cannot be determined and disclosed because they are subject to future negotiation at the time of the “de-SPAC” transaction (described below), the Commission should consider ways to encourage disclosure around “guardrails” or ranges of acceptable terms.
3. Disclosure that includes a clear description (with diagrams or charts as appropriate) in the SPAC registration statement of the mechanics and timeline of the SPAC process, including the precise nature of the instrument being purchased, the events required in the next two years for value appreciation of that instrument, and the details of the shareholder approval process at the time of de-SPAC (e.g. whether shareholders are permitted to vote for a deal while simultaneously redeeming their shares).
4. Disclosure in the SPAC registration statement regarding the opportunity set and target company areas of focus, including a clearer discussion of the boundaries of the search area and attributes of acceptable and unacceptable companies and the ground rules for any changes to the search area.
5. Disclosure regarding the competitive pressure and risks involved in finding appropriate targets and reaching market acceptable prices for those companies³ (i.e. disclosure beyond mere risk factors in the risk factor section of the SPAC registration statement), as well as disclosure regarding the absorption of expenses by the sponsor in the event there is not a successful de-SPAC transaction.
6. Disclosure of the acceptable range of terms under which any additional funding (e.g. public investment in private equity “PIPEs”) might be sought at the time of acquisition/redemption.⁴
7. Disclosure regarding the manner in which the sponsor plans to assess the capability of potential targets to be a “34 Act company” from a governance and internal control perspective, and whether the sponsor will take any steps to ensure the target company can meet minimum preparedness/quality standards for operating as public company.
8. Disclosure about the minimum pre-de-SPAC diligence the sponsor will commit to regarding the accounting practices used by the target company, including audit history, use of GAAP and non-GAAP pro forma numbers, and audit committee (composition; communication between committee, auditor, and management).

³ It should be clear to investors that the sponsor has an interest in completing a transaction even if doing so might not benefit the remaining investors after the de-SPAC transaction.

⁴ We suggest the Commission consider requiring disclosure of the identity and relationship of PIPE investors, and whether any side payments are to be made to certain shareholders as an inducement not to redeem their shares.

B. *Analysis:* The IAC recommends that the Commission prepare and publish an analysis of the players in the various SPAC stages, their compensation, and their incentives. Based on the information contained in that analysis, the IAC may follow-up with additional actions—*e.g.*, hosting another panel discussion to re-examine the issues raised, or even crafting additional recommendations to the Commission—regarding SPACs. Whether or not further actions by the IAC with respect to SPACs are warranted, however, we believe that Commission preparation and publication of such an analysis would be in the public interest and promote investor protection.

BACKGROUND

What is a SPAC?

In simple terms, a SPAC is a type of “blank-check” company that raises capital through an initial public offerings (“IPO”) with the intention to use the proceeds to acquire other companies at a later time.⁵ Unlike traditional IPOs, SPACs do not have commercial operations at the time of the IPO, which explains why they are referred to as “blank-check” or “shell” companies. SPACs first appeared in the 1980s but have gained accelerating popularity in recent years, especially since 2020.

SPAC sponsors generally raise money in IPOs for future acquisitions of other private companies. Because finding acquisition targets can take time (typically two years), the cash raised (typically \$10 per share) is held in a trust while the sponsors search for a target. After the SPAC completes a merger with the target company, the previously privately held target company becomes a publicly listed operating company. This last step of creating the listed successor company is referred to as a “de-SPAC” transaction. A SPAC is required to keep 90% of its IPO gross proceeds in an escrow account through the date of acquisition. The SPAC should complete acquisitions reaching an aggregate fair market value of at least 80% of the value of the escrow account within 36 months. If the acquisitions cannot be completed within that time, the SPAC must file for an extension or return funds to investors. At the time of de-SPAC transaction, the combined company also must meet stock exchange listing requirements for an operating company.

SPACs can be an attractive option for sponsors because they can raise money rapidly without having to deal with company preparation or company specific disclosure at the time of the IPO. Moreover, SPACs are attractive to targets because they represent a fast, certain route to liquidity without the delay, pricing risk, and market condition risk associated with the typical IPO process. However, the separation in time between the IPO disclosure and the company specific disclosure means that investors do not learn what they are investing in until after the fact and therefore, their invested funds are tied up for a period of time while the investors rely on the sponsors to find an appropriate target. Furthermore, the transactions by their very nature are complex and have some misalignments between the initial investors, sponsors, investors in the target and any intermediate financiers joining the de-SPAC transaction. At the time of the merger, often over

⁵ The Congressional Research Service provides a summary at [SPAC IPO: Background and Policy Issues 1](#) (Sept. 29, 2020).

two thirds of the SPAC's shares are tendered for redemption and the sponsor or third parties purchase shares in a private investment in public equity ("PIPE") transaction to replenish cash the SPAC paid to redeem its shares, diluting the original investors' slice of the new company's equity.⁶ These complexities and misalignments are why researchers (such as NYU Professor Michael Ohlrogge and others) assert that SPACs can be frustrating and will likely continue to frustrate the shareholder value performance expectations of many of their retail investors.

Recent Burst of Transactions

The relative attractiveness of SPACs combined with an atypical market environment during the COVID-19 pandemic have led to the proliferation of SPACs in 2020 and 2021. In a year when the pandemic subdued the global economy, leading to the worst economic contraction since the Great Depression, global IPO activity reached more than \$300 billion, a 60% increase over 2019. U.S. IPO activity also hit record levels, accounting for more than half of global volume (\$170 billion). While traditional U.S. IPOs had a strong 2020, raising \$67 billion, they were no match for the surge in SPAC IPOs, which amounted to more than 50% of total IPO capital raised in the U.S. in 2020, according to Goldman Sachs data.⁷

In the first half of 2021, SPACs continued to drive U.S. IPO growth. Of the 389 IPOs that raised \$125 billion in the first three months of 2021, 298 issuances were SPAC IPOs raising \$87 billion.⁸ This rate of SPAC growth not only set a new record: this first quarter activity exceeded all the funds raised for the *entire* 2020.⁹ Although the second quarter of 2021 saw a slow down with 61 SPACs having raised funds, this rate was still over four times the average quarterly rate for the 2018-2019 period. Technology, green energy and pharma sectors have dominated SPAC IPOs, as reflected in recent media reports.¹⁰

An Evolving Marketplace; Growing Concerns About Risks to Investors in SPACs

Following a SPAC slowdown, likely precipitated by increased regulatory scrutiny of SPAC IPOs including Commission and/or staff actions regarding accounting for warrants, enforcement actions, and consideration of underwriter/advisory incentives,¹¹ the SPAC market has seen an evolution including, for example:

⁶ Michael Klausner, Michael Ohlrogge & Emily Ruan, *A Sober Look at SPACs*, 39 Yale J. on Regul. (forthcoming 2021).

⁷ See Goldman Sachs Global Macro Research, *The IPO SPAC Tacle*, Top of Mind Vol. 95, 1 (Jan. 28, 2021), <https://www.goldmansachs.com/insights/pages/top-of-mind/the-ipo-spac-tacle/report.pdf>.

⁸ Francis Bignell, *US Sees Strongest IPO Quarter to Date as 389 IPOs Raise a Collective \$125 Billion During Q1 2021*, The Fintech Times (May 5, 2021), <https://thefintechtimes.com/us-sees-strongest-ipo-quarter-to-date-as-389-ipo-raise-a-collective-125billion-during-q1-2021/>.

⁹ *Id.*

¹⁰ See, e.g., Peter Santilli & Amrith Ramkumar, *SPACs Are the Stock Market's Hottest Trend. Here's How They Work.*, The Wall Street Journal (Mar. 29, 2021), <https://www.wsj.com/articles/spacs-are-the-stock-markets-hottest-trend-heres-how-they-work-11617010202>.

¹¹ See Amrith Ramkumar, *SPAC Selloff Bruises Individual Investors*, The Wall Street Journal (May 19, 2021), <https://www.wsj.com/articles/spac-selloff-bruises-individual-investors-11621396808>; Miles Kruppa & Ortenca Allaj, *A Reckoning for Spacs: Will Regulators Deflate the Boom?*, Financial Times (May 3, 2021), <https://www.ft.com/content/99de2333-e53a-4084-8780-2ba9766c70b7>.

- Reduction in average volume of SPAC IPOs;
- Increased participation of retail investors prior to the de-SPAC transaction has evolved (increased) which has impacted the ability to obtain quorums in voting the merger transaction;
- Increased pricing for D&O insurance reflecting increased awareness of potential risk;
- Decrease in the availability of PIPE funds and increase in PIPE investor negotiating leverage;¹²
- Increase in the length of sponsor's investment in the post-merger entity;
- An increasing percentage of SPAC investors seeking redemptions at the de-SPAC transaction;¹³ and
- The emergence of SPAC opportunities in other jurisdictions; for example, the United Kingdom, Hong Kong, Singapore, and India are exploring facilitating SPACs in their jurisdictions.

Throughout this period, investors and key market actors have raised ongoing concerns about SPACs, including:

- Potential lack of sufficient SPAC targets, which may incentivize sponsors to take substandard targets to market that are generally unprepared to satisfy legal, regulatory, and overall market expectations
- Questions about whether the targets are of sufficient size for the economics of the sponsor to be reasonable;
- The number of investors who vote in favor of a de-SPAC transaction while redeeming their shares, which implies that the investors do not actually have faith in the prospects of the merged entity but vote to approve the merger anyway.

We have also heard from various academics studying the SPAC market that they are analyzing differences between the SPAC market in the pre-2020 era and the 2020/2021 era. Again, academics cannot fully study the SPAC market until the completion of the merger transaction.

The March 2021 IAC Meeting

At the March 11, 2021 IAC meeting, a group of relevant market participants was invited to discuss recent developments in the SPAC market. Those individuals included

- Jocelyn Arel, Partner; National Head of SPAC Practice, Goodwin Procter LLP
- Michael O'Donovan, Partner, Strategic Advisory Group, PJT Partners
- Michael Ohlrogge, Assistant Professor of Law, NYU School of Law
- Dan Primack, Business Editor, Axios
- Dana Settle, Co-Founder & Partner, Greycroft, and Chair of Powered Brands

¹² Dmitri Batshev & Jason Katz, *How SPAC Skepticism Has Given PIPE Investors an Edge*, Lazard Insights (June 9, 2021), https://www.lazardassetmanagement.com/docs/-m0-121425/HowSPACsSkepticismHasGivenPIPEInvestorsAn_LazardInsights_202105_en.pdf

¹³ Chris Bryant, *Hedge Funds Are Demanding Their SPAC Money Back*, The Washington Post (Aug. 16, 2021), https://www.washingtonpost.com/business/hedge-funds-are-demanding-their-spac-money-back/2021/08/16/662f6978-fe60-11eb-87e0-7e07bd9ce270_story.html.

A [recording of the discussion](#) at the IAC is available on the SEC website.

In advance of the IAC meeting, we also reviewed the research paper, [A Sober Look at SPACs](#), of Professor Ohlrogge and his co-author Michael Klausner, which contains some interesting findings as well as recommendations to the Commission for future action. An interesting takeaway from the Ohlrogge paper is that the greatest risk of SPACs to investors may remain ahead with the merger being a point of significant inflection for investors – and their related risk and returns.

RATIONALES FOR IAC RECOMMENDATIONS ON SPACS

Preliminary and Limited in Scope

Given the dynamic nature of the SPAC market in recent months, the IAC offers the preliminary recommendations set forth above, focusing on the practical challenges SPAC investors face in fully assessing the risks and opportunities associated with these investment vehicles. As more data emerges, the IAC intends to revisit SPAC governance and may offer additional suggestions for reform.

Note that recent public commentary has included growing concern about the explosion in SPAC activity. Some commentary has had an economic focus relating to the question of whether the SPAC activity reflects an irrational bubble. *Such economic commentary is outside the scope of this recommendation.* Our focus is instead on regulatory and disclosure concerns. These concerns fall mostly into three main groupings:

1. *Concerns that the sponsors and targets of SPACs may effectively be conducting regulatory arbitrage by seeking a deal structure with a staggered disclosure approach which amounts to less-restrictive path to the public markets.*

The playing field may need to be leveled between these two types of public offerings. To cite one example, there is no logical reason for allowing a safe harbor for projections for either SPACs or IPOs in a public offering made to retail investors in a regulatory system based on disclosure. If projections are made, issuers must take full responsibility for those projections in both the SPAC and de-SPAC transactions. The IAC recommends this safe harbor for SPACs be eliminated. The public communications of SPAC promoters should be treated in the same way as public communications for an IPO, particularly for the de-SPAC transaction. It very likely may be appropriate for underwriter liability to be extended on the same basis for SPACs as for IPOs under sections 11 and 14.

To cite a second example: as we have familiarized ourselves with the SPAC process we have found that the IPO process (S-1) and the merger process (S-4) follow the same process with the SEC. A key difference – one not discussed at the March IAC meeting and many times glossed over – is that there is no underwriter in the merger process and no Section 11 liability. There is also no comfort letter and the sponsor may or may not have involvement in the target post-merger. In our conversations this point is not specifically addressed by many of the advisors to the process. Generally, there is emphasis on the engagement of the sponsor and target and their

legal teams as well as a strong emphasis placed upon the due diligence of the PIPE investors. While certainly a reasonable PIPE investor will do this, the implication is that the due diligence of all of these parties and particularly that done by the PIPE serves the interest of retail investors or other investors who are not a party to or have the same access to the information that the PIPE investor has. Such due diligence is not necessarily done with the interests of retail investors in mind, particularly if the PIPE investor – as may be the case in future mergers – buys in at a price other than \$10. While other investors may benefit to a degree from such due diligence, they do not have all the same information or ability to understand its impact as the PIPE investor and unlike offerings involving an underwriter, there is no comfort letter or Section 11 liability. We think the SEC should explore the data to determine whether this puts retail investors at a disadvantage and whether the SEC should make any recommendations to Congress regarding necessary statutory changes.

Further, when the SEC reviews the S-4, F-4 of DEF 14A in connection with a de-SPAC transaction we recommend that they make inquiries regarding the due diligence completed by all parties to the transaction. The recent SEC enforcement action highlights the anti-fraud violations arising from the lack of due diligence that was completed. While a great deal of emphasis has been placed on the difference in projections in SPAC transactions – and rightly so by even the SEC, the due diligence is foundational to such projections and we believe the SEC should be asking questions and seeking the clearest disclosure possible.

2. Concerns about inherent conflicts of interest between the sponsors/insiders of SPACs and retail investors.

SPACs by their very nature are rife with conflicts of interest which must be disclosed to potential investors. Even where those conflicts are disclosed, their import may not be clear to an unsophisticated investor. Because the purpose of the SPAC is to invest in a yet-to-be-determined company, the investors must place a great deal of trust in the SPAC sponsor to find the best candidate for merger. Even then, there may be financial arrangements that constitute conflicts of interest that are not fully disclosed or understood by investors. Further, the investors may not understand (or have the means to determine) whether the risks of keeping their shares in the merger may outweigh the benefits.

One method of addressing this would be to require improved disclosure of sponsor conflicts of interest by requiring a standardized disclosure of the sponsor's total investment in the transaction; the value of the sponsor's interest if the proposed merger closes including all management and promoter fees; and the break-even post-merger price for the sponsor. It should be clear to investors that the sponsor has an interest in completing a transaction even if this might not benefit the remaining investors after the de-SPAC.

3. Concerns relating to the effectiveness of disclosure about the risks, economics and mechanics of SPACs as a result of the complexity of these transactions and the staggered nature of the disclosure process.

The panel discussions at the March 2021 IAC meeting did little to dispel the problematic findings highlighted in the Ohlrogge study, namely that SPACs are likely to be a much better

investment vehicle for the issuer and perhaps the target company than for the individual retail investor who buys shares in the IPO and holds those shares through the de-SPAC process. For instance, the study found the dismal performance of SPACs over the past decade was highly correlated to the pre-merger dilution when share price is adjusted for warrants and rights, and the actual value of the SPAC IPO shares to the remaining retail investor was in fact at least three dollars per share lower.

Several factors contribute to the drain on investor share value, including the sponsor's 20% "promote" fee; warrants and rights given to investors who liquidated their shares during the de-SPAC; the underwriting fee paid for all IPO shares, including those redeemed in the de-SPAC; and the redemption of a significant number of shares in the de-SPAC by more institutional and PIPE investors. The study further noted that sponsors and targets negotiate the transactions in a way such that most of the costs of the SPAC transaction fall upon the remaining shareholders. Additionally, the valuation of the target company is artificially inflated by using the SPAC redemption price of \$10/share rather than the effective value of the shares after the de-SPAC dilution to remaining shareholders.

It was clear from the discussion that, while the sponsors and redeeming shareholders (often more sophisticated than the remaining shareholders) do very well in the SPAC, the risks and costs of the SPAC are not well understood by the average retail investor. If they understood that by remaining a shareholder through the SPAC transaction, they were likely to lose \$3/share in value while the sponsor and redeeming shareholders benefit, it is unlikely a reasonable retail investor would want to take on that risk (unless awed by a celebrity promoter). Yet, it appears to be the institutional investors that are redeeming in numbers, and doing so with the option to still profit from the investment. According to Ohlrogge's study, 97% of the most influential hedge funds in the SPAC market redeem their shares at the de-SPAC, and many of those investors obtained warrants at initial investment, giving them the option to buy more shares if later price changes benefit them.¹⁴ Retail investors, however, often buy on the open market through brokers and cannot purchase warrants, leaving them out of the potential upside of a price change.¹⁵

One method of enhancing disclosure would be to require issuers to provide a table of the cash per share contingent on specified levels of redemption, paralleling the cash net of fees required on the cover of an IPO prospectus, so they understand the impact of de-SPAC dilution.

Timing and Remaining Uncertainty in Current Market Situation

A great deal of new data and learnings will come to light in the next 18-24 months. However, the Commission does have the ability to enhance its protection of investors *now* with respect to new SPACs filings, and requests for effectiveness of, new registration statements. The Commission could increase investor protection by putting enhanced focus on certain issues during review, and conditioning effectiveness of the registration statement on the adequacy of

¹⁴ Michael Klausner, Michael Ohlrogge & Emily Ruan, *A Sober Look at SPACs*, 39 Yale J. on Regul. (forthcoming 2021).

¹⁵ See Research Report, *What Is a SPAC?*, CBI Insights (July 14, 2021), <https://www.cbinsights.com/research/report/what-is-a-spac/>.

disclosure in those areas at the time the SPAC is created. SPAC registration statements tend to be minimal given that there is no operating company to discuss, but additional disclosure about the structure and plans of the SPAC for its de-SPAC transaction could be included. Such enhanced scrutiny is the focus of our current recommendation. Once more data is available about the performance of the current glut of SPACs in the market, the Investor Advisory Committee may revisit the SPAC issue with additional recommendations.