Consumer Federation of America

June 13, 2022

Vanessa Countryman
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: File Number S7-13-22
Special Purpose Acquisition Companies, Shell Companies, and Projections

Dear Secretary Countryman,

I am writing on behalf of Consumer Federation of America (CFA)[1] in response to the above captioned proposal regarding Special Purpose Acquisition Companies, (SPACs), Shell Companies, and Projections.[2] This proposal would require, among other things, SPACs to provide enhanced disclosures regarding compensation paid to sponsors, conflicts of interest, dilution, and the fairness of their proposed business combination transactions, clarify that the Private Securities Litigation Reform Act of 1995 (PSLRA) safe harbor for forward looking statements is not available for de-SPACs, and affirm the underwriter status of SPAC IPO underwriters in connection with de-SPAC transactions.

These proposed amendments would bring SPACs into closer alignment with how traditional IPOs are treated under the Securities Act of 1933 and the Securities Exchange Act of 1934 and, in doing so, provide critical transparency and accountability to the SPAC market. We strongly support these aspects of the proposal, which would be particularly helpful in addressing deficiencies in the market that have resulted in significant harm to retail investors. Accordingly, we urge the Commission to finalize these aspects of the proposal without undue delay.

However, the proposal also includes a new safe harbor under the Investment Company Act of 1940 (ICA) that would provide special treatment to SPACs, allowing them to effectively function as investment companies for two years without having to comply with the investor protections afforded by the ICA. Because the proposed safe harbor goes well beyond the existing

[1] The Consumer Federation of America is a non-profit association more than 250 consumer groups that was established in 1968 to advance the consumer interest through research, advocacy, and education.
[2] Proposed Rule, Special Purpose Acquisition Companies, Shell Companies, and Projections, Release Nos. 33-11048; 34-94546; IC-34549, March 30, 2022, https://bit.ly/3Hm6pzG ["Proposing Release" or "Proposal" or "Proposed Rule"].

safe harbor for inadvertent investment companies, which imposes a 12-month time limit, we urge the Commission to narrow the proposed safe harbor. In addition, we urge the Commission to clarify that SPACs operating outside the bounds of the safe harbor are and always have been in violation of the law (assuming they do not meet the conditions of any other available safe harbor), and to enforce the law to reflect these realities.

I. Background on SPACs

SPACs offer private companies an alternative way to go public. While the specific structures of these transactions can be complex and vary, at a high level, SPACs operate as follows:

A SPAC is typically a shell company with no operations that is organized for the purpose of merging with or acquiring an unidentified private operating company. The typical process of going public via a SPAC is completed in two principal stages, beginning with the SPAC IPO. A SPAC IPO consists of redeemable shares and warrants, which are typically sold to institutional investors, with the proceeds placed in a trust for use in a future acquisition. The second stage is the "de-SPAC transaction," which must occur within a certain time frame specified in the governing documents (often two years). The SPAC is organized and managed by its sponsor, which is usually compensated through highly discounted shares and warrants, referred to as a "promote," which is contingent on the completion of a de-SPAC transaction. The result is a once-private company that becomes a public company without having actually gone through the rigorous process and accompanying safeguards of an IPO.

From the time that a SPAC goes public until the time a business combination with a private company is completed, a SPAC functions like a mutual fund, investing in Treasuries, money market funds, or other cash-like securities, while providing initial investors a fixed-income-equivalent return.

If a SPAC does not complete a de-SPAC transaction within the time frame specified in its governing instruments, the SPAC may seek an extension of the time frame from its shareholders or may dissolve and liquidate, with the sponsor not earning the "promote" and the assets held in the trust returned to shareholders. If, however, a SPAC identifies a target private company for a business combination transaction, the shareholders of the SPAC have the opportunity to vote to approve the de-SPAC transaction. Assuming the de-SPAC transaction is approved, investors typically may redeem their shares prior to the business combination regardless of whether they voted in favor of or against a proposed de-SPAC transaction. Alternatively, they can remain as shareholders of the company following the de-SPAC.

To offset shareholder redemptions and to fund larger de-SPAC transactions, SPACs often conduct additional private capital-raising transactions, typically in the form of private investment in public equity (PIPE) transactions. De-SPAC transactions often result in the former SPAC's shareholders owning a minority interest in the post-business combination company, with the former private operating company's shareholders and PIPE investors owning a majority interest in the post-business combination company following these transactions.

While the structure can take various forms, a SPAC provides minimal substantive disclosures to investors when a SPAC IPOs, other than a vague description of the types of industries in which the proceeds may be used to acquire a company. The targeted private company does not file public financial documents until after a business combination is announced. Once a business combination is announced, disclosure is provided via a joint proxy statement and registration statement. Once a de-SPAC is complete, the private company effectively becomes a public reporting company subject to the Exchange Act's requirements and receives a listing on a national securities exchange.

II. Under our current market and regulatory framework, SPACs operate as an end-run to longstanding rules designed to promote investor protection and fair and efficient markets. SPACs also impose significant costs on retail investors and undermine market integrity.

For many years, SPACs were associated with scams and relegated to the backwaters of the market.[3] However, our markets have experienced a SPAC boom in recent years.[4] While we support the promotion of public markets, we do not support attempts by private companies to engage in an end-run to longstanding rules designed to promote investor protection and fair and efficient markets. Unfortunately, under our current market and regulatory framework, SPACs appear to be doing just that. Moreover, SPACs, as currently structured, impose significant costs on retail investors and undermine market integrity.

A. SPACs currently operate as an end-run to longstanding rules designed to promote investor protection and fair and efficient markets.

SPACs effectively function in two phases – the SPAC phase and the de-SPAC phase. In their first phase, SPACs function as mutual funds – a type of investment company. In their second phase, de-SPACs function as IPOs – the first time a private company is introduced to the investing public.

The Investment Company Act of 1940 (ICA) imposes a comprehensive regulatory framework designed to protect investors whose funds are managed and controlled by another entity.[5] Under the ICA, the definition of investment company includes any entity that is

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[3] Crystal Tse and Liana Baker, *Once associated with fraud, 'SPAC' deals now are rehabbed and swapped for failed IPOs,* LOS ANGELES TIMES, December 29, 2016, https://lat.ms/3MO8hCG.

[4] Andrew Ross Sorkin, Lauren Hirsch, Michael J. de la Merced and Jason Karaian, *The Urge to Reverse Merge*, NEW YORK TIMES DEALBOOK, (Updated) October 22, 2021, https://nyti.ms/3OeIZ1o; *see also* Grace Maral Burnett, *ANALYSIS: More SPACs are Succeeding in Inking M&A Deals*, BLOOMBERG LAW, March 4, 2021, https://bit.ly/3MAphvZ.

See e.g., Alexander Osipovich, *Blank-Check Boom Gets Boost from Coronavirus*, WALL STREET JOURNAL, July 13, 2020, https://on.wsj.com/3QjNvh5.

[5] *See* Paul F. Roye, Director of the Division of Investment Management, Securities and Exchange Commission, *The Exciting World of Investment Company Regulation*, June 14, 2001, https://bit.ly/3n1sbQh ("The Investment Trust Study, and the subsequent Congressional hearings, found that, to an alarming extent, investment companies were being organized and operated to benefit the interests of their affiliates rather than the interests of their shareholders…. The U.S. Congress enacted the Investment Company Act to address these abuses in the investment company industry, assure investor protection, and preserve the important role investment companies play in capital formation."). *See Id*. ("[T]he reach of the '40 Act extends beyond disclosure and reporting requirements, which are

"engaged primarily" … "in the business of investing, reinvesting, or trading in securities."[6] In determining whether an entity meets that definition, the Commission and courts have looked to the following factors: (a) the company's historical development, (b) its public representations of policy, (c) the activities of its officers and directors, (d) the nature of its present assets, and (e) the sources of its present income (the "Tonopah factors").[7] In applying these factors, recent caselaw has focused on whether the nature of the assets and income of the company would lead investors to believe that the principal activity of the company was trading and investing in securities.[8]

During their initial stage as SPACs, SPACs clearly meet the definition of investment company, as they are engaged primarily in the business of investing, reinvesting, or trading of securities.[9] For example:

- SPACs invest all or almost all of their assets in securities—commonly securities issued by the United States government and shares of money market mutual funds—and these securities are typically held in a SPAC trust.
- The SPAC sponsor, typically through one its affiliates, act as investment adviser, providing investment advisory services to the trust in exchange for a fee.
- The SPAC sponsor, typically through one of its affiliates, controls the trust's governance.
- Investing in securities is the SPAC's primary business because that is all the trust does with its assets.
- "Nearly all" SPAC IPO investors treat SPACs like mutual funds.[10]

Given that SPACs function as investment companies during their first phase and investors treat them as such, SPACs should be subject to the protections afforded by the ICA and any exemptions should be narrowly tailored to ensure the ICA's policies and purposes are furthered.

Unfortunately, SPACs currently are not complying with many of the ICA's requirement and are therefore operating as illegal investment companies. Among other violations, SPAC sponsors' compensation in the form of a "promote" is impermissible under the ICA, SPAC sponsors and their affiliates engage in conflicts of interest that are impermissible under the ICA, SPACs issue warrants with terms that are impermissible under the ICA, and SPAC directors are not elected by fund shareholders and they have unequal

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the foundations of the federal securities laws. The '40 Act is, in effect, a comprehensive corporate statute. It places substantive restrictions on virtually every aspect of the operation of investment companies: their governance and structure; their issuance of debt and senior securities; their investments, sales and redemptions of their shares; and, perhaps most significantly, their dealings with service providers and affiliates.").

[6] Investment Company Act of 1940, Section 3(a)(1)(A).

[7] *See In the Matter of the Tonopah Mining Co. of Nev*., 26 S.E.C. 426 (July 21, 1947).

[8] *See Securities and Exchange Commission, v. National Presto Industries, Inc*., 486 F.3d 305 (7th Cir. 2007).

[9] For a more detailed discussion, *see* Pl.'s Mem. of Law in Opp. to Defs.' Mot. to Dismiss, *George Assad v. E.Merge Technology*, No. 1:21-cv-07072-JPO (S.D.N.Y. Nov. 5, 2021).

[10] Michael D. Klausner, Michael Ohlrogge and Emily Ruan, *A Sober Look at SPACs*, October 28, 2020, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3720919 ("A key feature of SPACs is that, when the SPAC proposes a merger, shareholders have the right to redeem their shares at a price equal to the $10.00 IPO price of the SPAC's units plus interest accumulated in the trust." Further, the authors find that "nearly all investors in SPAC IPOs redeem or sell their shares by the time of a SPAC's merger.").

voting power, both of which are impermissible under the ICA. Moreover, no exemption or exclusion from the ICA's requirements would appear to be currently available, given that SPACs typically operate as investment companies for longer than the one-year limit available under Rule 3a-2, which provides a safe harbor for inadvertent investment companies.[11]

In their second phase, de-SPACs function as IPOs – the first time a private company is introduced to the public markets. The Securities Act of 1933 was designed to promote full transparency and accountability when issuers offer securities to the investing public.[12] These principles of transparency and accountable apply to the greatest extent when a company is first introduced to the investing public.[13] This is for good reason, according to Harvard Law Professor and former Acting Director of the Commission's Division of Corporation Finance John Coates, because "An IPO is where the protections of the federal securities laws are typically most needed to overcome the information asymmetries between a new investment opportunity and investors in the newly public company."[14]

Indeed, it is at the de-SPAC stage when a private company is first introduced to the public markets. Before this time, there is little if any publicly available information about that company. Yet private companies are able to enter the public markets through de-SPACs without providing the types of disclosures or accepting the corresponding legal obligations that they would if they underwent a more traditional IPO. As a result, investors do not receive a Securities Act registration statement containing disclosures about the private company that is entering the public market for the first time and investors do not have the same legal recourse for material misstatements or omissions as they would if the company underwent a more traditional IPO. These features of de-SPACs are likely to degrade the quality of disclosures that are provided to the investing public and weaken incentives for these companies, their underwriters, and other parties involved in these offerings to help ensure that there are no material misstatements or omissions in disclosures to the public. As a result, de-SPAC disclosures may be less accurate and less reliable than if the company went through a more traditional IPO.

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[11] *See* Transient Investment Companies, Investment Company Act Release No. 11552 (Jan. 14, 1981).

[12] The Securities Act sets forth in detail the items that were required to be disclosed, including "essential facts" concerning: 1) the property in which the investor "is invited to acquire an interest"; 2) the "identity and the interests of the persons with whom he is dealing or to whom the management of his investment is entrusted"; and 3) "the price and cost of the security he is buying and its relation to the price and cost of earlier offerings." H.R. Rep. No. 73-85 at 18. According to the bill's authors, these items were comparable to the information "demanded by competent bankers from their borrowers" and were "indispensable to any accurate judgment upon the value of the security." *Id*. at 3-4. They warned that, "To require anything else would permit evasions, but to require these disclosures fulfills the President's demand that 'there is an obligation upon us to insist … that no essentially important element attending the issue shall be concealed from the buying public." *Id*. In order to better ensure the accuracy of information provided, the Securities Act also included strong civil liability provisions, entitling "the buyer of securities sold upon a registration statement including an untrue statement or omission of material fact, to sue for recovery of his purchase price, or for damages not exceeding such price, those who have participated in such distribution either knowing of such untrue statement or omission or having failed to take due care in discovering it." *Id*. at 9.

[13] *See* H.R. Rep. No. 73-85 at 2 ("There is, however, an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public.").

[14] John Coates, *SPAC Law and Myths*, February 11, 2022, https://bit.ly/3MRT2Zb.

B. SPACs impose significant costs on retail investors and undermine market integrity.

As currently structured, and largely as a result of the regulatory arbitrage discussed above, SPACs impose significant costs on retail investors and undermine market integrity.[15]

- **Conflicts of interest**

The incentives of SPAC sponsors, IPO investors, and PIPE investors are poorly aligned with retail investors' interests. For example, because SPAC sponsors' compensation (in the form of a "promote") is contingent on a de-SPAC being completed, SPAC sponsors have a strong incentive to find *any* deal that will be approved by shareholders rather than the best deal. This weakens their incentives to engage in robust due diligence and "drive a hard bargain" when negotiating with a merger target. These incentives often come at the expense of retail investors' interest.[16]

Because IPO investors are effectively guaranteed principal preservation plus interest during the SPAC stage and also receive warrants, which are separately tradeable, these investors have an incentive to vote for the de-SPAC, redeem their shares, and keep or sell their warrants, depending on the terms.[17] This creates an "empty voting" problem, where IPO investors have an incentive to vote for the deal but do not have strong incentives to ensure that SPACs seek out the best deal possible because they will redeem their shares before the de-SPAC.[18] These incentives also often come at the expense of retail investors' interest.

Because PIPE investors are often critical to make up for lost capital after IPO shareholders redeem and because PIPE investors have significant negotiating power, they can negotiate terms that are in their interest. However, these terms often come at the expense of retail investors' interest.

According to Professors Michael D. Klausner, Michael Ohlrogge and Emily Ruan, "As a result of these distorted incentives, SPACs have performed very poorly for most investors. At the same time, the boom in SPACs has provided spectacular windfalls for insiders and favored investors."[19]

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[15] *See* Office of Senator Elizabeth Warren, *The SPAC Hack, How SPACs Tilt the Playing Field and Enrich Wall Street Insiders*, May 2022, https://bit.ly/3xn17zG.
[16] *Id*. at 3 ("SPAC Sponsors' Incentives and Outcomes Do Not Align with Retail Investors, Leading to Low-Quality Deals that Harm Investors.).
[17] Moreover, because initial investors also receive warrants, they effectively receive an investment with no downside risk and potentially large upside. However, warrants dilute share value, which comes at the expense of non-redeeming investors, including retail investors.
[18] *See* Usha R. Rodrigues and Michael Stegemoller, *SPACs: Insider IPOs*, August 19, 2021, https://bit.ly/39kej0g ("document[ing] a disturbing level of empty voting in SPACs and demonstrate[ing] an inverse correlation with stock performance: SPACs with more empty voting perform worse.").
[19] Michael D. Klausner, Michael Ohlrogge and Emily Ruan, *A Sober Look at SPACs*, October 28, 2020, https://bit.ly/3mM1ezP ("We find that [SPACs] create substantial costs, misaligned incentives, and on the whole, losses for investors who own shares at the time of SPAC mergers. By contrast, there is an essentially separate group of investors that buy shares in IPOs and sell or redeem their shares prior to the merger, and these investors do very well").

- **Dilution**

The SPAC structure also creates several sources of dilution that are imposed primarily on retail investors. These include a sponsor's "promote," IPO investors' redemptions, warrants, and PIPEs, all of which dilute value for shareholders who do not redeem their shares prior to the de-SPAC. According to the Klausner et al. study discussed above, although SPACs raise $10.00 per share from investors in their IPOs, by the time a SPAC merges with a private company to take that private company public, the SPAC holds far less in net cash per share. For SPACs that merged during the authors' primary sample period between January 2019 and June 2020, the mean and median net cash per share were $4.10 and $5.70, respectively.[20] In a follow up article, the authors found that the average share price of SPACs that merged in 2021 was $6.30, roughly matching the actual cash per share these SPACs delivered, inflicting steep losses on investors, primarily retail investors, who bought into these SPACs at $10 or more and failed to redeem their shares.[21]

Consistent with the Klausner et al. analysis, Professors Minmo Gahng, Jay R. Ritter, and Donghang Zhang found that "the average deSPAC period market-adjusted return is substantially below zero."[22] According to their research, for the 153 business combinations completed by the end of March 2021 from SPACs that went public in 2015 or later, the mean and median cash delivered per share are only $7.48 and $8.13, respectively."[23]

- **Marketing hype**:

Retail investors are often lured into investing in SPACs based on claims that they allow investors to get in on the ground floor of the next early-stage, high-growth investment "opportunity." While a few SPACs have been successful and widely touted as success stories, they appear to be the exception to the general rule that SPACs are over-hyped and they under-deliver for retail investors.

According to a *Wall Street Journal* article and analysis, many SPACs "attract investors with bullish financial projections, despite having little or no revenue in their history."[24] Companies with high-growth revenue projections that went public via SPAC transactions were likely to be "overly optimistic and misleading to uninformed investors," according to the

[20] *Id*.

[21] Michael Klausner, Michael Ohlrogge, Harold Halbhuber, *SPAC Disclosure of Net Cash Per Share*, March 11, 2022, https://bit.ly/39ozGgE.

[22] Minmo Gahng, Jay R. Ritter, and Donghang Zhang, *SPACs*, December 14, 2021, https://bit.ly/3mGEzVs.

[23] *Id*. In contrast, the authors find that, "For the 210 SPAC IPOs from January 2010 – December 2019, investors have on average earned an annualized return of 15.9% during the SPAC period." This is also consistent with the conclusions that IPO investors fare considerably better than retail investors and that retail investors' returns come at the expense of IPO investors' returns. *See also* Grace Maral Burnett, *ANALYSIS: YTD Post-Merger SPAC Performance Is Mostly Negative*, BLOOMBERG LAW, June 11, 2021, https://bit.ly/3aN2zU8 (According to the June 2021 article, "Two-thirds of the 36 currently publicly traded de-SPACed U.S. companies that were taken over by U.S. SPACs that went public on or after Jan. 1, 2019, and whose de-SPAC transactions were announced and completed since Jan. 1, 2019, and for which at least one month of post-merger performance data is available, are reporting a loss in value. And for the most part, we aren't just talking about small dips: The average depreciation in value of the 24 negatively performing post-merger entities is 26%, with the two worst performers reporting a loss in value of over 60%.").

[24] Heather Somerville and Eliot Brown, *SPAC Startups Made Lofty Promises. They Aren't Working Out*, WALL STREET JOURNAL, February 25, 2022, https://on.wsj.com/3NHJ129.

article.[25] "Dozens of startups that went public in a pandemic-fueled stock market frenzy are missing the projections they used to win over investors, many by substantial margins and just a few months after making those forecasts," according to the *Journal's* analysis.[26] For example, in 2021, nearly half of all companies with less than $10 million of annual revenue that went public through a SPAC "have failed or are expected to fail to meet the 2021 revenue or earnings targets they provided to investors," according to the *Journal's* analysis.[27] These companies fell short on revenue projections by an average of 53%.[28] The article highlighted several of the worst offenders, including:

- A startup battery maker that wooed investors with rapid growth forecasts said it would miss its revenue target by as much as 89%;
- A scooter rental app is expected to bring in less than 20% of what it projected this year;
- An electric bus company that planned to boost revenue faster than any U.S. startup ever told investors to disregard its projections.[29]

These examples do not appear to be outliers. When academics examined SPACs' use of ambitious forecasts, they found "a correlation between ambitious forecasts and poor stock performance.[30] Specifically, these academics found that SPACs that engage in high revenue forecasts "attract significantly more retail investor purchases and social media discussion and are negatively associated with share redemptions."[31] In addition, they found that these companies "are more likely to miss future revenue expectations."[32] The academics further observed that SPACs that engage in high revenue forecasts "underperform similar peers, IPO firms, and the Russell 2000 index at the six-, 12-, and 24-month intervals following the merger close date."[33] In short, "The more aggressive your revenue is, the more likely you are to underperform," according to the one of the study's authors, University of Buffalo School of Management Professor Michael Dambra.[34]

SPACs' incentive to engage in marketing hype that they would not similarly engage in when undertaking a more traditional IPO is likely informed by SPAC participants' view that the Private Securities Litigation Reform Act of 1995 (PSLRA) safe harbor for forward looking statements is available for forward looking statements made in connection with de-SPAC transactions. As former Division of Corporation Finance Acting Director John Coates astutely observed, "It is not clear that claims about the application of securities law liability provisions to de-SPACs provide targets or anyone else with a reason to prefer SPACs over traditional IPOs. Any simple claim about reduced liability exposure for SPAC participants is overstated at best,

[25] *Id.*
[26] *Id.*
[27] *Id.*
[28] *Id.*
[29] *Id.*
[30] Michael Dambra, Omri Even-Tov, Kimberlyn George, *Are SPAC Revenue Forecasts Informative?*, June 2022, https://bit.ly/3mFgMFw.
[31] *Id.*
[32] Id.
[33] *Id.*
[34] Heather Somerville and Eliot Brown, *SPAC Startups Made Lofty Promises. They Aren't Working Out*, WALL STREET JOURNAL, February 25, 2022, https://on.wsj.com/3NHJ129.

and potentially seriously misleading at worst."[35] Accordingly, as discussed below, we agree that providing clarity on this question, as the Proposing Release does, would be incredibly helpful.

III. These proposed amendments would bring SPACs into closer alignment with how traditional IPOs are treated under the Securities Act of 1933 and the Securities Exchange Act of 1934 and, in doing so, provide needed transparency and accountability in the SPAC market.

This proposal would, among other things, require SPACs to provide enhanced disclosures regarding compensation paid to sponsors, conflicts of interest, dilution, and the fairness of these business combination transactions, clarify that the Private Securities Litigation Reform Act of 1995 (PSLRA) safe harbor for forward looking statements is not available for de-SPACs, and affirm the underwriter status of SPAC IPO underwriters in connection with de-SPAC transactions. These proposed amendments would bring SPACs into closer alignment with how traditional IPOs are treated under the Securities Act of 1933 and the Securities Exchange Act of 1934 and, in doing so, provide needed transparency and accountability in the SPAC market. We strongly support these aspects of the proposal, which would be particularly helpful in addressing deficiencies in the market that have resulted in harm to retail investors.

First, the proposal would require SPACs to provide enhanced disclosures regarding compensation paid to sponsors, conflicts of interest, dilution, and the fairness of these business combinations, among other things. Requiring SPACs to provide more detailed information regarding these topics would enhance investors' ability to make more informed investment decisions.

Specifically, enhanced disclosures regarding compensation paid to sponsors and conflicts of interest would provide information that helps investors better understand how sponsor compensation and conflicts of interest held by sponsors, affiliates, officers and directors of the SPAC, and/or promoters might adversely affect their interests, which they could then factor into their decision making. In addition, more detailed information on the potential impact of dilution on the value of SPAC shares could help investors better understand the various sources of dilution and the extent to which their investments might drop in value, which they could then factor into their decision making. Moreover, the requirement for a SPAC to state whether it reasonably believes that the de-SPAC transaction is fair or unfair to unaffiliated security holders, the bases for such belief, and whether the SPAC or SPAC sponsor received any report, opinion, or appraisal from an outside party regarding the fairness of the de-SPAC transaction could incentivize sponsors to avoid transactions that could potentially be viewed as unfair.

Second, the proposal would clarify that the PSLRA safe harbor for forward looking statements is not available for de-SPACs and affirm the underwriter status of SPAC IPO underwriters in connection with de-SPAC transactions. These aspects of the proposal would resolve ambiguities about how the law applies in this context and promote accountability for SPAC market participants. As discussed above, the economic substance of the de-SPAC is that it is the first time when a private company is introduced to the public markets. In other words, it is

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[35] John Coates, Acting Director, Division of Corporation Finance, *SPACs, IPOs and Liability Risk under the Securities Law*s, April 8, 2021, https://bit.ly/39nMFPW.

effectively an IPO in a different form. Given that the PSLRA safe harbor is not available for IPOs, the safe harbor should not be available in the de-SPAC context either. As Professor Coates explained in his article *SPAC Law and Myths*:

> If these facts about economic and information substance drive our understanding of what an "IPO" is, they point toward a conclusion that the PSLRA safe harbor should not be available for any unknown private company introducing itself to the public markets. Such a conclusion should hold regardless of what structure or method it used to do so. The reason is simple: the public knows nothing about this private company. Appropriate liability should attach to whatever claims it is making, or others are making on its behalf.[36]

We agree.

We support clarifying the scope of the PSLRA safe harbor for other reasons as well. The PSLRA safe harbor currently is not available for blank check companies that are penny stock issuers. Yet we see no legitimate reason why the availability of the safe harbor should be based on whether or not a blank check company issues penny stock. On the contrary, such a restrictive application encourages blank check companies that do not issue penny stocks (i.e., SPACs) to engage in aggressive marketing hype and unrealistic projections. We therefore support the proposal's approach to amend the definition of blank check company for purposes of the PSLRA safe harbor for forward-looking statements, such that the safe harbor would not be available for projections by blank check companies that are not penny stock issuers, which would include SPACs and target companies in de-SPAC transactions. Doing so would strengthen incentives for SPACs to avoid potentially unrealistic and potentially misleading forward-looking statements and to expend more effort or care in the preparation and review of forward-looking statements.

Based on the same reasoning that de-SPACs are functionally IPOs, we support the proposal's clarification that a person who has acted as an underwriter in a SPAC IPO and participates in the distribution by taking steps to facilitate the de-SPAC transaction (or any related financing transaction), or otherwise participates (directly or indirectly) in the de-SPAC transaction, will be deemed to be engaged in the distribution of the securities of the surviving public entity in a de-SPAC transaction within the meaning of Section 2(a)(11) of the Securities Act. This aspect of the proposal would strengthen incentives for underwriters to perform due diligence to ensure the accuracy of the disclosures in these transactions and ensure that underwriters are accountable if they do not perform adequate due diligence.

IV. The proposed safe harbor allows SPACs to function as investment companies without having to comply with the investor protections afforded by the ICA. Because the proposed safe harbor goes well beyond the existing safe harbor for inadvertent investment companies, we urge the Commission to narrow the proposed safe harbor. In addition, we urge the Commission to clarify that SPACs operating outside the bounds of the safe harbor are and always have been in violation of the law (assuming they do not meet the conditions of any other available safe harbor) and to enforce the law to reflect these realities.

[36] John Coates, *SPAC Law and Myths*, February 11, 2022, https://bit.ly/3MRT2Zb.

As discussed above, SPACs clearly meet the definition of investment company during their first phase and IPO investors treats them as such during that time. The Proposing Release includes a new safe harbor under the ICA that would provide special treatment to SPACs to effectively function as investment companies for an extended duration without having to comply with the investor protections afforded by the ICA.

The proposed safe harbor is conditioned, in part, on a SPAC's meeting two duration conditions. First, a SPAC would need to announce a de-SPAC agreement within 18 months after the SPAC's IPO and second, the de-SPAC transaction would need to close within 24 months. As the Proposing Release acknowledges, this time frame is much longer than the 12-month time frame that is currently provided for inadvertent investment companies. Accordingly, the proposal would give SPACs favored treatment relative to all other inadvertent investment companies, ostensibly because SPACs exist for longer than 12 months and therefore can't comply with Rule 3a-2 as currently structured.

We do not see a legitimate reason to provide special treatment for one type of inadvertent investment company relative to all other types of inadvertent investment companies merely because their business model doesn't fit neatly within the current regulatory framework. As the Commission stated at the time Rule 3a-2 was issued, "[T]he Commission stresses that a company's inability to become engaged primarily in a noninvestment company business within the rule's one-year period would raise serious questions concerning the applicability of the Act to that company."[37] We agree and do not believe the Commission should provide a special safe harbor for SPACs at all. In our view, if a SPAC can't meet the conditions of Rule 3a-2 or any other existing safe harbor, it should be deemed to be an illegal investment company.

Recognizing, however, that such a position may not be palatable to the Commission, we urge the Commission to narrow the proposed safe harbor, clarify that SPACs operating outside the bounds of the safe harbor that is ultimately finalized are and always have been in violation of the law, and enforce the law to reflect these realities. Specifically, we urge the Commission to reduce the time for SPACs to announce a de-SPAC transaction from 18 months to 12 months, which would promote consistency between the proposed safe harbor and the 12-month limit in Rule 3a-2. Additionally, we urge the Commission to reduce the time for de-SPACs to close from 24 months to 18 months. While this suggested timeframe would still be longer than the 12-month timeframe in Rule 3a-2, such a time would reduce the time that SPACs function like investment companies, thereby making it less likely that investors treat SPACs as investment companies.

In discussing the boundaries of the proposed safe harbor, the Proposing Release states that a SPAC that does not meet the conditions of the proposed safe harbor would "raise serious questions as to its status as an investment company under the Investment Company Act."[38] In our view, the Commission should be more declarative that SPACs operating outside the bounds of the safe harbor that is ultimately finalized are and always have been in violation of the law (assuming they do not meet the conditions of any other available safe harbor), and the Commission should enforce the law to reflect these realities.

[37] *See* Transient Investment Companies, Investment Company Act Release No. 11552 (Jan. 14, 1981).
[38] Proposing Release at 138.

As the Commission well knows, 49 global law firms have stated that they "view the assertion that SPACs are investment companies as without factual or legal basis…"[39] Yet these firms' confidence is belied by the typical SPAC disclosure, which lists as a risk factor that, "If we are deemed to be an investment company under the Investment Company Act, we may be required to institute burdensome compliance requirements and our activities may be restricted, which may make it difficult for us to complete our initial business combination."[40] Clearly there is a disconnect between firms' public posturing and the regulatory disclosures of their clients. Given this disconnect, it is imperative that the Commission speak with clarity and strength and that it enforce the law to ensure that firms and companies understand their legal obligations and take them seriously. If the Commission permits illegal investment companies to persist, it sends a disturbing message to market participants that non-compliance with the law will be tolerated, which may increase market participants' willingness to flout their legal obligations.

Conclusion

For the foregoing reasons, we urge the Commission to finalize without undue delay the proposed provisions of the rule that would bring critical transparency and accountability to the SPAC market. We also urge the Commission to narrow the proposed ICA safe harbor to ensure that SPACs are not permitted to function as illegal investment companies for an extended period of time without complying with the protections afforded by the ICA.

Respectfully submitted,

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[39] Kristi Marvin, *49 Law Firms Unite and Push Back on Recent SPAC Litigation*, SPAC INSIDER, August 27, 2021, https://bit.ly/3MLeU8z.

[40] *See* John Coates, *SPAC Law and Myths*, February 11, 2022, https://bit.ly/3MRT2Zb.