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Regulatory Concerns Grow as Market for SPACs Heats Up

On March 10, 2021, the SEC's Office of Investor Education and Advocacy ("OIEA") cautioned investors not to make investment decisions related to Special Purpose Acquisition Companies ("SPACs") on the basis of endorsements by celebrities. That alert came out only three months after the OIEA issued a bulletin in which SEC staff reviewed the complexities and key concepts underlying SPACs and the SEC Division of Corporation Finance ("DCF") issued its own disclosure guidance on the investment mechanism. Recently, FINRA weighed in on emerging anti-money laundering risks associated with SPACs. In its 2021 Examination Report, FINRA expressed concerns about firms having adequate supervisory policies and performing the kind of independent due diligence necessary to address the risks inherent in this type of investment. These efforts indicate that the regulators are paying close attention to the increasing—some say frenzied—popularity of SPAC investments during the current market volatility. Here's a closer look.

SPACs: The Other IPO

Dubbed “the poor man’s private equity funds,” SPACs have been said to “give ordinary investors a way to participate in the purchase of a hot company before it goes public.” The DCF defines a SPAC as “a company with no operations, that offers securities for cash, and places substantially all the offering proceeds into a trust or escrow account for future use in the acquisition of one or more private operating companies.” The purpose of the creation of the shell company, often referred to as a “blank check company” and funded through an initial public offering (“IPO”), is to find private companies to acquire and then, after acquisition or merger, operate the combination as a public company.

Unlike a traditional IPO, which is a potential stage in the development of a business that seeks to raise capital in the public markets, a SPAC “does not have an underlying operating business and does not have assets other than cash and limited investments, including the proceeds from the IPO.” According to the OIEA, issues arise for potential investors at *two key stages:* at the early and IPO stage of the SPAC and at the business combination stage.

Regulatory Concerns

At the IPO stage, issues arise from the fact that there is no underlying business—only a management team often including some of the sponsors that formed the SPAC—upon which to form an investment decision. The IPO prospectus may or may not even include the type of industry or business that the shell company will target for acquisition. For these and other reasons, the SEC warned that retail investors should never “invest in a SPAC just because someone famous sponsors or invests in it or says it is a good investment.” This is not an idle suggestion: with celebrities like Alex Rodriguez, Shaquille O'Neal, Colin Kaepernick, Jay-Z and Serena Williams each creating SPACs, the concern about retail investors following blindly is real.

FOR MORE ON SPACS AND HOW THEY WORK, CLICK HERE

At the business combination stage of a SPAC, there are several regulatory concerns that might arise, mostly as to conflict-of-interest considerations around target company evaluations, deal structure, sponsor affiliations, additional financing, and compensation. The SEC has expressed several specific disclosure concerns to ensure that investors fully understand their rights under SPACs, for example, the SEC wants investors to fully understand the consequences of SPACs that fail to complete an acquisition within the time frame established by the sponsors. (If the SPAC fails to complete the business combination as stipulated within the IPO period, the shareholders are entitled to a pro rata share of the amount in the trust instrument.)

Further, the DCF highlights that “although most of the SPAC’s capital has been provided by IPO investors, the sponsors and potentially other initial investors will benefit more than [public] investors from the SPAC’s completion of an initial business combination and may have an incentive to complete a transaction on terms that may be less favorable to [the public investor].” An example of an area where the sponsor’s interests and the retail investor's interest may diverge include those related to additional financings that may have different rights than those of retail investor’s investments. Such financings may further dilute interests in the combined company, negatively impacting public investors.

The obligations for firms under FINRA rules center on whether the SPAC is suitable for certain investors and that marketing materials “provide an accurate and balanced description of SPACs” including risks associated with the investments. In its 2021 Exam Report, FINRA reaffirmed much of the SEC’s (and its own) prior guidance warning about (i) “misrepresentations and omissions in offering documents;” (ii) shareholder communications on SPAC acquisition targets; (iii) transaction fees; (iv) affiliate compensation; (v) control of funds; and (vi) the potential for insider trading. FINRA urged firms who are involved at the early stages of a SPAC to ensure that any written supervisory procedures require “due diligence of SPACs’ sponsors, and procedures that address other potential fraud risks.” At a recent SIFMA program discussing FINRA’s priorities, FINRA representatives identified SPACs as an “emerging risk” and were particularly interested in the SPAC sponsor, ensuring that conflicts for underwriting fees and disclosures are made, including in the proxy.

Current Market for SPACs

The scale and pace of the SPAC trend is considerable. According to a January 2021 *Wall Street Journal* article, “nearly 300 SPACs are now seeking deals, armed with about $90 billion in cash.” The year over year numbers are impressive. On March 9, 2021, the *Journal* reported, “the 67 SPACs created this year have already raked in nearly $20 billion from investors… well above the total from all of 2019, which was a record before last year’s historic haul of $82 billion.”

As described in another March 2021 *Journal* article, “hedge funds that buy into SPACs early see them as a way to make lofty returns without much risk [since] individual investors are attracted by the chance to get positions in newly public companies that they could rarely purchase through traditional IPOs.” That describes both the allure in the market and the concern for regulators.

Market watchers see the pace as unsustainable at “an average of five new SPACs launched each business day,” with concerns that “there are now hundreds looking for companies to acquire,” many in the same sector." The pressure to find and close a business combination before being required to return the capital to shareholders is increasing and “inflating deal values.” SPACs that cannot get the deal done may actually cost shareholders part of their initial investment. The speed and size of the frenzy, and these added pressures have sparked a market response. SPAC boom skeptics—sellers betting against shares of SPACs—have “more than tripled to about $2.7 billion from $724 million at the start of the year.”

Conclusion

The things that make SPACs so popular with small companies looking to raise money in the market today are the same things that make them so worrisome for regulators. Current market volatility is encouraging companies who were contemplating traditional IPOs to take the SPAC route. SPAC acquisitions are quicker to close than the registration process for traditional IPOs, and SPACs provide more certainty around a capital infusion (given that target companies can negotiate a fixed valuation with a sponsor). All this means that due diligence for a SPAC is not as demanding as for a conventional IPO. When market participants are making strategic business choices based on which option is less costly and burdensome, regulators become interested. Increased scrutiny over compliance follows. Bates will continue to keep you apprised.

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