CFA Institute

THE NEW AGE OF SPECIAL PURPOSE ACQUISITION COMPANIES

What Investors Should Know

May 2022

The mission of CFA Institute is to lead the investment profession globally by promoting the highest standards of ethics, education, and professional excellence for the ultimate benefit of society.

CFA Institute, with more than 170,000 members worldwide, is the not-for-profit organization that awards the Chartered Financial Analyst® (CFA) and Certificate in Investment Performance Measurement® (CIPM) designations. CFA®, Chartered Financial Analyst®, AIMR-PPS®, and GIPS® are just a few of the trademarks owned by CFA Institute. To view a list of CFA Institute trademarks and the Guide for the Use of CFA Institute Marks, please visit our website at www.cfainstitute.org.

Contents

Preface vi

Executive Summary 1

Section 1 : How a SPAC Works 4

THE SPAC LIFECYCLE 5

Initial Phase 5

Redemption Rights 6

Shares and Warrants 7

The Sponsor 8

Hedging against the Risk of Redemptions: PIPEs, Non-Redemption Agreements, and Forward-Purchase Agreements 9

The deSPAC Phase 10

The Special Role of the Share Price in the deSPAC 11

The Shareholder Vote to Approve the Merger 12

The Post-Merger Phase 13

Regulatory Questions Raised by SPACs 14

Section 2: Incentives and Conflicts 21

"No Deal" Conflicts 21

Sponsors who Operate Multiple SPACs or Other Investment Funds 22

SPAC Boards of Directors Incentives and Conflicts of Interest 23

IPO Investors' Short-Term Incentives vs. Long-Term Holders 24

SPAC Underwriter Conflicts 25

Section 3: Disclosure Quality and Prominence 26

Qualifications and Experience of the Sponsor 27

SPAC Participants who are Affiliated with the Sponsor 27

Side Payments 27

Sponsor Economics 28

Standardized Information on Shares, Warrants, and Fees 31

IPOs compared to SPACs 31

Section 4: Recommendations to Regulators Regarding SPAC Structure and Process Issues 32

Traditional IPO Process: A Public Listing via the Securities Act of 1933 using form S-1. 32

SPAC Process: Part regular-way IPO, Part Reverse Merger, Part Direct Listing. 33

Recommendations For U.S. Securities Law Adjustments. 34

Recommendation 1: Leveling Application of PSLRA Safe Harbor on Forward-looking Statements. 34

Recommendation 2: Leveling Application of Section 11 Liabilities for Financial Advisers to the merger. 35

Recommendation 3: Codifying a New Form for Investor Protection: Form KCR (Key Conflict & Risks). 36

Recommendation 4: Trading on Inside Information and Gap Trading Anomalies. 37

Recommendation 5: ExaminingSPAC Promotion and Digital Engagement Practices (DEP). 38

Recommendation 6: Conflicts. 38

Recommendation 7: New Disclosure Requirements. 40

Appendix A: PIPE Basics 41
PIPE Investors as a Signal of Deal Quality 41
Comparing PIPE Investors and IPO Underwriters: PIPE Investors Are Not Gatekeepers 43
Appendix B: CFA INSTITUTE SPAC CRIB SHEET: WHAT INVESTORS NEED TO KNOW BEFORE THEY INVEST 45
Introduction 45
Setting the Scene 45
Key Considerations 46
1. Highly Speculative Investments 46
2. Financial Market Engineering 46
3. SPAC Units, Shares, and Warrants 47
4. Trading SPACs pre-IBC 47
5. Sponsor Conflicts 47
6. Merger Announcement Trading 48
7. Redeeming SPAC Shares 48
8. Long-Term Prospects for SPAC IBC Investments 49

Preface

In May 2021, CFA Institute, the global association of investment professionals, created a new SPAC Working Group to examine and make recommendations regarding the surge in U.S public listings of special purpose acquisition companies (SPACs) and the implications for investor protection, corporate governance, and market integrity.

CFA Institute (the "Institute" or "we") convened a broad group of experts and market participants, including SPAC practitioners, data and service providers, legal and accounting experts, academics, and stock exchange representatives. This international group, which included observers from Europe and Asia-Pacific, served as an external advisory body to CFA Institute policy staff. Throughout the second half of 2021, we held three plenary half-day meetings as well as three subgroup meetings. The meetings were conducted under Chatham House rules and included presentations by SPAC experts who were outside of the SPAC Working Group.

CFA Institute thanks all participants in the working group. The in-depth discussions and range of perspectives have informed our understanding of SPACs. Our goal from the start was to publish a report on SPACs, with a focus on investor protection and market integrity issues. This Report is written for an audience of CFA Institute members, investors, the public at large, and U.S. and global regulators and policymakers. ***The Report represents the views of CFA Institute and not necessarily those of individual members of the Working Group***.

The Report aims to meet the objectives set out initially by Margaret Franklin, CFA, President and CEO, CFA Institute:

> We believe the working group will provide a valuable perspective to U.S. and other global regulators, who have already signaled increased scrutiny of the SPAC structure and related disclosures. We want to make sure the issues of investor protection and market fairness are fully examined as the SPAC structure continues to proliferate around the world.

SPAC Working Group Members

U.S. / Canada Members (alphabetically)

- Jocelyn Arel, Goodwin Procter LLP
- Amy Borrus, Council of Institutional Investors (CII)
- Joseph Brady, North American Securities Administrators Association (NASAA)
- Ward Davis, G Squared Ascend
- Jennie Dong, NYSE
- John Griswold, Greenwich Roundtable and Former CommonFund Institute
- Ed Hackert, Marcum
- Vahan Janjigian, CFA, Greenwich Wealth Management
- Ben Kwasnick, SPAC Research
- Ada Litvinov, CFA, British Columbia Public Service
- Michael Ohlrogge, NYU School of Law
- Jay Ritter, University of Florida Warrington School of Business
- James Ryans, CFA
- Rajiv Shukla, Alpha Healthcare Acquisitions Corp
- Karen Snow, NASDAQ
- Maureen Thompson, Certified Financial Planner Board of Standards (CFP Board)

International Observers – Europe

- Edoardo Carlucci, Better Finance
- Rainer Riess, Federation of European Stock Exchanges (FESE)

International Observers – Asia-Pacific (APAC)

- King Au, CFA, Financial Services Development Council
- Daryl Liew, CFA, REYL Singapore; Listing Advisory Committee of SGX

CFA Institute Staff

- Paul P. Andrews, Managing Director for Research, Advocacy, and Standards
- Kurt Schacht, JD, CFA, Head of Advocacy, Americas
- Stephen Deane, CFA, Sr. Director for Capital Markets Policy, Americas

Executive Summary

In 2013, SPACs represented an insignificant portion of the market for new, public offerings. They grew to roughly a quarter of this market by 2019, and then exploded: 53% of the market in 2020; 61% in 2021. To understand the market for public offerings it is crucial to understand how SPACs operate. Today, the statistics on the number of SPAC IPOs, and the follow-on merger transactions known as a deSPAC, tell the story of the dramatic surge of the SPAC.

SPACs Have Grown in Recent Years. Since 1996, there has been a steady move of capital formation out of public markets and into private markets in the United States. The number of public companies has declined from 8,000 to 4,000, even as total market capitalization has grown. Most of these firms did not go out of business but were acquired by other firms as part of the great consolidation.[1] With attributes like generous fee structures for promoters, venture capital-like investment opportunities for retail, flexibility as to financial structure and expanded access to public markets for target companies, SPACs have become very popular.. Because of these fundamental drivers, we anticipate that the reemergence of the SPAC structure is likely to continue.

SPACs Have a Distinct and Complex Structure. There are three distinct phases to a SPAC (the initial SPAC stage; the deSPAC stage; the post-merger stage). There are also different types of securities involved in a SPAC transaction (equity and warrants). There are more categories of participants compared to regular IPOs (sponsors, regular SPAC shareholders, Private Investment in Public Equity [PIPE] investors). This mixture of structural options and a wider range of deal stakeholders creates a network of changing and sometimes conflicting incentives and priorities.

SPACs Can Impact Access and Protections for Retail Investors. Historically, the SEC's regulatory architecture has employed a lighter touch for investment vehicles targeted to institutional investors (hedge funds, private equity, venture capital) and a more rigorous framework for retail investors who may not have comparable sophistication or resources to evaluate investments. At present, the amount of retail investor participation in the SPAC market is unclear. One research piece asserts that "institutional investors contribute the

[1] *See* Vartika Gupta, Tim Koller, and Peter Stumpner, "Reports of corporates' demise have been greatly exaggerated," McKinsey & Co. (Oct. 21, 2021), available at https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/reports-of-corporates-demise-have-been-greatly-exaggerated.

vast majority of investment dollars in SPACs,"[2] but if SPACs remain a major path for companies to enter the public markets, we expect retail investors to continue to participate in more significant numbers. In this report, CFA Institute recommends a pragmatic approach that increases disclosures to benefit retail investors, while keeping SPACs as a flexible tool for companies to approach the public markets.

A GUIDE FOR SPACs' PROCESS AND RECOMMENDATIONS

This report is broken into four sections:

Section 1: How a SPAC works. The first section examines the three phases of the SPAC lifecycle, SPAC structural details, and the roles of the key players. This section also explores key features of SPAC share redemption rights, the warrants that are included along with the SPAC shares, how sponsors are remunerated for completing the SPAC process, and the key role private investors play via PIPE transactions in ensuring the stability of the offering.

Section 2: Incentives and conflicts. The SPAC structure allows for a range of deal incentives that can raise distinct conflicts of interest. We discuss four in particular: the "no deal" conflict; sponsors who are engaged in multiple deals; directors and IPO underwriters with contingent compensation; and inherent conflicts between short-term SPAC traders versus longer-term deSPAC investors.

Section 3: Disclosures. One of the best ways to help retail investors assess SPAC investment risk is to improve disclosures. We suggest more detail on matters such as: the qualifications and experience of the sponsor; affiliations between the sponsor, PIPE investors, and target company; the existence of any side deals; a sponsor's compensation and dilution effects; and shares and warrants issued and fees and expenses incurred.

Section 4: Regulatory recommendations. Based on extensive discussions, we offer seven pragmatic recommendations to further investor protection for SPAC investors. While in some cases these parallel recent U.S. Securities and Exchange Commission (SEC) proposals, our focus is to provide immediate assistance to investors as they analyze hundreds of current SPAC offerings. Our recommendations are:

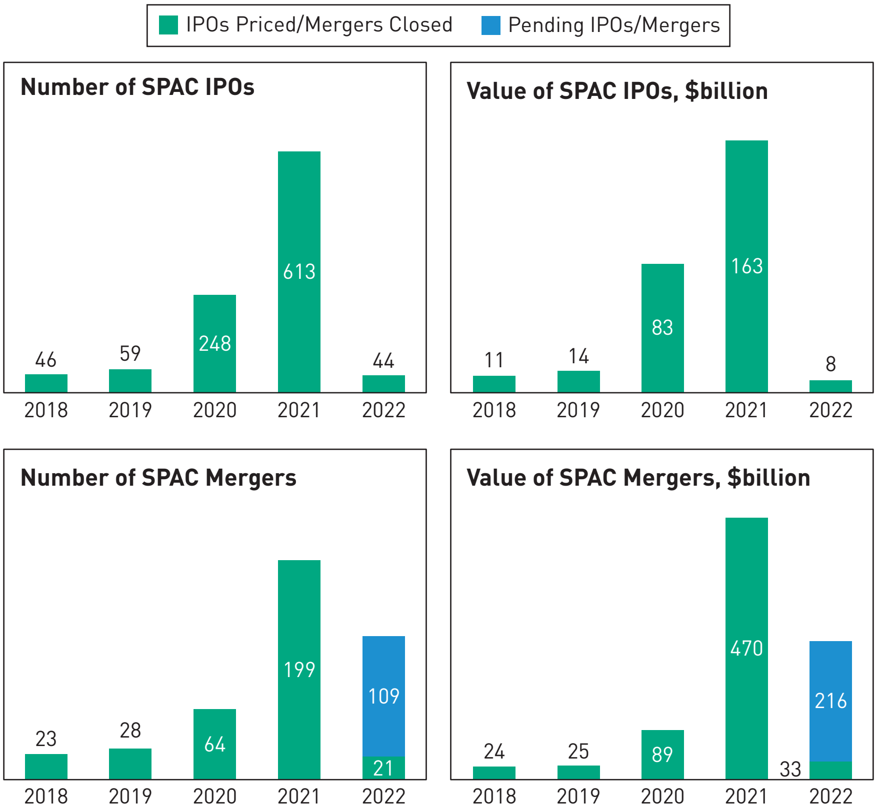
[2]Committee on Capital Market Regulation, *Retail Investors and SPACS*, October 19, 2021. https://www.capmktsreg.org/2021/10/19/nothing-but-the-facts-retail-investors-and-special-purpose-acquisition-companies/

1. **Ensuring an equivalent application of the PSLRA safe harbor.**
2. **Ensuring an equivalent application of Section 11 liabilities for Financial Advisers to the merger.**
3. **Codifying a new form for investor protection: Form KCR (Key Conflict & Risks). See Appendix B.**
4. **Review of trading on Inside Information and Gap Trading Anomalies.**
5. **Examining SPAC Promotion and Digital Engagement Practices (DEP).**
6. **Assessing deSPAC merger transactions with affiliated targets.**
7. **Implementing enhanced disclosure requirements.**

Section 1: How a SPAC Works

A SPAC – short for a Special Purpose Acquisition Company – is a publicly listed company established for a single purpose: to find a private operating company and merge with it, thereby taking it public. The numbers of both SPAC IPOs and deSPAC mergers have soared in recent years.

SPAC IPOs & MERGERS

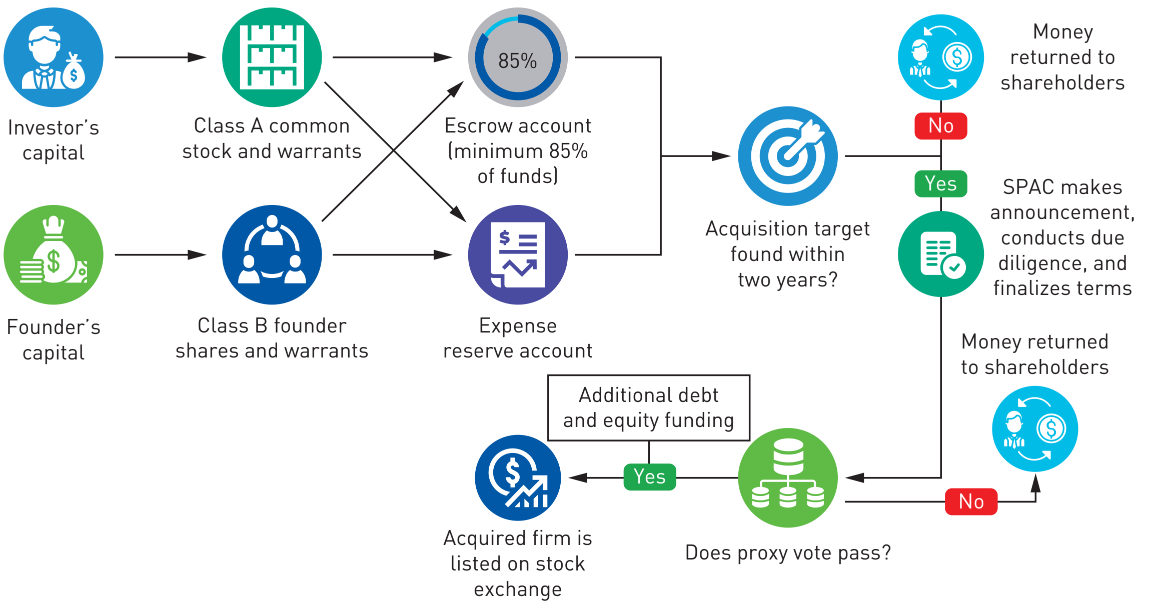


Data: SPAC Research, as of Feb 28, 2022

SPAC alpha

THE SPAC LIFECYCLE

The lifecycle of a SPAC comprises three stages: the **initial SPAC stage**, which begins when the SPAC launches its IPO and ends when it announces a proposed merger; the **deSPAC stage**, when it has negotiated, structured and announced the merger deal; and the **post-merger stage**, when the SPAC and merger target actually combine in what is called an initial business combination (merger), resulting in a new, publicly traded company.



Initial Phase

In the pre-merger period, the SPAC is a publicly traded shell or "blank-check" company,[3] not an operating business. Its goal is to find a private operating company (the target),

[3]SPACs do not currently meet the formal SEC definition of a blank-check company, which is limited to penny-stock companies. Nonetheless, SPACs essentially are blank-check companies. On March 30, 2022, the SEC proposed to amend the definition of blank-check companies to include SPACs for purposes of the Private Securities Litigation Reform Act of 1995 ("PSLRA"). If the proposal is adopted, the SEC explained, "the safe harbor for forward-looking statements under the PSLRA would not be available to SPACs, including with respect to projections of target companies seeking to access the public markets through a deSPAC transaction." See SEC Release Nos. 33-11048; 34-94546; IC-34549; File No. S7-13-22 (Special Purpose Acquisition Companies, Shell Companies, and Projections) ("proposing release") at 19-20, available at https://www.sec.gov/rules/proposed/2022/33-11048.pdf.

negotiate terms of a merger with the target, attract new private capital, win SPAC shareholder approval for the deal, minimize SPAC shareholder redemptions, and retain adequate capital to complete the merger.

SPACs must complete a merger within a specified period of time, or they must dissolve and return funds to shareholders.[4] The **merger completion deadline** varies from SPAC to SPAC but has ranged from 18 to 24 months and dipped to as low as 12 months in 2022. The completion deadline makes the merger a do-or-die event for the SPAC and its sponsor.

The merger transforms the SPAC from a shell company into an operating business with goods or services to sell. It also transforms the target company from a private company to a public company—with all the reporting obligations and investor protection requirements that come with this new status.[5]

Redemption Rights

A key investor protection feature of the SPAC process is the redemption right. After the SPAC announces a proposed merger deal and it is approved by SPAC shareholders, those shareholders who have elected to redeem their SPAC shares have the ability to tender such shares to the SPAC and receive their applicable portion of the cash proceeds held in the SPAC trust.[6] This redemption feature offers a unique investor protection that traditional IPOs do not offer and has been one of the important selling points used to attract public investors to SPACs.

Shareholders can rely on the redemption option because the SPAC places all of the IPO proceeds into a trust. The trust then invests the money in short-term Treasury securities

[4]Specifically, disbanding SPACs must return to shareholders their pro rata share of the money in the trust fund.
[5]SPACs enjoyed a meteoric rise since 2019, though the stock prices of many SPACs that have completed a merger have declined over the past half-year or so. These investments have been portrayed as way for ordinary, retail investors to gain access to early-stage, high-growth companies and be part of potentially large profits to come. This has proven enticing to those who believe that retail investors have been shut out of lucrative investment opportunities in both private equity and traditional IPOs. These perceptions notwithstanding, SPACs present an array of unique features—including disclosures, conflicts of interest, and dilution—that pose particular risks for retail and other investors.
[6]The deadline to demand redemption expires a day or two before the shareholder vote to approve the merger, but redeeming shareholders will only receive their money back if and when the merger is completed. This has been touted as a money-back guarantee: if shareholders are not satisfied with the proposed deal, they can get their money back. There are, however, some important caveats to that claim, which we discuss later.

and rolls them over as needed.[7] This practice stands in stark contrast with traditional IPO public companies, which use their IPO proceeds to fund and grow their business. The SPAC is able to place 100% of the IPO proceeds in the trust, because the sponsor uses its own funds to pay the set-up costs and expenses of the IPO and to cover the SPAC's pre-merger operating expenses.[8]

Shares and Warrants

SPAC "units" are typically what are issued in a SPAC IPO. The unit is a bundled security comprising two components: **shares** and **warrants**.[9] A warrant is a stock option issued and payable by the company itself. The warrant gives the holder the right, but not the obligation, to buy a specified fraction of a share at a certain price (for SPACs, typically $11.50 per share) in the future, post-merger company. After about two months,[10] unit holders are allowed to detach the warrants and trade them separately. After this time, any investor buying shares on the public market will receive no warrants along with them—even if they pay $10.[11]

Later, at the merger stage, anyone who purchased units will be allowed to redeem their shares for the full amount ($10 plus interest earned in the SPAC trust) and still retain their warrants. This feature has been successful in attracting investments from initial IPO investors: typically, professional traders and hedge funds. The SPAC structure is attractive because the guaranteed redemption option—which professional investors and hedge funds almost always exercise—protects their downside risk (even if the public share price falls below $10), and the warrants they retain provide them exposure to potential upside if the post-merger company succeeds.[12]

[7]Investing SPAC trust funds primarily in government securities has one additional advantage: it exempts SPACs from one of the tests that determine whether a company is an investment company subject to the Investment Company Act. But for this exemption (Rule 3a-1), SPACs would appear to meet this particular test. The SEC has proposed a safe harbor from the definition of "investment company" for SPACs that meet certain specified conditions. *See* Proposing Release, *supra* note 3.

[8]Sometimes the sponsor tops up the trust with an additional contribution, so that the money in the trust equals 101% or 102% of the IPO proceeds.

[9]Some units also consist of rights, which can be exchanged for a fraction of a share (such as one-tenth of a share) at no cost, provided that the SPAC merger is completed. *See Michael Klausner, Michael Ohlrogge, and Emily Ruan, A Sober Look at SPACs, 39 YALE J. ON REGUL. 228 (2022), at 237.*

[10]The split usually takes place 52 days after the date of the registration statement, which is 51 days after the IPO. In some cases, however, the split is allowed sooner.

[11]If a SPAC unit includes rights, they will also detach when the unit is split.

[12]In return for parking their money in the SPAC trust, investors who purchase SPAC units and subsequently redeem their shares will earn risk-free interest at a rate that can exceed that of money market funds or other cash-equivalent vehicles. This comes, however, at the cost of illiquidity and the opportunity costs that entail for the period that the money remains in the trust. Moreover, this is essentially a fixed-income strategy, which would require investors to redeem their shares at the time of the merger instead of investing in the

The Sponsor

In the first, pre-merger stage of a SPAC, shareholders invest in SPACs based on the capabilities of the **sponsor**, which creates, organizes and runs the SPAC public company. Sponsors typically appoint the SPAC's board of directors and arrange for financial, legal, and accounting advisers. In addition, sponsors fund the pre-merger operations and lead the search for the merger target. Once identified, they negotiate the terms of a merger deal, support preparation of extensive legal and regulatory filings, and work to ensure shareholder approval of the merger.

While the sponsor is usually a limited liability company, the term "sponsor" typically refers to the individual (or individuals) who leads both the sponsor entity and the SPAC public company. These individuals often serve as CEOs and board chair of the SPAC itself. The sponsor, along with the board of directors, controls the SPAC.

A wide variety of individuals have served as the sponsor. These include famous celebrities, such as entertainers, sports figures, and former politicians or well-known professional investors. Others come from the world of hedge funds, private equity funds, and venture capital funds. Still others are former CEOs and top executives, who have expert knowledge and long experience in particular industries.

As compensation for its work, the sponsor receives what is called a **promote**. The promote consists of **founder shares**, which the sponsor takes for a nominal fee. The founder shares amount to 20% of post-IPO equity. The founder shares—along with any warrants that the sponsor acquires at fair market value—are at-risk capital for the sponsor. This means they will have no value if the SPAC fails to complete a timely merger.[13] Unlike the SPAC shares that the public buys, the sponsor's shares cannot be redeemed.

The founder shares and warrants provide the sponsor a strong financial incentive to complete a merger before the completion deadline expires. The sponsor has a much lower break-even point than public shareholders, and that means the sponsor can earn a profit even if the merger ends up being low quality and the public shareholders lose money.

merger with the target company. Therefore, this strategy is quite separate from what is often featured; i.e., that SPACs are an opportunity for retail investors to invest in early-stage and emerging growth companies. Investors who purchased units could retain their warrants for upside exposure to the post-merger company. This strategy would not be available, however, to investors who purchase shares instead of units, including retail investors who purchase shares after the merger announcement.

[13]The founder shares are Class B shares, whereas public shareholders own Class A shares. Upon completion of the merger, the sponsor's founder shares convert from Class B shares into Class A common shares.

This **"no-deal" conflict of interest** is a key consideration that every SPAC investor should consider, and we explore it more thoroughly in the conflict-of-interest section below.

Hedging against the Risk of Redemptions: PIPEs, Non-Redemption Agreements, and Forward-Purchase Agreements

As part of the terms of the merger, target companies negotiate a **Minimum Cash Condition**, which requires that the SPAC provide a specified minimum amount of cash to complete the merger.[14] Redemptions take on special importance in light of the Minimum Cash Condition. If the redemptions are too high, they will deplete trust fund money to a level below the minimum cash condition, and the target company has the right to back out of the deal.

To reduce that risk, SPAC sponsors attempt to avert, or at least have a backup plan for, high redemption levels.

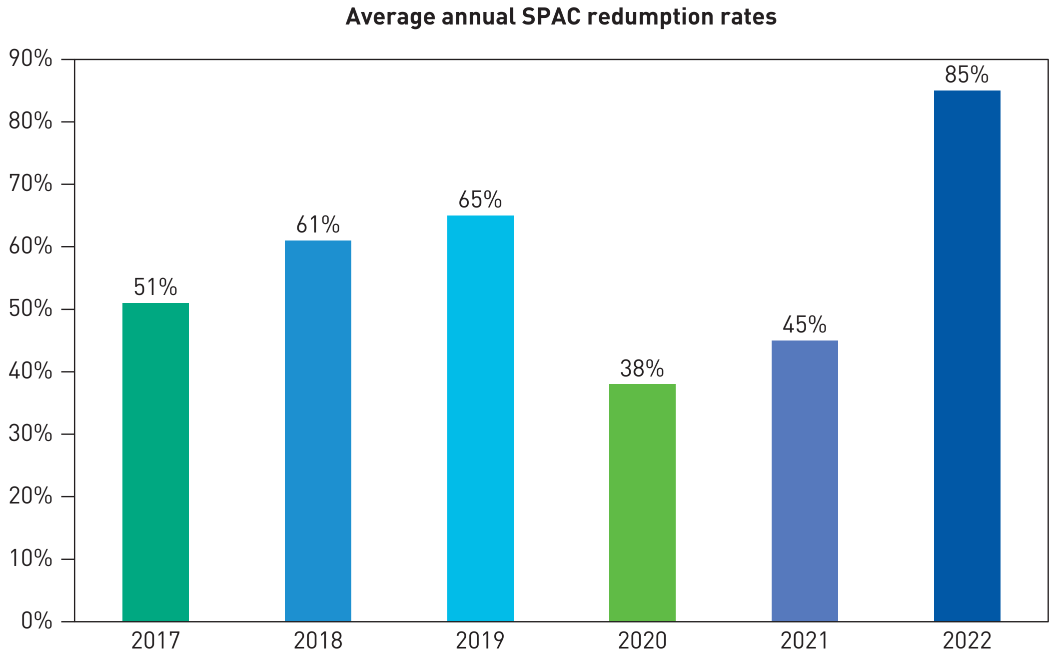
For example, SPACs often seek to supplement the money in the trust by raising additional cash through private deals with institutional investors. These private deals are called **PIPEs**, short for private investments in public equity. Therefore, the PIPE capital adds to the trust money and can help to compensate for trust redemptions. And, whereas the SPAC IPO trust money can be redeemed, PIPE capital is generally locked in to complete the merger. PIPEs also serve an additional important role as a signal of deal quality and may thereby indirectly reduce the level of redemptions.

SPACs also use non-redemption agreements and forward-purchasing agreements, sometimes in combination, to assure adequate cash to complete the merger. In a **Non-Redemption Agreement**, a large investor makes a binding commitment not to redeem its shares until the merger is completed. In a **Forward Purchase Agreement**, a large investor typically makes a tentative agreement to purchase a set number of SPAC shares at a future date that will occur before the merger is completed, assuming such investor is satisfied with the quality of the proposed merger target. Both types of agreements help to top off

[14]Cash contributions to the merger from the SPAC (and other capital providers, as noted below) are critical to successfully closing a merger. Cash is the tangible value that the SPAC can offer in exchange for a percentage of the enterprise value of the target company. Furthermore, the SPAC can bring other benefits to the target. The merger enables the target to become a public company, the SPAC sponsor may bring valuable industry and management experience to the target, and the SPAC can bring public company know-how to an inexperienced target. While those aspects are important, it is the cash merger consideration provided by the SPAC that receives the most attention from potential targets.

the cash that the SPAC can count on to deliver and helps the sponsor hedge against the risk of large redemptions from other shareholders.

Since the first quarter of 2021, most SPACs have experienced increasing redemption rates and difficulty attracting PIPE investments. This, in turn, has amplified the importance of non-redemption agreements.



Data provided by SPAC Research (www.spacresearch.com)

The deSPAC Phase

After the initial phase, the SPAC then enters a new and more volatile phase—the deSPAC phase—when it publicly announces it has identified a merger target and has entered into a preliminary merger agreement.

The merger announcement typically sparks an uptick in public trading, with higher volumes of SPAC shares trading hands. This may well be the most intense trading time in the lifecycle of the SPAC—all based on expectations for the still-private target company.

In essence, at this point SPAC investors are trading SPAC shares as if they were the shares of the merger target, which remains a private company for several more weeks. As such, the target has never filed any financial or other public disclosures with the SEC.

Though the content of SPAC and IPO disclosures overlap in important ways, significant differences remain in terms of process, timing, and content available to investors during the deSPAC phase. This creates an unusual (if not unique) situation because in other contexts *public* trading of the securities of *private* companies is usually prohibited. We refer to these differences as the **trading disclosure gap**.

Along with the merger announcement, the SPAC often makes public an investor deck, available to any existing or prospective SPAC investors, which seeks to tell a more detailed story about the target and its prospects. Investor decks describe the business purpose of the target company, the market need its product or services intends to fill, and how the target will use the proceeds from the SPAC merger. Investor decks also may present market cap and enterprise value estimates for the new public company under various redemption scenarios. In addition to the decks, the SPAC must file a formal regulatory document with the SEC on a Form 8-K announcing the planned merger.

The trading-disclosure gap window closes when the SPAC files a merger registration statement and a proxy statement with the SEC.[15] Those filings provide investors essentially the same information they would receive in a traditional IPO—with one important difference. SPAC merger filings and proxy statements usually have contained forward-looking statements, whereas traditional IPO statements almost never do.

The Special Role of the Share Price in the deSPAC

The SPAC's share price plays a special role in the deSPAC process. It can serve as a barometer for the expected level of redemptions and may be indicative of the quality of the merger target's business.

Shareholders wishing to divest can do so in either of two ways: by selling their SPAC shares on the open market before the merger closes, or by redeeming them directly from the SPAC for a pro rata portion of the money in the trust (typically $10 per share plus interest). While redemptions will reduce the balance in the trust, selling on the open market will have no effect on the amount in the trust. If the share price rises much above

[15]This window closes partially when the SPAC files a preliminary S-4 merger document or a proxy statement, and it closes completely when the final documents are filed. During this interim window of time—which could last more than a month—is typically the most intense trading time in the life of the SPAC.

$10 per share, exiting shareholders should choose a market sale over redemptions. Conversely, if the share price falls much below $10, the divestment strategy would be to redeem rather than to sell.

Data on the actual level of redemptions are often unavailable to SPAC investors before their deadline to exercise their redemption rights. Some SPACs may voluntarily disclose redemption levels before the shareholder vote on the merger, but they are not required to do so. Moreover, redemption levels could change significantly after the disclosure. In lieu of redemption data, many SPAC shareholders look instead to the public share price of the SPAC as one indication of the market's view of the merger and, therefore, as a good proxy for redemption levels. Investors should understand, however, that share prices can be volatile, rising initially when the merger is announced, only to fall before it is completed.[16]

The Shareholder Vote to Approve the Merger

SPACs typically must clear one final hurdle before they can complete the merger: submitting the deal to a shareholder vote. Failure to receive a majority of SPAC shares voting in favor of the merger blocks the merger transaction from closing. Naturally, if shareholders believe the proposed merger is a sound one and have decided to hold their shares, they will likely vote in favor of the merger. But even if shareholders view the deal as a bad one and choose to redeem their shares, they also have an incentive to vote in favor of the merger.[17] That is because shareholders can only exercise their rights of redemption if the merger is approved. (The deadline to demand redemptions occurs a day or two before the merger vote, but the actual redemption only takes place upon completion of the merger.) If the merger vote fails, shareholders cannot redeem their shares. The negative shareholder vote will terminate that particular deal, but the SPAC can either elect to liquidate at that point and return all trust money or remain active and continue searching for

[16]In this context, it's important for SPAC investors who buy post SPAC IPO to understand that most of the initial IPO investors in the SPAC generally intend from the start to dispose of their shares at the time of the merger, regardless of the target quality or its prospects. As discussed earlier, the investment strategy of these professional investors is to divest their shares to get their money back (giving them full downside protection), while keeping their warrants (thus retaining upside potential). These initial IPO investors rent their money to the SPAC's trust until the merger is completed, and they keep their warrants as compensation. These investors had decided from the start—well before the target is even identified—to dispose of their shares before the merger deal. The SPAC share price will determine how they will dispose of their shares—either by selling them in the public market or redeeming them from the trust.

[17]This also holds true for other investors with a strategy of disposing of their shares and retaining free warrants in the proposed merger. These investors can only receive their redemption money if and when the merger is completed and can only keep their warrants as upside potential after a merger is approved and completed.

an alternative merger before its merger deadline passes. This forces a shareholder wishing to redeem to wait out the clock before they can actually do so.[18]

In a previous generation of SPACs, shareholders could only redeem shares if they voted against the merger. But in recent years, shareholders have had the right to redeem their shares whether they vote in favor or against the merger.[19] This decoupling of the vote on merger approval from the redemption right gives SPAC shareholders who purchased units the opportunity to exercise a strategy of risk-free returns on the shares redeemed while keeping the warrants as an upside bet on the newly merged entity. This in and of itself has become a prominent trading strategy facilitated by the SPAC process.

These considerations explain why almost no merger votes have failed in the history of SPACs. They also explain why the shareholder vote fails to serve as a disciplining measure on sponsors to avoid proposing transactions with weak merger targets.

The Post-Merger Phase

The merger completes the SPAC lifecycle and, with it, the purpose of the SPAC: to merge with a private operating company (the target) and take it public. In place of a blank-check SPAC, the target becomes the public company with an operating business with products or services to sell. The name and ticker symbol of the post-merger company will change from those of the SPAC. The new company assumes the remaining money left in the SPAC trust along with the proceeds of PIPE investments, as well as the obligations embedded in outstanding SPAC warrants and rights. [20] The new company also takes on the reporting, internal control, auditing, and other investor protection obligations that come with its new status as a public company.

Under the terms of the merger, the owners of the target company usually exchange their shares for new shares in the post-merger company. As a result, the owners of the former target company usually end up owning a large, majority stake of the post-merger equity.

[18]If the vote fails, three things could happen: (1) the SPAC could voluntarily dissolve itself and distribute the trust money to shareholders; (2) the sponsor could attempt to find another target, negotiate a merger deal, win shareholder approval for it, and consummate the merger before the SPAC's merger deadline passes; or (3) the merger deadline will expire. Shareholders could get their money back only after the earliest of these three possibilities takes place.

[19]The SPAC may require that shareholders cast a vote to be eligible to demand redemption, but how a shareholder votes (for or against the merger) does not affect shareholder redemption rights.

[20]Once the merger is complete, the underwriter of the SPAC's IPO receives the balance of its compensation (typically set at 3.5% of the IPO proceeds). The deferred fees for the SPAC underwriter and all professional fees/expenses of the deSPAC are paid from the remaining money in the trust after redemptions.

SPAC shareholders who did not redeem their shares become shareholders in the new public company. The founder shares owned by the SPAC sponsor (along with the founder shares transferred to other investors) automatically convert from Class B shares into Class A common shares of the new merged company upon completion of the merger. One or more of the executives who managed the sponsor (and thus controlled the pre-merger SPAC) may sit on the board of the post-merger company.

The sponsor's shares remain private securities, and sponsors must wait for the company to register those shares before it can sell them. Even then, sponsors typically commit to lock-up agreements that allow them to sell shares only after a specified period of time, often one year following the merger. The PIPE investors typically have no lock-up agreements once the merger is completed. But the PIPE's shares in the new public company remain private shares until the company registers them in a follow-on action. This will take a few months, and until then PIPE investors cannot sell their shares. Once that happens (the PIPE share registration becomes effective), it is not unusual for PIPE investors to exit their investment.

Regulatory Questions Raised by SPACs

There are a number of similarities between the deSPAC phase and a traditional IPO. As noted in the following graphic, since 2019 the number of companies going public via the SPAC process has far outpaced the traditional IPO process in the U.S.

If the merger is completed, this will be the first time that the private operating company lists public shares that begin trading on the public stock exchanges. The formal announcement of the deal is commonly the first time that the SPAC's investors have any tangible information about the target company, its management, and its basic business fundamentals.

Furthermore, a decision by a SPAC shareholder not to redeem shares can be viewed as an affirmative decision to invest in the target company similar to a traditional IPO. In the words of a recent Delaware Chancery Court ruling:

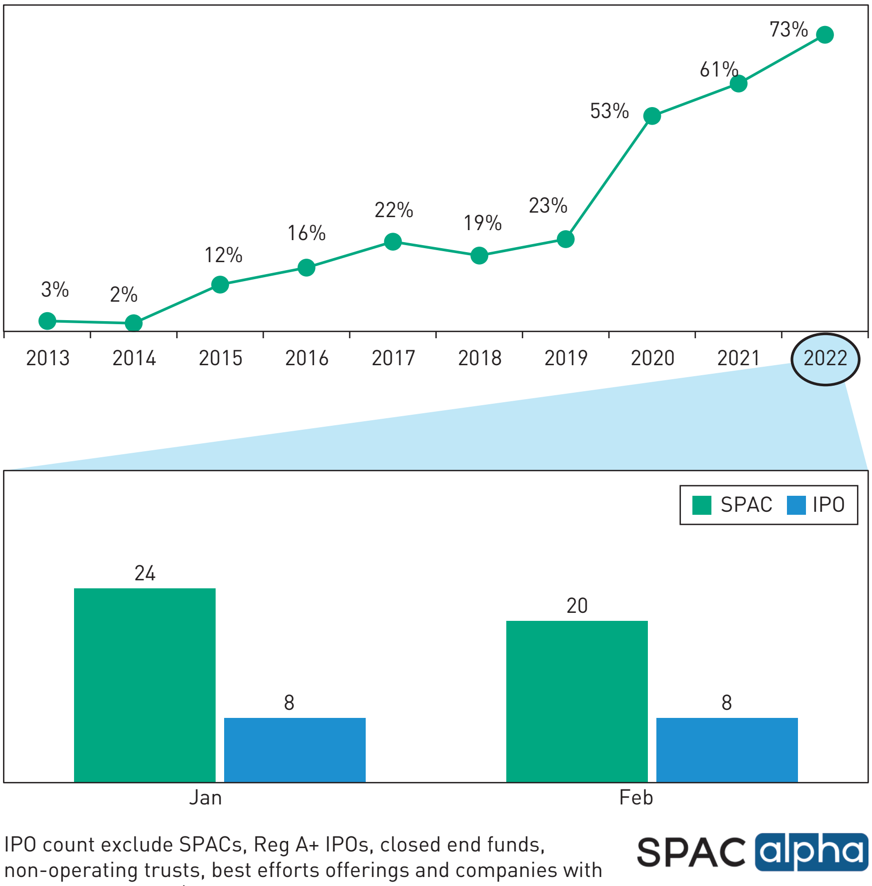
> The [decision of whether to exercise their redemption right] was a call for stockholder action in the form of an 'investment decision,' not unlike 'purchasing' and tendering stock or making an appraisal election...The public stockholders' investment culminated thus: divest or invest in the post-merger entity..."[21]

[21]In re Multiplan Corp. Stockholders Litigation, C.A. No. 2021-0300-LWW ("Multiplan"), (Jan. 3, 2022), (Del. Ch.) at 38.

This raises the question: if SPACs and IPOs are similar, should they have similar regulatory requirements?

US SPACs VERSUS ALL OTHER US IPOs

Market Share by Number of US-listed SPACs vs all US IPOs



IPO count exclude SPACs, Reg A+ IPOs, closed end funds, non-operating trusts, best efforts offerings and companies with market cap below $50m
Data: Renaissance Capital, SPAC Research, as of Feb 28, 2022

The rules governing a traditional IPO are highly complex, but they have a simple goal: to prevent companies previously unknown to the investing public from "conditioning the market" or creating a trading frenzy based on inaccurate, incomplete, or misleading statements. For that reason, all the key players in a traditional IPO—including the company, its board of directors, senior executives, major shareholders, underwriters, and other advisers—face heightened legal liability for the offering and sale process and for the accuracy of disclosures. A quiet period is imposed on the company until certain public disclosure documents are filed. Underwriters for the traditional IPO become third-party gatekeepers with heightened legal liability for the completeness and truthfulness of the IPO disclosures.

Under prevailing industry practices, however, these traditional IPO rules have not been interpreted and applied to SPAC mergers. The SEC is now proposing certain actions in this regard including several regulatory changes aimed at leveling the regulatory playing field for traditional IPO rules with the rules for SPAC mergers.

The information SPACs provide (decks, 8-K filings, press announcements) is useful for investors, and offers a window into the thinking of management that investors would not get in a traditional IPO. At the same time, it is different from the detailed, regulated information that accompanies initial trading in a traditional IPO.

Two areas, in particular, have prompted discussion: forward-looking statements and investor dilution.

Forward-looking Statements

One of the distinguishing features of SPACs are the forward-looking projections contained in their regulatory filings and marketing materials. These prompted a multiplicity of views in the working group: some suggesting that a ban on forward-looking statements would effectively eliminate SPACs; others were of the view that too many of these statements are exaggerated and often baseless.

A forward-looking statement is a statement of how top management views a company's future prospects in qualitative or quantitative terms. Forward-looking statements often contain projections of annual financial metrics, such as revenue, earnings, or EBITDA, or other key performance indicators stretching several years into the future.

Forward-looking statements that appear in the various SPAC merger documents have thus far been considered by industry practitioners as eligible for a safe harbor from private litigation, subject to either of two conditions: (1) that the statements are accompanied by meaningful cautionary statements, [22] and (2) that the company does not make statements with actual knowledge at the time the statement is made that such statement is false or misleading. In other words, the company cannot be sued simply because its good-faith, reasonably based projections turn out to be wrong.

Congress granted this safe harbor to encourage public companies to share management thinking about the future, despite the inherent uncertainty involved.[23] Critically, though, the safe harbor applies only to companies that are already public. Regulators explicitly excluded IPOs from the safe harbor.[24,25]

For investors, forward-looking statements are a double-edged sword. *Trustworthy* forward-looking statements can have great value for investors if they candidly reflect management's thinking of the company's future prospects and are based on good-faith quantitative financial projections. The information is investment-useful, even if it ends up off the mark. Accordingly, management's views grounded in quantitative projections can have great informational value. That is especially true in assessing the future prospects for new, public companies like merger target companies coming public in the deSPAC process. Yet, these are the situations where forward-looking information can stretch the bounds of trustworthiness.

For example, one might value a proposed merger based on metrics such as assets, market value, earnings, and future prospects. But early-stage companies—including most SPAC merger targets—often have only modest assets, untested public market value,[26] and little or no profits. A substantial number of target companies have no revenue. These "pre-revenue companies" constituted approximately 20% of SPAC merger targets in the second

[22]The cautionary statements must specify important factors that could cause actual results to differ materially from those in the forward-looking statements.
[23]The safe harbor appears in the Private Securities Litigation Reform Act of 1995 (PSLRA).
[24]The law also excludes blank-check companies from the safe harbor. SPACs, however, are designed such that they do not meet the SEC's current definition of blank-check companies. For details, see *supra* note 3.
[25]Three points bear emphasis. First, Congress recognized the value of forward-looking statements for investors and markets. Second, Congress considered the accuracy of disclosures in the IPO process—when the company is first introduced to the public—to be even more important, but susceptible to being more speculative in nature. The law reflects the need for special vigilance in regulating the content and timing of public information during an IPO. But third, the law does not prohibit forward-looking statements in IPO disclosures. It simply removes the safe harbor, thus subjecting IPO documents to heightened liability. Faced with that liability risk, underwriters typically insist that IPO documents do without forward-looking statements.
[26]Private companies typically engage in one or more rounds of private capital raising, which places a private-market valuation on the company. Moreover, SPAC proponents argue that public trading of the SPAC's shares in the period between deal announcement and consummation by allowing public markets to place a value on the merger. Some see this as a useful function that fills a gap in the traditional IPO process.

half of 2021. That matches the approximate share of pre-revenue companies that have gone public in traditional IPOs in recent years.[27]

The target company's management may also value the ability to communicate forward-looking statements to public investors. Management can express its own qualitative and quantitative projections unfiltered and directly to investors. The advantage of being able to present forward-looking information—with what has been perceived as less potential liability exposure—is so important that some believe it may prove to be the decisive reason to choose a SPAC merger over a traditional IPO as a means to go public.[28] On the other hand, forward-looking statements about deSPAC merger targets can be problematic, being overly rosy or lacking in reasonable basis. Some could be characterized as completely implausible.[29]

How common is the problem? Some practitioners insist that SPACs have been consistently improving the detail and basis for their deSPAC forward-looking statements,

[27]For the past nine years, 30% to 40% of traditional IPO companies have been biopharmaceutical companies. Most of these companies had no revenue when they went public. Even among those that did have revenue, a majority earned their revenue primarily from research contracts, not product sales.

[28]Despite the sharp legal distinction, however, the reality is a bit more complicated in the case of traditional IPOs. Several members of the Working Group (included SPAC supporters as well as critics) insisted that forward-looking statements also creep into the traditional IPO process, but only indirectly via analysts' reports. Although virtually all traditional IPO companies avoid making forward-looking statements in their SEC filings, they do share such statements and projections privately with sell-side analysts at investment research firms and investment banks. These analysts then make their own projections and report them to clients or the public. To the extent that an IPO company succeeds in influencing analyst reports, its expectations and projections indirectly reach the public. In making their own projections, however, analysts may revise or even reject management's view. This may give some companies a compelling reason to choose to go public via a SPAC instead of a traditional IPO. Likewise, SPAC proponents argue that the ability to make forward-looking statements about the target company benefits investors by giving them the opportunity to hear management's views of the future in their own words.

[29]In one example, the SEC fined a SPAC, its sponsor, and its merger target for false claims that the target, a space transportation company, had successfully tested its jet propulsion technology. *See* SEC, "Press Release: SEC Charges SPAC, Sponsor, Merger Target, and CEOs for Misleading Disclosures Ahead of Proposed Business Combination," (July 13, 2021). In another case, a SPAC merger target had never launched a rocket to date—and yet projected that it would be launching rockets on nearly a daily basis by 2025. This dubious assumption, in turn, drove the company's overly optimistic revenue and profit projections. *See* Andrew Park, Written Testimony before the House Financial Services Committee ("Park Testimony") (May 24, 2021). Congress has also heard testimony questioning the forward-looking statements made by certain SPACs. For example, a sample of nine electric vehicle companies that went public via a SPAC in 2020. Their aggregate annual revenue totaled $139 million, and yet they projected a combined $26 billion in annual revenue by 2024. See Park Testimony, citing Ortenca Allaj, Sujeet Indap, and Miles Kruppa, *Financial Times*, "Automotive tech start-ups take wild ride with SPACs" (Jan. 12, 2021), available at https://www.ft.com/content/688d8472-c404-42d6-88b7-fbd475e50f7c.

spurred on in part by pressure from the SEC.[30] On the other hand, various SPAC observers and practitioners—including both academic researchers and SPAC sponsors—believe that the problem is significant and troubling. It may indeed intensify as SPAC time limits approach and the competition to find and complete mergers intensifies.[31]

Other SPAC features increase the risks around forward-looking statements. First, the sponsor has a strong financial incentive to promote the deal. The incentive to accentuate the positive may lead down a slippery path that crosses from the optimistic to the unrealistic. Second, there are no third-party gatekeepers to serve as a check on rosy or false forward-looking statements. That stands in contrast with the gatekeeper role of underwriters in traditional IPOs. Third, the accuracy of forward-looking statements can influence a SPAC shareholder's decision on whether to redeem their shares, the single most important investor protection feature of SPACs. The redemption right is only as good as the quality of the information on which the redemption decision is based. Untruthful hype will potentially lead SPAC investors to not redeem, keep their SPAC shares, and suffer potential losses in the post-merger company.

Dilution and Reduction in Share Value

Dilution from the sponsor's 20% promote takes a large amount of public shareholders' investments in the SPAC and subsequent merger. This is because the sponsor pays only a minimal amount for founder shares that are worth 20% of SPAC's interest in the post-merger IPO equity. (Specifically, sponsors often pay $25,000 for the 20% interest referred to as the sponsor's "promote".) These securities dilute the shares of public shareholders because the SPAC does not receive an equivalent amount of cash from the sponsor in exchange for the founder shares.

The warrants embedded in units represent a second source of dilution. As mentioned earlier, IPO investors pay $10 per unit, which consists of one public share and a warrant. This means that the IPO investors receive the warrants for free. Sponsors also purchase warrants, but pay fair market value for them.

[30]When a SPAC (or any other public company) files a preliminary proxy statement with the SEC, its staff reviews the document. The staff does not judge the merits of the company's value proposition, but instead reviews the document for compliance with federal securities laws and regulations. In the process, staff often engages with the company, raising questions or providing comments. This process can lead the company to make revisions before submitting its final proxy statement. According to the Working Group, the SEC staff has been questioning SPACs to specify the basis for forward-looking statements, such as projections of revenue or EBITDA.

[31]Experiential factors may also play a role. Professional analysts and investors in venture capital and early-stage companies are used to discounting or dismissing exaggerated claims and puffery. Those investors, which frequently dominate the SPAC market, want more forward-looking information, not less.

Under the standard terms of most SPACs, warrants can only be exercised after the completion of a merger and have an exercise price that is typically \$11.50 per share. If the post-merger share price fails to rise above \$11.50, the warrants will never be exercised and will instead expire worthless. The SPAC warrants typically expire if unexercised after five years.

The complexity of the SPAC structure—combined with the conditional, future nature of the exercise of warrants—may obscure their impact on public shareholders. But these warrants represent potential dilution to post merger shareowners if eventually exercised and an immediate reduction in share value to SPAC shareholders premerger. The reduction in share value reflects, or builds in, the impact of the expected future dilution of the warrants.

Meanwhile, such warrants have a present value, even in the pre-merger phase, and are traded on public markets (typically for about \$1 per warrant). The warrants' market value can be thought of as their probability-weighted expected value, or the statistical probability that the warrant will eventually come into the money (because the share price will rise above the exercise price). Hence, target companies can be expected to factor in these potential financial impacts—both from founder shares and warrants—when they negotiate a merger price for their company.[32]

One might expect the discounts offered to PIPE or other investors to serve as a further source of dilution of reduction in share value, because these investors purchase shares at a discounted effective price per share. It does not represent further dilution of the SPAC shareholder if it is simply a reallocation of a portion of the sponsor's founder shares to entice the PIPE to invest. These so called "sweeteners" offered by the sponsor to attract and keep other capital providers in the merger deal, are a reallocation of existing dilutive shares, not additional dilution.

Perhaps counterintuitively, even if PIPE investors receive direct discounts (rather than a transfer of founder shares), that is not dilutive to other shareholders. To see why, consider, a PIPE investment at a discounted price of \$9 per share. Though less than the \$10 that other shareholders may pay, this is still \$9 more per share than what the sponsor pays for founder shares and what IPO investors pay for the warrants embedded in units. As a result, the PIPE investment raises the SPAC's average cash per share. Put another way, the PIPE investment allows the dilution from the founder shares and warrants to be spread over a larger number of shares.

[32]For the owners of the target company, the SPAC warrants represent potential dilution of their slice of the future pie; the present-day value of those warrants represents the cost of that dilution in today's dollars.

Section 2: Incentives and Conflicts

The structure of a SPAC means that the different parties in the transaction—sponsor, initial investors, PIPES, and later investors—have different incentives. The lack of alignment between incentives sometimes creates conflict. The working group discussed a range of these conflicts in the course of its work and concluded the six most important conflicts included: "no deal," multiple SPACs, boards of directors' compensation, short term vs. long term investors in the SPAC lifecycle, non-redemption agreements, and underwriter contingent payments.

"No Deal" Conflicts

The sponsor's paramount financial interest is for the SPAC to acquire a target company before the merger deadline expires. For the sponsor, completing a merger is a binary event. If it fails to complete a target merger, the sponsor will lose its entire investment in the SPAC and all of its founder shares and any of the sponsor's warrants will become worthless. On the other hand, if the merger is completed, the sponsor will realize strong profits from its founder shares and potentially further upside from its warrants.

The sponsor clearly prefers a strong merger over a weak one. But faced with the choice of a weak deal or none at all, the sponsor has a strong financial incentive to choose the former.

Simply closing on a merger transaction, regardless of whether it is value-creating for the shareholders, will in most cases still prove highly profitable for the sponsor. Even an unprofitable merger is better for the sponsor than none at all, because the deal will allow the sponsor to recover at least part of its investment.[33]

The sponsor's incentives pose a material conflict of interest with the non-redeeming SPAC shareholders, who could lose money on a weak merger that the sponsor supports. Specifically, the sponsor's financial incentive to complete a merger could cause it to (1) negotiate with a weak target company, if the SPAC has no viable alternative targets; (2) agree to an inflated enterprise value or bad deal terms with a target as the SPAC termination deadline approaches; and/or (3) hype and promote even a low-quality merger to attract investments, limit redemptions, and ensure completion of the merger.

[33]Suppose, for example, that the sponsor invests $4 per share in the SPAC and the post-merger share price falls to $3 per share. The sponsor will lose $1 per share on its investment, but at least it will recover $3 per share. With no deal, the sponsor will recover $0 per share.

There are now more than 700 SPACs chasing deals, with more SPAC IPOs entering the merger "hunt" every month. For the next 18 months, competition for target companies will only intensify. This will add to the pressure on SPAC sponsors to find and complete a merger, and it will give added leverage to the pool of private operating companies available and willing to negotiate with SPACs. These companies may simultaneously explore traditional IPOs or a private sale, intensifying the competition to acquire them. These dynamics fuel the conflicts facing sponsors and may challenge the prospects for post-merger shareholder returns.

Sponsors who Operate Multiple SPACs or Other Investment Funds

One type of potential conflict of interest arises when the same sponsor manages multiple investment funds. This could be multiple SPACs or a SPAC at the same time it manages other private investment fund vehicles, such as a private equity (PE) or venture capital (VC) firm searching for investments or acquisitions similar to the SPAC.

In recent years, SPAC sponsors have been backed by PE firms, VC firms, and others (see chart on page 23). Moreover, some sponsors have launched and managed several SPACs simultaneously or in quick succession. Conflicts of interest arise when the sponsor's various affiliated funds compete for the same professional time, attention, resources—and most troubling, the same pool of merger targets.

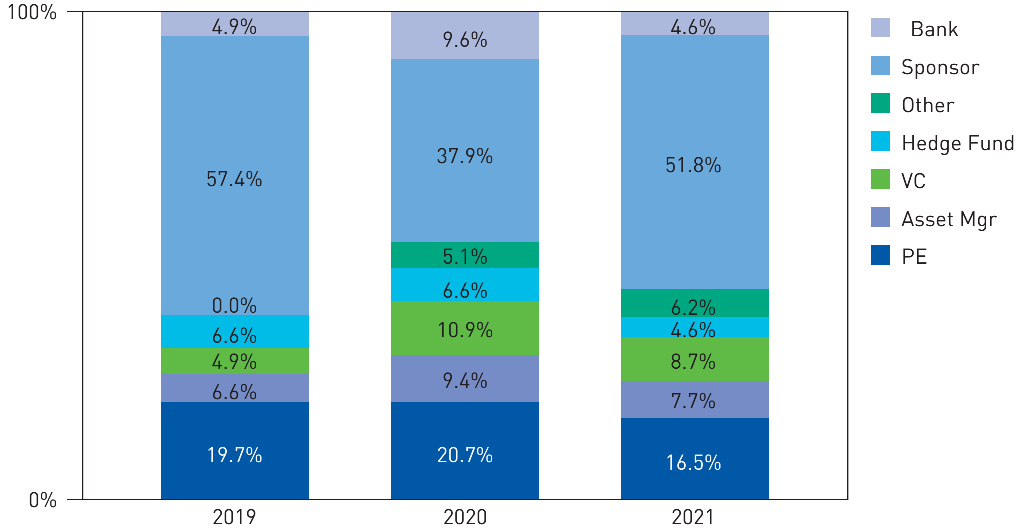
Conflicts could also arise if the target company for the SPAC was also one of the portfolio companies owned by the sponsor's PE or VC firm. In this case, the sponsor would find itself on both sides of the merger negotiations with the target company.

It is conceivable, however, that both sides could benefit from such a deal: the PE fund succeeds in exiting its investment, while the SPAC finds a strong merger partner. In fact, there have been deals involving target companies affiliated with the SPAC sponsor that elicited a positive market reaction.[34]

[34]In 2021, for example, SPAC sponsor Fifth Wall announced a merger with smart home technology company Smart Rent. Fifth Wall owned less than a 10% interest in Fifth Wall. This SPAC saw 0% redemptions and 24% appreciation in the stock price (to $12.44 per share). Also in 2021, sponsors Tilman Fertitta and Jefferies Financial Group announced a merger with online casino company Golden Nugget, a wholly owned company of Tilman Fertitta. This deal also produced 0% redemptions and a return of 124% (to $22.40 per share).

Nonetheless, the potential risk of conflicts of interest with SPAC investors runs high. The Working Group heard concerns that the broader fraternity of PE managers might rotate among deals, facilitating one another's exit of a private equity portfolio company at one moment and expecting the same support as a SPAC sponsor searching for a deal the next time.

SPAC sponsor Composition by Year of IPO



- 2020 saw a significant reduction in traditional sponsor teams and in increase in institutionally sponsored SPACs
- Traditional sponsor teams dropped from 57.4% of total SPACs in 2019 to 37.9% in 2020
- 2021 saw a reversal with traditional sponsor teams comprising 51.8% of the total
    - The 2H-2021 showed a noticeable decrease of institutionally backed SPAC IPOs underwritten by the bigger banks
- 52.5% to teams in 2020, and were backed by either PE, VC, Asset Managers, Hedge Funds or "Other" (Family Offices, Holding Companies)
    - 2021 saw this drop back to 43.7%

SPAC Boards of Directors Incentives and Conflicts of Interest

The board of directors of a public company, including a SPAC, have a fiduciary duty to the company and its shareholders. Typically, directors are on the front line of M&A decisions on whether a business combination is in the best interests of shareholders. A conflict of interest arises, however, if their board compensation impairs the independence of board members.

A number of SPACs award directors free or deeply discounted shares and warrants in return for their board service. In these cases, directors have a strong financial incentive to support whatever merger deal the sponsor proposes: if no deal is consummated before the merger deadline, the value of the directors' shares and warrants—like those of the sponsor—become worthless. This is a mirror image of the conflict of interest that the sponsor itself faces. SPAC directors' financial incentives only multiply if they sit on the boards of several SPACs managed by the same sponsor, or if they hope to be appointed to the boards of future SPACs that a serial sponsor might launch.

A high-profile lawsuit is playing out in the state courts revolving around director conflicts and allegations of breaches of fiduciary duties to shareholders.[35] The outcome will potentially have significant ramifications on how SPAC boards manage conflicts and maintain independence.

IPO Investors' Short-Term Incentives vs. Long-Term Holders

A SPAC's IPO investors often have short-term interests that compete with those of the SPAC itself and its other shareholders. In particular, most of the SPAC's initial IPO investors have an investment strategy to redeem their shares at the earliest opportunity while keeping their warrants to retain a free option on the upside potential of the post-merger company. As a result, these investors are attracted to those SPACs that allow for earlier redemption times, so the investors can get a more expedient return of capital. In addition, the IPO investors, and any other unit purchasers, have an interest in SPACs structured with more generous warrants embedded in the units.

[35] *See Multiplan, supra note 21.* The lawsuit relates to the merger of a SPAC named Churchill Capital Corp III ("Churchill Capital") and Multiplan Inc. The suit, in the Delaware Court of Chancery, was filed against Churchill Capital; Michael Klein, who led the SPAC's sponsor; and certain of the SPAC's directors, officers, and affiliates. The Complaint alleges that the defendants breached their fiduciary duties by prioritizing their personal interests above the interests of public shareholders in pursuing the merger and by issuing an allegedly false and misleading proxy, harming stockholders who could not exercise their redemption rights on an informed basis. For additional details, see the Court's preliminary opinion of Jan. 3, 2022, available at https://courts.delaware.gov/Opinions/Download.aspx?id=328120, and a law memo by Mayer Brown LLP summarizing the case, available at https://corpgov.law.harvard.edu/2022/01/30/chancery-court-allows-despac-litigation-to-proceed/.

Most IPO investors have less interest in the merger deal because they intend to divest before the merger is consummated.[36] And the tighter the merger deadline, the sooner they can redeem their shares and get their money back.[37] As a result, there is a tension between the interests of IPO investors (who prefer quick investment turn-around) and the interests of the SPAC and its other shareholders that generally encourages a comprehensive search and due diligence review of potential targets.

While marquee sponsors generally have more negotiating power and experience at setting the terms of their SPAC IPO structure, a less renowned sponsor may feel compelled to make compromises to attract IPO investors. Recent developments in SPAC structures appear mixed. While 2021 saw a decrease in warrants attached to units, for instance, merger deadlines were compressed, from a range of 18 to 24 months to as little as 12 months.

SPAC Underwriter Conflicts

The investment banks that underwrite the SPAC IPO have a financial incentive in the completion of a merger because much of their compensation is contingent on the merger approval and closing the transaction. Specifically, underwriters typically receive a total of 5% of the IPO proceeds: 2% at the time of the IPO, and the remaining 3% if and when a merger is completed. That financial incentive can impair the independence of any advice that the underwriter may offer about the proposed merger. The SEC has proposed rules to extend the SPAC IPO underwriter's liability to the deSPAC transaction.

[36]The IPO investors also have an interest in a strong deal, because it will allow them to sell their shares at a higher price after the merger announcement, and also in a successful post-merger company, because it will increase the value of their warrants. But, as we have seen, the IPO investors have other, and probably greater, interests in a shorter completion deadline and in more generous warrants.

[37]Most SPACs have a provision allowing the sponsor to seek shareholder approval to extend the deadline. Such an extension, however, generally comes at a financial cost to the sponsor and triggers the right of shareholders to redeem their shares.

Section 3: Disclosure Quality and Prominence

To improve disclosures, SPACs should provide further clarity and detail around five basic questions. Some of this information will be useful for the SPAC IPO phase while other details will relate more to the deSPAC merger phase and the investor's decision to redeem SPAC shares.

1. What are the qualifications and experience of the sponsor?

2. What, if any, affiliations does the sponsor have with PIPE investors, the target company, aor any others associated with the SPAC that may create a conflict of interest at any stage of the SPAC/deSPAC process?

3. What, if any, side deals has the SPAC made with investors, including anchor investors, PIPE investors, or those who make non-redemption or forward-purchase agreements?

4. What are the sponsor's economics? That means a more complete and transparent presentation of the dilutive effects of the sponsor's 20% promote on other IPO investors. This could include the dollar value of the sponsor's interest in the new public company post-merger under various share price scenarios. What is the sponsor's break-even share price?

5. What is the amount of net dollars per share that the SPAC will deliver to the target, under various redemption scenarios and after taking account of dilution and all other costs?

6. Finally, what are the total amounts of the shares and warrants issued and fees and expenses incurred, at the time of the SPAC's IPO and subsequently?

Disclosures should be in dollar terms and percentage of total shares or dollars where applicable. Where a range of outcomes is possible—when the answer depends on the level of future redemptions or share prices—a table of dollar values should be presented under a prescribed range of potential scenarios. Disclosures should be made in plain language, prominently displayed at or near the front of key SPAC IPO and deSPAC merger filings with the SEC.

Qualifications and Experience of the Sponsor

SPAC IPO registration statements should include detailed biographies of the sponsors, including their track record (if any) in sponsoring other SPACs. The information should include the current status of the other SPACs, their ticker symbol, whether any of them have completed mergers and, if so, the ticker and current share price of the post-merger SPACs. Disclosures should also make clear whether the sponsor concurrently serves as sponsor for other active SPACs still seeking merger deals.

It is helpful for investors to know such details as the experience of the sponsor's management team. Does their background consist only of general mergers and acquisition experience, early-stage growth businesses, or passive investment experience? Or has the sponsor been actively engaged in sourcing, valuing, and closing transactions similar to the intended focus of the SPAC search? Even where the sponsor has clearly relevant investment and industry experience, investors will benefit from a detailed description of the sponsor's capabilities.[38]

SPAC Participants who are Affiliated with the Sponsor

SPACs should disclose all material affiliations between the sponsor and other key participants, such as PIPE investors and the merger target company. The disclosures should cover not only the top executives running the sponsor, but all major owners and affiliates, including those with an economic interest in the sponsor's profits.[39] That way, investors can draw their own conclusions about potential conflicts involving any of investors or affiliates of the sponsor including anchor or PIPE investors.

Side Payments

SPACs should disclose side payments made to anchor investors, PIPE investors, and investors who commit to non-redemption or forward-purchase agreements. This should include each such investor's blended or effective price per share and any contingent commitments to protect the investor's downside risk.

[38]For example, the sponsor may be accustomed to accepting high valuation multiples for private companies in the first few rounds of private capital raises. However, such generous multiples might be excessive for a more mature SPAC merger target that is about to become a public company.

[39]If an investment fund is one of the syndicate members, however, the disclosures need not list the beneficial members of the fund.

Sponsor Economics

SPACs are complicated structures, and it could be challenging for retail investors to understand the financial implications of those structures on shareholder returns. To address this complexity and provide clarity on key elements, we recommend that the SEC consider some combination of the following disclosure approaches. And to make the disclosure more salient, we recommend that they be made dollar terms where possible.

Net Cash Per Share Delivered to the Target

SPACs should present a table showing the net cash per share that it will deliver to the target under various redemption scenarios. As with any investment, SPAC shareholders should always ask questions such as: "How much of my invested money is the SPAC putting to work for me?" How much of my money will be spent on other items that do not contribute to the SPAC's investment in a merger target, and how will the SPAC actually invest in acquiring the target company?

In their merger agreements, SPACs value their shares at $10. But that is the gross value, before deducting the costs of founder share dilution and other expenses. By deducting those costs, we arrive at net cash per share—the value per share that the SPAC will deliver to the target company. This shows public shareholders how much of their investment in the SPAC is being put to work for them, and how it has been reduced by those factors. According to one study, net cash per share of the median SPAC over a recent time period was about $5.70.[40]

In concept, this is the same as a mutual fund or an investment adviser disclosing how much money it was taking in fees and how much is left to invest on the investor's behalf. Disclosure of net cash per share has the great advantage of making these costs concrete and salient for all investors. Moreover, the disclosure presents investors with a ready-made comparison in deciding whether to redeem their shares or to invest in the merger.

Calculating Net Cash Per Share

In calculating net cash per share, the SPAC must take several factors into account. Sponsors often make changes to their initial ownership of founder shares and warrants or subjects them to earnouts. Some, but not all, of these changes will affect the calculation of net value per share. For example, if a sponsor decides to forfeit some of its founder shares

[40] *See* Klausner *et al*, *supra* note 9, at 233. (An earlier draft of the paper put the median cash per share at $6.67.)

and warrants, that will directly reduce dilution costs. On the other hand, if the sponsor transfers some of its shares or warrants to others, that will change the sponsor's compensation but will have no effect on the total amount of dilution or net value per share.

It can be difficult or impossible for shareholders to calculate net value per share, because the disclosures may be scattered throughout lengthy documents or may not be disclosed at all. SPACs should readily have all this information, however, so it should not be difficult for them to include it in their calculation of net dollars per share.

<u>The Value the Sponsor Brings to the Merger</u>

The owners of the target company agree to exchange the value of their company in return for the cash contributed by the SPAC and the shares they receive in the new public company. Accordingly, it is fair to conclude that the net cash per share that the SPAC delivers represents a good benchmark for how the target company owners value their company.

The Working Group also discussed other important but less tangible values that many sponsors and the SPAC process bring to the going public table. For example, the target company's profile and added visibility as a new public company is extremely important for customer awareness and growth. The SPAC route may be less expensive in that a traditional IPO that includes similar deal expenses but often under values the company leaving money on the table as the opening day pop in the traditional IPO stock price regularly demonstrates. Finally, there is considerable value where the sponsor can provide expertise with strategic guidance; improved operating experience and important business contacts that can contribute to the post-merger company's progress.

<u>Quantifying the Sponsor's Compensation</u>

For years, SPACs have clearly disclosed the sponsor's promote of founder shares equal to 20% of the post-IPO equity. Nonetheless, the SEC should consider two additional disclosure approaches to make the information more salient for shareholders.

Break-Even Point

The SPAC should identify the specific <u>post-merger</u> share price that will represent the break-even point for the sponsor. Shareholders will be able instantly to see how the sponsor's break-even share price compares with their own. Suppose, for example, that the sponsor's break-even point is $5 per share, and shareholders had the option to redeem their SPAC shares at $10.04 per share. Thus, the sponsor's break-even point of $5 per share is roughly half of the shareholder's break-even point.

Game Theory Chart

Second, disclosures should include a table, along the following lines, of the impact of a merger on the sponsor and on shareholders under three scenarios—an optimistic merger scenario, a pessimistic one, and a no-deal scenario.

In the optimistic scenario (with the stock rising to $15 per share), both the sponsor and shareholder will profit on the merger shares they hold, and their interests are aligned. In the pessimistic scenario (with the stock price falling to $5 per share), it is in the shareholders' interests to have redeemed their shares for $10.04 instead of investing in the merger. Yet it is in the sponsor's interests to proceed with the merger and realize a return of 50% on the merger shares. (Note: The sponsor returns are based on the total amount of its investment in the SPAC, including absorbing pre-merger costs and purchasing warrants, which in this case is $7.23M.)

In the no-deal scenario leading to the dissolution of the SPAC, SPAC shareholders will receive their pro rata share of the trust—the same amount they invest in the merger by choosing not to redeem their shares. The sponsor, however, will lose its entire multi-million-dollar investment in upfront fees and expenses to launch the SPAC IPO and manage it in the pre-merger stage.

This chart demonstrates the sponsor's superior economics as long as a merger is completed and correspondingly the incentive to avoid a no deal liquidation outcome. Such a chart would offer far greater transparency and clarity on the effects of a 20% sponsor promote than a simple disclosure that the sponsor will receive a 20% promote.

	Merger IS Completed		Merger is NOT completed
	Stock price rises to $15.00 per share	Stock price falls to $5.00 per share	
Public Shareholders	49.4% return	50.2% loss	$ 10.04 received from trust.
Sponsor	150% return	50.0% gain	All shares and warrants worthless. Sponsor loses $7.23 million.

Note: The specific numbers in this chart are illustrative only. Actual numbers will vary with each particular SPAC.

Standardized Information on Shares, Warrants, and Fees

Finally, the SPAC should disclose certain basic information at the beginning of the disclosure documents filed in connection with the SPAC's IPO (i.e., the registration statement) and subsequently at the time of the merger with a target company (i.e., in the merger registration statement on Form S-4, the merger proxy statement, or both). The disclosure should present a bulleted list of the following components:

- Total number of SPAC shares issued
- Total number of SPAC warrants issued
- Underwriter fees paid at the time of the SPAC's IPO and additional fees payable upon the completion of a merger
- Costs of SPAC and target company financial advisers and PIPE placement agents.

Some of these components, such as the number of warrants issued, may change throughout the lifecycle of the SPAC. Therefore, SPACs should disclose this information in both the IPO and merger documents, even if some of it proves to be repetitive.

IPOs compared to SPACs

There is considerable overlap and disparity in the application of securities laws and regulations that apply to traditional IPOs (sometimes referred to as the "**regular-way**" IPO) versus a **direct listing** versus the listing of new public company shares in the context of a **reverse merger with a SPAC**.

The initial business combination (merger) that occurs when the SPAC merges with a target company, resulting in a new, publicly listed issuer has features similar to each of these IPO structures. This multi-structure lens has resulted in differential regulatory application and an environment that encourages regulatory arbitrage.

Section 4: Recommendations to Regulators Regarding SPAC Structure and Process Issues

In assessing the needs and options for adjusting or "leveling" the formal regulations relating to the SPAC process in contrast to the regular IPO process, it is important to compare and differentiate the two structures.

Traditional IPO Process: A Public Listing via the Securities Act of 1933 using form S-1.

Form S-1. This has been the most common and traditional structure for an initial public offering (IPO). Here, a private company (referred to as the issuer) raises capital by selling new equity shares to investors through investment banks acting as underwriters and lists such shares for trading on a stock exchange for the first time. In accordance with the Securities Act of 1933 (the '33 Act), a Form S-1 (referred to as a registration statement) is required to be filed with the SEC. The first part of Form S-1 is called the prospectus, which is the disclosure document that issuers of securities must provide to potential investors.

Prospectus. Among other things, a prospectus is drafted to explain the company's financial performance; details of its products, services, and operations; details about management; risk factors; and other relevant information. The inclusion of financial projections is permitted but they are rare, in part due to liability concerns, and in part because those projections are instead shared with the underwriters' research analysts, who can take them into account when building their own models that they then discuss with institutional investors.

Liability. Under the '33 Act, the issuer, its officers, directors, and the underwriting banks are legally accountable and responsible for any material misstatements or omissions in the various IPO regulatory filings including the prospectus/registration filings.

SPAC Process: Part Regular-way IPO, Part Reverse Merger, Part Direct Listing.

Initial IPO. A regular-way IPO is conducted for the initial step in the SPAC structure creating a publicly listed company. This original SPAC IPO is conducted consistent with the Form S-1 process and rules noted above. The purchase price paid by initial SPAC investors is escrowed in a trust account.

The deSPAC merger. The publicly listed SPAC then searches for, and merges with, a private operating company (target) in an initial business combination (merger). The result of the merger is similar to a regular-way IPO in that the public SPAC investors invest their cash in a private company, the company becomes publicly listed and trading in its equity shares on a public stock exchange begins. In the U.S., the merger is conducted between the SPAC and the target operating company under different federal rules, using different SEC forms and subject to state law corporate governance requirements.

No Formal Underwritten Offering. An array of finance and investment practitioners are involved in the merger, including teams for both the SPAC and the target, as well as teams for any parties providing additional financing for the merger. These include their financial advisory firms, lawyers, certified public accountants, and other financial and M&A experts. In the typical merger, there is no formally designated underwriter function for the merger. The shares that become publicly listed via the merger process do not technically involve an underwritten sale of securities and are similar to other traditional mergers where merger party shares (SPAC shareholders and target shareholders) are converted into the shares of a new public company.

Form S-4. The cash investment in the target made by non-redeeming SPAC shareholders is currently not treated as a purchase of target stock. Therefore, there is no prospectus for the sale of stock of the new public company for cash. Instead, the merger transaction is regulated as an acquisition of the target by the SPAC. The primary SEC disclosure document is a proxy statement for the SPAC shareholder vote on the merger, often under cover of a Form S-4 registration statement required to register SPAC shares delivered to target shareholders or due to a reincorporation. The information this SEC disclosure document contains about the target is nearly identical to what would be required in a traditional IPO. Unlike in an IPO, however, there are typically extensive forward-looking statements (FLS) about the new public company's prospects and expectations for future financial performance.

Redemption Rights. Unlike a regular way IPO, SPAC public shareholders do have the added protection of being able to redeem their SPAC shares at their original offering price and no longer participate in the merger process. Many observers see this as a unique and additive investor protection for SPAC shareholders.

Recommendations For U.S. Securities Law Adjustments.

This Report makes seven recommendations to help address various issues arising from the differences in how each structure is currently regulated.

Recommendation 1: Leveling the Application of the PSLRA Safe Harbor on Forward-looking Statements.

While professional analysts and primary users of financial disclosures generally support the flow of forward-looking statements, in the context of leveling the PSLRA safe harbor treatment between IPOs and deSPACs, we support removal of the safe harbor for forward-looking information in both regular IPOs and deSPAC mergers.

With respect to the PSLRA *safe harbor* for forward-looking statements, existing public issuers normally have flexibility to offer more detailed and extensive disclosures on projections and forward-looking prospects with less fear of liability under the PSLRA (for misstatements or omissions) if the forward-looking projections fall short. This safe harbor does not apply in a regular-way IPO. In an IPO, there is a greater asymmetry of information about the company coming public and selling new publicly listed shares for the first time. Without the safe harbor, regular IPOs seldom, if ever, provide written forward-looking statements or financial projections.

In contrast, when a new public listing of shares happens via the deSPAC merger process, which looks economically equivalent to a regular way IPO, projections and forward-looking prospects for the merger company are likely required as part of the regulatory and proxy information provided to investors. Those projections are important information for shareholder decisions regarding the merger approval vote required for the deSPAC merger to proceed, and also for decisions whether to exercise the right to redeem SPAC shares. Currently, those deSPAC forward-looking projections are eligible for the safe harbor under PSLRA.

In our view, both the regular IPO and deSPAC approaches for taking a new, emerging company public should be treated similarly regarding the application of PSLRA to forward-looking projections. We support the SEC's recent proposal to eliminate the safe harbor for deSPAC forward-looking statements. The SEC should monitor the effects of removing the safe harbor for deSPACs on the quality of forward-looking information being provided and whether it continues to be provided as part of the merger/proxy documentation. It remains important information for decisions on merger voting and exercising redemption rights.

Recommendation 2: Leveling the Application of Section 11 Liabilities for Financial Advisers to the Merger.

We recommend the SEC issue interpretive guidance confirming that for all future mergers between a registered SPAC and target company, such transactions would be treated as a sale of stock for cash to non-redeeming SPAC shareholders and that relevant advisory parties to the transaction be subject to Section 11 and Section 12 of the Securities Act of 1933. The application of underwriter liability in this context should be narrow in scope and clearly defined to avoid destroying the SPAC process entirely.

In examining this issue, we consider how the merger transaction has elements of both a direct listing IPO and a reverse merger transaction. It is important to clarify the bounds of investment bank responsibilities under Section 11 in these instances generally and in the merger context specifically. Section 11 of the '33 Act provides investors with the ability to hold issuers, officers, underwriters, and others liable for damages caused by untrue statements of material fact or omissions of material fact made *in connection to the offering of securities* or contained within registration statements at the time they become effective.

Direct Listing

Technically speaking in the SPAC merger, there is no firm commitment underwritten offering. In this regard the transaction is similar to a direct listing of shares. In direct listings, the liability of the issuer's financial advisers as potential underwriters is uncertain. In practice, investment banks acting as such direct listing financial advisers have, however, decided to perform substantially the same due diligence procedures as in an IPO, even if not required.

Reverse Merger

There are also similarities of the SPAC merger to a reverse merger. Here too, the application of Section 11 liabilities in these reverse takeover (RTO) transactions is unclear. Similar to the direct listing process, there is no firm commitment underwritten offering. In addition, there is a history of RTO-like transactions marked by numerous failed public listings. In 2012 the SEC found substantial evidence of abuse of dormant shells and took action to suspend trading on hundreds of shells to prevent fraudsters from manipulating the stock price. We noted previously in this report the coming rush of mergers as hundreds of SPAC Sponsors compete for merger targets (of any quality) to avoid a "no deal". Regulators should be cognizant of a SPAC merger process facilitating potentially large numbers of very low-quality targets becoming public companies, reminiscent of the RTO and dot.com bubbles.

Assigning Underwriter Liability in a SPAC merger

For several reasons noted above, it is hard to draw an exact regulatory overlay or to say that SPAC mergers are the same as a traditional IPO, a direct listing IPO, or an RTO structure. It is also challenging to offer a blanket regulatory approach that eliminates what many see as the potential for regulatory arbitrage. These structures are distinct, highly complex and very nuanced in the way they each bring a new company into the public market.

Should New SPAC/deSPAC Regulation Apply to Immediate Market Risks?

In our view, the regulatory "leveling" question in the context of new public listings becomes one of balance. On the one hand we support the objectives of a strong and reliable supply of IPOs in maintaining healthy public markets. We also support efforts to increase and facilitate retail investor access to emerging growth opportunities. However, we see the SPAC structure as simply a variation of how private operating companies become publicly traded. The applicable protections for markets and investors, regardless of the business process and legal structure chosen, should be similar where appropriate.

Moreover, in the context of the number of approaching SPAC mergers, considering the unique incentives and conflicts of a Sponsor to avoid a "no deal", there are current and immediate investor protection risks brewing. When viewed through the lens of the dot.com bubble and resulting market disruption, there is reason to consider certain preemptive steps in the public interest.

Recommendation 3: Codifying a New Form for Investor Protection: Form KCR (Key Conflict & Risks).

We recommend that something akin to the standard forms used in other areas of securities law such as Form CRS, which alerts retail and other investors to the duties and responsibilities of brokers and investment advisers, be developed regarding SPAC investments. We have included *in this report an Investor Crib Sheet released previously by CFA Institute (see Appendix B) for immediate use in light of current bubble-like qualities of SPAC issuance and pending merger transactions. We urge that a similar model form be developed and codified into SEC regulation.*

Given the important investor protection gaps and conflicts of interest that are unique to the SPAC process, we have identified the elements of an investor protection "warning label" that should accompany all required filings for both the initial SPAC IPO and subsequently updated for further details as to risks and conflicts associated with a proposed merger. These risk items may be in addition to, or a repeat risk factor contained and scattered elsewhere in, current regulatory filings for each phase of the SPAC process. As a matter of public policy, financial literacy, and investor protection, it is important to address the bubble-like qualities of the current SPAC phenomenon to avoid a repeat of the level of fraud and market disruption caused by the dot.com bubble. Ensuring a prominent, concise, plain-language and consistent list of Key Conflicts and Risks in a convenient form at the two key stages of the SPAC–merger process is one of the few things we see as having the potential to give investors of all levels of experience a fighting chance to see, understand, and act in their self-interest in the face of unique decision points, conflicts, and risk factors that are present in the SPAC structure.

Recommendation 4: Trading on Inside Information and Gap Trading Anomalies.

We recommend the SEC conduct a full examination of the issues identified above. The staff should determine if additional guidance or rules are needed to address insider trading concerns or market manipulation risks unique to the deSPAC process. This would include assessment of whether the Commission and exchanges have adequate tools in place to monitor and detect insider and other trading irregularities throughout the deSPAC phases.

The full SPAC process of going from an initial public offering of SPAC shares to the closing of a merger with a target operating company has many phases and opportunities for the trading of public shares that a highly susceptible to insider trading and social media manipulation. Of particular concern is the high potential for rumor and "priming the pump" type communications on various social media channels. In addition, the access to material nonpublic information (MNPI) is widespread due to the various participants in the deSPAC process regarding potential merger targets, additional merger financing, and the ongoing prospects of finding a suitable target. These concerns increase as a merger announcement is being formulated and disseminated. The opportunities for trading gains in both the SPAC shares and warrants based on advance details of the target, the merger terms and valuations are significant.

Of additional concern is the trading of SPAC shares and warrants *subsequent* to the merger announcement but *prior t*o the formal merger documentation being filed. Trading on this "information gap" is fraught with Material Non-Public Information and market manipulation risks and disclosure uncertainty that can threaten market integrity. Securities trading during this gap is based on little of the required detail and protections against misstatements or omission of facts that typically apply. In some cases, the gap may last weeks or even months before all the merger details are resolved and formal merger documents and disclosures designed to protect and inform public trading is complete.

Recommendation 5: Examining SPAC Promotion and Digital Engagement Practices (DEP).

We recommend that the Commission augment its current examination of DEP by brokers, advisers, and other SPAC practitioners in the context of marketing and distribution activities which are designed to specially promote investment and trading in SPAC securities.

In August of 2021, the SEC issued a request for information regarding broker and registered investment adviser use of DEPs and related tools and technologies. The request sought comments from a range of market participants, including investors. While it focused primarily on broker/adviser practices in the areas of behavioral prompts, differential marketing, and gamification of their sales and trading platforms, the primary purpose of the request was to address potential gaps in investor protection.

Of particular concern to the Working Group is the significant vulnerability of SPAC securities to rumor and differential marketing combined with very limited fundamental information about either an investment in the SPAC or prospects for a potential merger.

As the SEC continues its work to examine DEP generally, it would be important to consider marketing and promotion practices specifically in the context of the current proliferation of SPAC IPOs and pre-merger trading of SPAC units, shares, and warrants.

Recommendation 6: Conflicts of Interest.

We recommend the SEC review the conflict scenarios noted above and provide further guidance on disclosure fairness and prominence around such activities. In the U.S. market, regulators should consider whether the nature of the SPAC merger and the presence of material, related-party conflicts should trigger the heightened disclosure requirements under Rule 13e-3. Transactions under this rule are subject to added disclosure requirements about such conflicts, and any self-dealing precautions taken.

The Working Group examined a range of conflicts and competing interests that can arise when a SPAC sponsor and its affiliates are engaged on multiple SPACs at the same time, simultaneously serving as general partners in other private equity and venture capital funds or otherwise working for various operating companies that might be candidates for being a SPAC merger target. The combination of overlapping duties and fiduciary responsibilities to SPAC investors, private fund investors, and potentially one's own family or employer can become a complicated web of conflicts of interest.

The Working Group discussed a number of these circumstances in an effort to understand whether these are simply a matter of free-market forces and properly left to market participants to modulate deal terms and industry practice, or whether any of these overlapping fiduciary scenarios deserve intervention through regulatory channels or exchange listing standards.

The group discussed the current condition where many SPAC sponsors have multiple SPAC offerings in flight and find themselves searching for multiple target companies simultaneously. Questions naturally arise regarding which SPAC receives which opportunity and in what, if any, order of prioritization. Some suggested that this takes care of itself naturally as each SPAC identifies a target business sector in which to search for deals plus each SPAC board has members with specific industry specialties and disciplines that help determine the best SPAC/target fit. In private markets, most PE firms with multiple active funds generally have an allocation policy in place.

Another conflict condition that may be problematic and creates potentially competing fiduciary duties is when SPAC officers and directors are simultaneously the key players and general partners in large private funds that are also searching for merger and acquisition targets. There are features that may distinguish whether a target business is clearly more suitable as an investment for the private equity or venture capital fund versus the SPAC. Yet questions arise as to whether the decision is ad hoc, affected by whether the SPAC is running out of time to complete a merger, and whether the SPAC is often relegated to the private fund's rejects. The fiduciary duty complications in this regard can be daunting.

Finally, the circumstance that seemed most problematical for our Working Group discussions dealt with the idea that the SPAC Sponsor and/or its affiliates could be on both sides of a deSPAC transaction at the same time. A clear example would be where an individual might be a SPAC officer or director (a fiduciary to the SPAC shareholders) and at the same time a private fund manager/partner (a fiduciary to the fund investors). If the SPAC were to end up merging with one of the companies in the fund's PE portfolio, the fiduciary in question would be on both sides of the transaction. A more nuanced version of this type of "house deal" would be where firm "A" provides PIPE financing or proposes merger targets for firm "B"'s SPACs and vice versa.

The working group discussed the ethical and public trust aspects of these type of scenarios. Whether and to what extent any of these activities are happening and whether they may proliferate as the time frame for search and closing of large numbers of SPAC mergers begins to narrow remains to be seen. In any event, the working group agreed that the time has arrived for exchange and regulatory authorities to consider mitigation of the most significant breaches of market integrity.

Recommendation 7: New Disclosure Requirements.

We recommend enhanced disclosures for registration statements and merger proxy materials used in the SPAC deSPAC process, including:

- *Fully disclose the qualifications and experience of the sponsor.*
- *Fully disclose any affiliations the sponsor and its officers and directors have with PIPE investors, the target company, or others associated with the SPAC that may create a conflict of interest at any stage of the SPAC/deSPAC process.*
- *Fully disclose any side deals has the SPAC made with investors, including anchor investors, PIPE investors, or those who make non-redemption or forward-purchase agreements.*
- *Fully disclose details of the sponsor's economics using one or more of the recommended formats, including the dollar value of the sponsor's interest in the new public company post-merger under various share price scenarios, and the sponsor's break-even share price.*
- *Fully disclose the total amounts of the shares and warrants issued and fees and expenses incurred, at the time of the SPAC's IPO and subsequently.*

To the extent the SEC can modify disclosure and other rules applicable to various regulatory forms utilized and required for different phases of the SPAC and deSPAC process, we recommend formal guidance or rules to deal with improved disclosures regarding the following areas and topics to improve transparency and ensure proper clarity, consistency, and prominence of key disclosures. The range of disclosure improvements suggested are listed above in the Section on Disclosure Quality and Prominence and summarized below.

Appendix A: PIPE Basics

PIPE Investors as a Signal of Deal Quality

Some claim that the presence of PIPE investors validates the quality of a SPAC merger deal for other, less experienced investors. In this context it is helpful to understand the investment decision-making process of PIPE investors in a SPAC.

PIPE investors are typically sophisticated, well-resourced institutional investors with a professional knowledge of the target company's industry—the size of the market, the target's competitors, and the key risks that companies in the industry face. PIPE investors also may have a strong grasp of key industry metrics that allow comparisons of companies within the industry. Likewise, PIPE investors will be familiar with standard industry multiples that can be used to determine a company's enterprise value. Finally, PIPE investors may have experience in assessing the strength of the target management team.

PIPE investments can amount to millions of dollars. The SPAC issues PIPE investors private shares, which PIPE investors can neither redeem nor sell in public markets. PIPE investors can only sell into public markets after the post-merger company registers the securities.

PIPE investors perform their own due diligence in deciding whether to invest in a SPAC. They may meet two or three times with the target company's management team and get access to a data room, where they can review information about the company. PIPE investors also may decide to access material, non-public information about the target company, in a process called "crossing the wall." If they cross the wall, PIPE investors will sign a confidentiality agreement and also commit not to trade public shares of the SPAC until the company "sanitizes" the material non-public information by disclosing it to the public. For this reason, many PIPE investors are careful not to cross the wall.

Contrast that process with a traditional IPO road show, where the company presents its business case in a series of back-to-back meetings with groups of investors over the course of an intense week. IPO investors may make their investment decision after a single road-show session lasting an hour. The company presents an investment deck, but to comply with securities regulations does not allow investors to keep it after the road-show session.

SPAC proponents maintain that the PIPE decision-making process is deeper and more diligent than that of a traditional IPO investor. The IPO process, however, also features a critical element that is absent in a SPAC merger: the IPO registration statement. The SPAC merger and proxy statements will provide equivalent information, but that will only come weeks after the PIPE negotiations and merger announcement. These filings will be unavailable to PIPE investors who make their investment decision just before the merger announcement.

Though PIPE investments can serve as a signal of deal quality, it is common for PIPE investors to receive significant financial inducements to invest in the merger that are unavailable to public shareholders. These side deals can significantly distort any indicative value of PIPE participation.

The most direct form of inducement would be to offer PIPE investors a **discounted price** for their investment.[41] The most common type of sweetener is where the SPAC sponsor **transfers some of its founder shares or private warrants** to the PIPE investors for free. In that case, even though the PIPE investor pays $10 per share, the free founder shares or warrants lower the PIPE investor's **effective price per share**. These special incentives give PIPE investors a margin of safety by lowering their break-even point.

Sweeteners do not necessarily dilute the shares of public shareholders. Transferred shares, for example, merely shift ownership of founder shares or warrants without increasing their total number. And discounts for private SPAC shares may improve the overall cash per share that the SPAC delivers to the target: Even if PIPE investors pay $8 or $9 per private share, that is more than the minimal amount that sponsors pay for their founder shares and warrants. As a result, even with discounts or sweeteners, PIPE investments contribute significant cash to the SPAC and may lift the overall net cash per share that the SPAC will deliver to the target.

In addition to the sweeteners, there are other reasons that public investors must be cautious of PIPE participation as a reliable signal of deal quality. A number of PIPE investors have ties to the sponsor. For example, the PIPE investor may have an economic interest

[41]SPACs, like any other public company, could not engage in price discrimination in offering public shares. But SPACs issue private shares to PIPE investors, with a promise to register those shares after the merger so the PIPE investors can sell them in the public markets.

in the sponsor, or they may be affiliated with a PE or VC fund that is affiliated with or managed by the sponsor.[42]

Far more conflicted would be the existence of a "**club deal**," in which the PIPE investors and the SPAC sponsor agree to invest in each other's SPACs. It is unclear whether and to what extent such club deals exist among SPACs. Nor is it clear whether SPACs consistently or clearly disclose any such deals. Without disclosures, the public may be unaware of the arrangements.

Investors must understand that even the purest of PIPE signals is no guarantee of future success. Some SPACs have attracted crème-de-la-crème investors (either as anchor investors at the initial IPO or later as PIPE investors), only to see their post-merger stock prices collapse. These are early-stage growth companies and very speculative investments no matter the players.

Comparing PIPE Investors and IPO Underwriters: PIPE Investors Are Not Gatekeepers

So far, we have been discussing whether PIPE investments are a signal of deal quality. That is a completely separate question from the role of gatekeeper. PIPE investors are not gatekeepers, and it is crucial for investors to understand the difference.

PIPE investors do not advise, serve, or otherwise owe duties to protect public investors or vouch for the accuracy and truthfulness of statements and filings made by the SPAC, its sponsor, or the target company. Instead, PIPE investors are making an investment decision based on their own self-interest, not the interests of all shareholders. Imagine, for example, that in the course of its due diligence, a prospective PIPE investor discovers something troubling about the deal, such as self-dealing on the part of the SPAC sponsor or target company. The PIPE investor may simply decide against investing in the SPAC merger and move on. It has no obligation to alert the public.

[42]For example, the PIPE investor may be a limited partner in the sponsor's past or concurrent PE or VC fund managed by the sponsor. In that case, the limited partner may see the PIPE investment as an opportunity to co-invest with the sponsor while keeping costs down. Alternatively, even if the PIPE investor is unaffiliated with the sponsor, it may have other considerations that weaken the signaling effect. For instance, a PIPE investor could have a supplemental motive to develop a business relationship with target company. Such a motive, while perhaps reasonable for the PIPE investor, would be extraneous to the investment goals of public shareholders.

Underwriters, in contrast, play a true gatekeeper role in a traditional IPO. They take on **liability** for the completeness and truthfulness of the IPO registration statement. Underwriters face the same liability as the company and its board of directors and key officers, unless the underwriters can make an affirmative defense that they have exercised due diligence in the preparation of the registration statement. This gives the underwriters a strong incentive to undertake their own due diligence.[43] To this end, the underwriter hires its own team of lawyers, who scrutinize every statement in the filing documents and typically travel to the company's headquarters as part of their due diligence.

In sum, investors must understand that PIPE investors are not gatekeepers. More generally, shareholders should learn the players and key details of each PIPE investment before viewing it as an indicator of merger deal quality.

[43]Aside from the legal liability, underwriters have an additional incentive to protect their reputations. Their names appear prominently in the IPO announcement (in a terse newspaper advertisement called a "tombstone") and on the cover of the registration statement. Any underwriter that makes a practice of selling lemons to IPO investors—usually by allocating the initial IPO shares to their best clients—cannot expect to stay in business for long.

Appendix B: CFA INSTITUTE SPAC CRIB SHEET: WHAT INVESTORS NEED TO KNOW BEFORE THEY INVEST

Introduction

Special Purpose Acquisition Companies (SPACs) typically involve a two-part process of first raising capital from public investors in a SPAC initial public offering (IPO) and then using this capital to invest in a private operating business. That business becomes a public company in what is referred to as the initial business combination (IBC). The result is two distinct phases to SPAC investing. The first phase, investing in the SPAC IPO shares at $10 per share, comes with principal protection—that is, investors can redeem these shares and receive $10 per share back if they do not want to invest in the proposed IBC. The second SPAC investing phase begins with the completion of the IBC. Owning shares in the post-IBC company is akin to traditional public equity investing and no longer comes with redemption rights or principal protection.

Setting the Scene

<u>A Record Numbers of SPAC IPOs</u>. The mounting numbers of SPACs already in the public market pose growing investor protection concerns. With more than 700 SPACs in various stages in the marketplace this year and dozens more SPAC IPOs coming online each month, investors should be aware that competition is fierce. Most of these SPACs will be competing to find a merger target this year to complete an IBC. Investors must understand the key risks. SPACs or "blank-check companies" (as they historically were called) initially present a risk-free yield opportunity, yet owning SPAC shares is essentially a bet on the SPAC management's ability to complete an IBC. Little information is available about the SPAC at the time of the IPO and no information is provided about its ultimate IBC target. Investors literally give the SPAC management (the "sponsor") a blank check.

Two SPAC Investment Phases. Retail investors should understand the investment prospects of this complicated SPAC structure and must frame their performance expectations for a SPAC investment in each of the two phases noted. Each phase has important nuances and risks to consider.

SPACs as a Trading Strategy. Retail investors who seek to invest in the SPAC shares and treat them as a trading vehicle, should fully understand how the structure works; the different securities involved, including shares, warrants, and rights; and how to take advantage of (arbitrage) the $10 redemption price. In short, traders can attempt to buy SPAC shares for less than $10 and later redeem them for $10 to play the risk-free yield opportunity. This process, however, requires paying vigilant attention to redemption periods and having some familiarity with corporate actions. Many professional investors use the SPAC structure in these ways without considering fundamental investments in SPAC target companies after the redemption opportunity has been presented.

SPACs as a Long-Term Investment Strategy. Long-term investors who buy a SPAC with the intention of holding through the IBC to participate in emerging growth opportunities, must understand this: successful, long-term venture capital investing requires (1) a diversified portfolio of plausible business prospects (not celebrity sponsors or futuristic dreams) and (2) a holding period of five to seven years. Picking one or two SPACs on a whim and expecting to strike performance gold is more like buying a lottery ticket.

Key Considerations

CFA Institute created this "SPAC Crib Sheet" for investors to highlight the key structural, risk, and conflict issues that investors should understand as they consider these SPAC investment vehicles.

1. *Highly Speculative Investments*

SPAC investments can be complex and speculative once the redemption opportunity has passed.

2. *Financial Market Engineering*

These structures are used by financial engineers and professionals, primarily for their benefit and the benefit of the target company. SPAC sponsors can have more advantageous financial outcomes than other SPAC stakeholders depending on the completion and performance of the IBC.

3. SPAC Units, Shares, and Warrants.

- SPAC Components. An investment in the SPAC public shares (before the merger) has component parts.

- Trading of Components. Understand the differences among SPAC units, shares, and warrants, and how each security will trade.

- Warrants. Understand how the warrant works, including its term, strike price, and whether they are "fractional" or "callable."

4. *Trading SPACs pre-IBC*

- Promotional Factors. Be aware of rumors and other social media hype. These shares are particularly vulnerable to IBC speculation and celebrity sponsor attention because they lack other fundamental information.

- Track Record. Understand if the sponsor has any experience or track record with other SPACs or otherwise finding profitable acquisitions.

- Redemption Rights. Investors can redeem their shares for only $10 at the time of the IBC. If they pay more than $10 in trading leading up to the IBC and then redeem, they will lose money (see "7. Redeeming SPAC Shares").

- No IBC. If the sponsor cannot find a merger target within 18–24 months, the SPAC typically terminates and returns funds to SPAC investors. This is known as a *no-deal* event. Again, even if an investor has paid more than $10 per share, they will receive only $10 per share in a liquidation scenario.

5. *Sponsor Conflicts*

- SPAC Liquidation Consequences. A SPAC sponsor must find a merger target and complete an IBC within the allotted time limit or liquidate the SPAC. In this *no-deal* scenario, the expenses and fees related to the original SPAC IPO will not be reimbursed to the sponsor and the sponsor's free shares and warrants will become worthless.

- Liquidation Consequences May Affect the Quality of the IBC. The sponsor has the objective of finding a strong merger target and completing the IBC. Faced with the choice of a weak target and avoiding a liquidation, however, the sponsor is highly incentivized to move forward with merger targets of any quality. Ultimately, the market will weigh in on IBC quality. Investors should be cautious holding on to shares past redemption for any SPAC that is trading below its cash-in-trust value per share at the time of the shareholder meeting.

- Increased Performance Risk. Investors need to consider the merger quality and potential no-deal conflict when deciding whether to redeem their SPAC shares and receive their funds back.

6. *Merger Announcement Trading*

- Gap Trading. Investors are able to trade the SPAC shares after the merger announcement but before the SPAC files legally required and regulated merger registration and proxy statements (the information gap).
- Lack of Fundamentals. During this information gap, investors who trade will be doing so on rumor, hype, speculation, and minimal regulatory or other detailed information about the target company or IBC.
- Buying Above $10 per Share. If investors purchase SPAC shares for more than $10 during the gap, they will lose money when they redeem these shares. They will receive only the redemption price—typically $10 per share plus interest.

7. *Redeeming SPAC Shares*

- Right of Redemption. Investors must know their rights and the *deadline* for redeeming shares.
- Merger Vote. SPAC shareholders can vote in favor of the merger and still redeem their shares.
- Redemption Amount. If investors redeem, they typically receive $10 plus a small interest earnings per share.
- Holding the Shares. If investors do not redeem their shares, they will receive shares in the new IBC company. IBC shares may or may not trade at $10 once public trading begins.

- Key Considerations When Deciding to Redeem:
  i. know as much as possible about the target company,
  ii. identify whether the sponsor has expertise in the target company's business sector,
  iii. identify if and for how long the sponsor is locked up from selling their IBC shares,
  iv. identify if and for how long other anchor investors like private investment in public equity (PIPE) investors are locked up from selling their IBC shares, and
  v. confirm the sponsor's track record in operations, mergers and acquisitions generally, and other SPACs specifically (this information is in the IBC documentation).

8. Long-Term Prospects for SPAC IBC Investments

- IBCs as Venture Capital Investments. Many recent IBCs have been for emerging growth-stage companies. Such investments may have a return profile similar to that of venture capital and may experience a higher failure rate than more traditional or mature public companies.
- Track Developments. Investors should know something about the emerging business they are invested in and follow its progress.
- Holding Period. Accept the notion that early stage firms may take several years to emerge as profitable and successful growth companies.
- Diversified Approach. Be aware that early stage firms generally have high failure rates. Professional venture capital investors own a diversified portfolio of firms to balance out winners and losers. Buying one or two SPACs that are acquiring early stage companies, and holding shares through the redemption deadline, is a risky strategy.

THE AMERICAS
(800) 247 8132 PHONE (USA and Canada)
+1 (434) 951 5499 PHONE
+1 (434) 951 5262 FAX

915 East High Street
Charlottesville, VA 22902
USA

477 Madison Avenue
21st Floor
New York, NY 10022
USA

ASIA PACIFIC
+852 2868 2700 PHONE
+852 2868 9912 FAX

23/F, Man Yee Building
68 Des Voeux Road
Central, Hong Kong SAR

Si Wei Beijing Enterprise Management Consulting Company Limited
Unit 7, Level 12, Office Tower C1, The Towers, Oriental Plaza
No 1 East Chang An Avenue, Dong Cheng District
Beijing, 100738, China

CFA Institute India Private Limited
Naman Centre, Unit No. 103
1st Floor, Bandra-Kurla Complex, G Block, Bandra (East)
Mumbai 400 051, India

EUROPE, MIDDLE EAST, AND AFRICA
+44 (0) 20 7330 9500 PHONE
+44 (0) 20 7330 9501 FAX

131 Finsbury Pavement
7th Floor
London EC2A 1NT
United Kingdom

Rue du Champ de Mars 23
1050 Brussels, Belgium

CFA Institute

www.cfainstitute.org
info@cfainstitute.org