SEC Advisory Group Pushes for More Sunlight on SPACs As FINRA Conducts SPAC Exam Sweep

Special purpose acquisition companies continue to draw scrutiny from the Securities and Exchange Commission, which appears to be gearing up for increased regulation of SPACs throughout their lifecycles. Early last month, executives and academics comprising the SEC's Investor Advisory Committee ("IAC") recommended that the SEC regulate SPACs "more intensively by exercising enhanced focus and stricter enforcement of existing disclosure rules" and that it publish its own "own analysis of the players in the various SPAC stages, their compensation, and their incentives."

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Senators Set Their Sights on SPACs

SPAC mania is real, and lawmakers are taking notice. With the number of pending and completed SPACs in 2021 already more than double the number from 2020 (which was itself nearly triple the number from 2019), a group of senators, led by Elizabeth Warren, recently sent letters to several prominent SPAC sponsors raising concerns that although SPACs may mean big profits for sponsors and sophisticated institutional investors, retail investors may be left holding the bag if (or when) things go wrong. These letters, as well as a recent exchange between Senator Sherrod Brown and SEC Chairman Gary Gensler, may signal that SPACs will soon be subject to increased oversight by regulators and lawmakers.

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What started as rumblings from regulators about SPACs' structure and management has now developed into a war on three fronts. To varying degrees, private plaintiffs, regulators at the SEC and FINRA, and Congress have all trained their sights on SPACs. Broadly, each SPAC-attack centers on the same issue: how SPACs compensate sponsors and other early investors and, relatedly, how SPACs communicate those arrangements—and potential conflicts—to later investors.

Unsurprisingly, private litigants have raced to the front of the SPAC pack, having filed lawsuits in federal court advancing a novel legal theory that SPACs are properly treated as investment companies, with all of the attendant regulations and restrictions on insider compensation and disclosure. The SEC and FINRA, meanwhile, have been cautiously ramping up a regulatory push with increasingly specific and concrete steps to collect information on SPACs, likely in anticipation of new regulations. The SEC has received a recommendation from its Investor Advisory Committee that the Agency require SPACs to disclose a host of information about sponsors' expertise and conflicts of interest, and specifics about the SPACs' searches for target companies and due diligence processes. FINRA, meanwhile, has launched a sweep of member firms' dealings with SPACs, seeking information on everything from member firms' internal policies and training related to SPACs, to SPAC-related investment recommendations, services, compensation and potential conflicts of interest. Congress, it seems, is taking the most deliberative approach. Progressive Senators, led by Elizabeth Warren, have issued letters demanding information from six prominent SPAC sponsors seeking information about the dynamics between early SPAC investors and sponsors and later, typically less sophisticated investors. Although unclear what action—if any—Congress will take, the interest of powerful legislators is sure to bring more public attention to SPACs. This issue of the SPAC Report examines these challenges and analyzes what each could mean for the future of SPACs.

A SPAC by Any Other Name Might Not Smell As Sweet

What's in a name? For SPACs, the answer might turn out to be "quite a lot." While investors prize SPACs for their flexibility and ability to avoid regulatory roadblocks when taking a private company public, a new legal theory is emerging that could upend the way that SPACs are regulated.

SPACs' basic appeal is that they are, in effect, operating companies with no operations. That is what allows SPACs to breeze through the IPO process themselves, and then streamline the IPO process for the private companies that they acquire. A trio of lawsuits filed in August 2021 allege that classifying SPACs is not so simple. Drawing on a theory first proposed by Robert Jackson Jr., a former SEC Commissioner, and now a professor at New York University School of Law and John Morley, a Professor at Yale Law School, the lawsuits allege that SPACs are not actually operating companies at all and in fact were never intended to operate. Instead, the plaintiffs contend, certain SPACs are actually investment companies. If the lawsuits' legal theory is successful and gains purchase with regulators, SPACs could find themselves required to restructure their businesses and rethink whether the SPAC model is even viable.

ICA Background

Born of the Stock Market Crash of 1929, the Investment Company Act of 1940 (ICA) was a regulatory response to abuses by money managers in the period before the Great Depression. Like other post-Great Depression securities laws, the ICA vest the Securities and Exchange Commission (SEC) with broad authority to implement its provisions in the name of protecting the investors. As its name suggests, the ICA regulates investment companies, and the Law describes two kinds issuers that fall under its ambit. The first—so-called "orthodox investment companies"—covers "an issuer which is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities." The ICA also governs "Inadvertent Investment Companies," which it defines as "an issuer which is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of [U.S.] Government securities and cash items) on an unconsolidated basis."
Once an issuer is deemed an investment company, it is subject to a host of regulations and disclosure requirements regarding its business and operations. For instance, the Act regulates how advisers can be compensated, prevents certain transactions between advisers and the issuer, and dictates board compensation and the contents of the fund's portfolio. Many of these requirements would be anathema to the SPAC model, which often privileges big-name sponsors and SPAC managers who ostensibly lend their expertise to the SPAC's search for a target company.

Can we call a SPAC a SPAC?

The trio of lawsuits alleges that SPACs should be classified as investment companies under the ICA and required to comply with the ICA's stringent requirements. In the suits, plaintiffs assert that SPACs should be classified as an Investment Companies for two reasons: (1) the business in which the SPAC is engaged primarily; and (2) how they store proceeds from their initial public offering and before they acquire a target company.

Assad v. Pershing Square Tontine Holdings, Ltd., 21-cv-6907 (S.D.N.Y. 2021), perhaps the splashiest of the actions, illustrates these bases for changing that way that SPACs are classified and does so against the backdrop of one of the more controversial SPACs. In *Assad*, the plaintiff brings a shareholder the SPAC Pershing Square Tontine Holdings, Ltd. ("PSTH") brings a derivative suit against PTSH's sponsor and directors. This is no normal SPAC, however. PTSH is the largest SPAC ever, headed by brash billionaire Bill Ackman, and it has a tortuous history to match. Unlike many SPAC sponsors, Ackman claimed that he would not collect a fee and PSTH soon became a hot topic for retail investors. As initially conceived, PTSH had a unique structure, one that Ackman claimed would favor retail investors, but that also might have left PSTH vulnerable to litigation and objections from the SEC. PSTH would acquire take a significant position in the recording giant Universal Music Group ("UMG"), which is a subsidiary of France's Vivendi SE. PSTH would hold the shares in trust until Vivendi completed its spin off and listing of UMG on the Euronext Amsterdam exchange. Only then would PSTH distribute the UMG shares to its investors. In other words, rather than take UMG public itself, PTSH would become a large shareholder in advance of the IPO that was already in the works.
As alleged in *Assad*, PTSH held itself out to do precisely what investment companies do—i.e., buying and selling securities. After PTSH's IPO on July 22, 2020, PTSH's prospectus explained that the proceeds from the IPO along with cash that the company acquired in exchange for warrants it sold to certain directors and its sponsor, would be put into trust. The trustee would thereafter invest PTSH's money into U.S. Treasury obligations or into money-market funds that invested only in U.S. Treasury obligations. That, the plaintiff alleges, is the first basis upon which to classify PTSH as an investment company—all the Company has ever done with its assets is to invest in securities. The Complaint also asserts, however, that PTSH's proposed business combination means that it was only ever meant to operate as an investment company. PTSH's proposed business combination—or "deSPACing"—was to be executed by purchasing a minority stake of UMG. That, according to the plaintiff, means that PTSH was conceived as an investing company and would only ever be an investment company.

The Devil is in the (Compensation) Details

Assad, and the other lawsuits, also encapsulate the ways in which a designation as an investment company would transform the current ways in which many SPACs organize their business. Most obviously, were a SPAC declared to be an investment company by virtue of the way it invested its proceeds from its initial IPO, SPACs would be left with few options for what to do with their assets while they search for a private company to acquire. SPACs could stuff their proceeds under the proverbial mattress and simply hold the money they make from an IPO as cash, which would not trigger the ICA. That would mean, of course, losing out on the potential return on investment from reinvesting those funds, and could impact the SPACs' ability to acquire the target company of its choosing. Further, the lawsuit's focus on PTSH's novel structure by which it would acquire shares in UMG rather than merge with its target suggests that exotic SPAC arrangements might be subject to scrutiny from shareholders in addition to regulators. In what Ackman called a "deal killer," the SEC objected to PTSH's proposed share purchase, while not citing the ICA, Ackman noted that part of the issue in the Agency's view was that the transaction did not meet the New York Stock Exchange's definition of a SPAC business combination. This one-two punch of regulatory scrutiny and shareholder derivative litigation suggests that SPACs should hew closely to the standard approach of merging with a target company rather than proposing innovative business combinations. Unorthodox arrangements like PTSH may be forced to course correct, as Ackman did after *Assad* and SEC called into question whether the new model was legal, leaving the SPAC with little more than wasted time and an avalanche of bad press.

Perhaps more importantly for the broader SPAC market, *Assad* asserts that the way that PTSH compensated its directors and sponsor was impermissible under the ICA. At the early stages, SPACs often enlist high-profile or sophisticated investors such as hedge funds to provide the SPAC with funding and expertise in locating and acquiring a target company. Often these early investors get sweetheart deals in fees or stock for their assistance shepherding the SPAC through the acquisition. How the SPAC treats these “insiders,” however, has been a hot topic among regulators, with the SEC issuing Guidance in late-2020 that encouraged SPACs to disclose potential conflicts of interest and the incentive structures around its issuance of warrants and other compensation to early investors.

Assad goes a step further and alleges that because PTSH is an investment company, its compensation structure for directors and its sponsor was illegal. Part of PTSH’s public pitch was that it would eschew compensating its directors and sponsors to avoid precisely the kinds of conflicts that the SEC had identified as problematic, with Ackman even going so far as to say that he would not collect a fee from PTSH and that he and PTSH’s directors would “work for free.”

While perhaps true that Ackman and other insiders would not collect a fee, the *Assad* Complaint alleges that they were nonetheless compensated handsomely with a mix of securities and options in the Company. The Complaint alleges that this compensation structure violates the ICA in a host of ways, but two assertions are particularly problematic for the SPAC industry. Assad alleges that PTSH’s compensation for its directors and sponsor was impermissible because, under the ICA, an investment company must register with the SEC as such before offering securities. Were this portion of the ICA applied to SPACs, it could spell the end of SPACs giving certain early investors—who claim to provide essential expertise—preferential shares in the Company. The Plaintiff goes on to allege that PTSH’s corporate governance was likewise in violation of the ICA because PTSH issued the directors compensation without a full vote of the Company’s shareholders and the securities were issued for well below fair market value, as is required by ICA sections 16, 22, and 23, respectively. Wresting control over insider compensation from a SPACs’ sponsor to all of a SPACs’ shareholders could mean a more bureaucratized structure, depriving the SPAC of the flexibility for which it is prized.
In what could be a proxy for the entire SPAC industry, the *Assad* plaintiff seeks a declaratory judgment that PTSH should be categorized as an investment company under the ICA and further asks the court to rescind or enjoin the compensation to PTSH’s directors and sponsor. The suit is already proving divisive in the finance and legal worlds, with law professors choosing sides, and even a collection of large law firms weighing in. Moreover, the suits alleging that SPACs should be regulated under the ICA are but a piece of the growing wave of private litigation against SPACs, which have spiked along with SPACs’ popularity on Wall Street. Ackman, for his part, is undeterred. While PTSH’s UMG acquisition is no more, he has floated the idea of something called a Special Purpose Acquisition Rights Company—a “SPARC”—that would not raise any money from investors up front but would instead give shareholders warrants exercisable at a specific price, that they could later use to invest in whatever deal Ackman is able to negotiate. While SPACs represent a blank check, the SPARC model is a blank I.O.U. It remains to be seen whether the SEC and other regulators will sign off on this untested arrangement.

While it is unclear how the lawsuits focused on the ICA will end, what is apparent is that SPACs have to contend with scrutiny not only from regulators, but also novel legal challenges from private parties. While PTSH was in some ways anomalous, other SPACs may face legal challenges based on their compensation or corporate governance structures. And it is clear that these challenges are proceeding in tandem, with both governmental and private challenges focusing on the way that SPACs handle potential conflicts with sponsors and other early investors and how they dispose of the substantial sums they raise from their IPOs. As is clear from these lawsuits, SPACs' continued viability may depend on convincing other market participants that they are not skirting short-circuiting normal investor protections.

SEC Advisory Group Pushes for More Sunlight on SPACs as FINRA Conducts SPAC Exam Sweep (cont'd)

Special purpose acquisition companies continue to draw scrutiny from the Securities and Exchange Commission, which appears to be gearing up for increased regulation of SPACs throughout their lifecycles. Early last month, executives and academics comprising the SEC's Investor Advisory Committee ("IAC") recommended that the SEC regulate SPACs "more intensively by exercising enhanced focus and stricter enforcement of existing disclosure rules" and that it publish its own "own analysis of the players in the various SPAC stages, their compensation, and their incentives." Although the SEC will likely take at least six months before taking any action on SPAC regulation, the Financial Industry Regulatory Authority Inc. ("FINRA") has already started delving into how firms offer and provide services to SPACs.

In particular, among other things, the IAC urged the SEC to require: (1) robust disclosures relating to SPAC sponsors' expertise, contributions, and conflicts of interest; (2) plain-English disclosures regarding the financial incentives of various participants; (3) clear descriptions of the SPAC process and timelines with details of rules regarding votes by shareholders considering deals; (4) more information on a SPAC's target and opportunity search process, as well as related risks; and (5) more information about the due diligence the sponsor will agree to regarding accounting practices by the target company.

In particular, the IAC's recommendations, which urge the adoption of broad disclosure rules for SPAC sponsors and financial incentive disclosures for various other participants, come on the heels of last year's guidance on disclosures for SPAC IPOs. Like the SEC's December's disclosure guidance, these recommendations exemplify the continued concern surrounding potential conflicts of interest inherent in the SPAC sponsorship structure. If adopted, the first recommendation would lead to required disclosures of the role of each SPAC sponsor, including the articulation of the sponsor's "appropriateness, expertise, and capital contributions, as well as an overview of any political conflicts of interest on the part of the sponsor and other insiders or affiliates, and any divergence of the sponsor's financial interest relative to that of the retail investors in SPAC." Should the SEC accept this recommendation, increased disclosures would extend to *any* insider or affiliate, including celebrity sponsors. The second recommendation, for plain-English disclosures on the economics of various participants' roles in the SPAC process, including the "founder shares" or "promote" paid to each participant and its dilutive impact, are designed to allow a retail investor to meaningfully evaluate the upside and downside potential of the SPAC transaction. The balance of the recommendations from the IAC are aimed at shedding light on the processes employed by individual SPACs and appear to take aim at the natural information asymmetry present between SPAC participants and potential investors.

Although the SEC has not yet acted on these recommendations, on September 14, SEC chair Gary Gensler assured members of Congress that he has asked his staff to generate proposals for public comment and that the SEC is "looking at greater disclosures and if there's inherent conflicts along the way." In his remarks, Chairman Gensler focused on the concerns related to the cost of relying on underwriters, sponsors, and promoters as well as the risk of dilution faced by retail investors due to institutional investor's redemption right at the two-year deadline. Any action by the Commission, however, remains months away, as the SEC's rulemaking agenda released this past summer lists April as the target for proposing changes to SPAC regulations.

Recent SEC enforcement decisions do little to shed additional light on the agency's next steps, as the Commission has not announced any new enforcement actions since bringing charges against a host of players, including the target company's CEO, involved in the proposed SPAC acquisition of the space technology company Momentus in mid-July of this year, which we discussed in our last newsletter. SPAC-tators should not, however, take this lull to mean that regulators will take their foot of the gas while the SEC sorts out its next steps. Earlier this month, FINRA announced an examination sweep asking targeted firms to detail their SPAC activities from July 1, 2018 through September 30 of this year. FINRA does not reveal the names or number of targeted firms involved in the sweep exam, but the results will likely shed light on the extent to which registered representatives are recommending SPACs as investments for retail customers. Moreover, at the end of July, the Department of Justice ("DOJ") announced the unsealing of a criminal indictment charging the former CEO of Nikola Corporation Trevor Milton with securities and wire fraud for his role in allegedly defrauding retail investors who participated in Nikola's IPO via SPAC. The SEC also filed a parallel civil action against Milton, alleging violations of Section 10(b) of the Exchange Act and Section 17(a) of the Securities Act.

The IAC's recent recommendations emphasize that which SEC and DOJ enforcement actions to date have already suggested – that regulators are likely to continue to scrutinize SPAC transactions from every angle and are working to arm themselves with the regulatory mechanisms necessary to shine a light on each aspect of a SPAC transaction's process and structure. Those considering use of a SPAC, including those participating in a sponsor role, should expect greater scrutiny and examine the proposed transaction for the glint of anything that might catch a regulator's eye.

Senators Set Their Sights on SPACs (cont'd)

SPAC mania is real, and lawmakers are taking notice. With the number of pending and completed SPACs in 2021 already more than double the number from 2020 (which was itself nearly triple the number from 2019), a group of senators, led by Elizabeth Warren, recently sent letters to several prominent SPAC sponsors raising concerns that although SPACs may mean big profits for sponsors and sophisticated institutional investors, retail investors may be left holding the bag if (or when) things go wrong. These letters, as well as a recent exchange between Senator Sherrod Brown and SEC Chairman Gary Gensler, may signal that SPACs will soon be subject to increased oversight by regulators and lawmakers.

Addressed late last month to six prominent SPAC sponsors, the open letters, which were co-signed by Senator Sherrod Brown, Chair of the Banking, Housing and Urban Affairs Committee, along with Committee Members Senators Elizabeth Warren, Tina Smith, and Chris Van Hollen, seek information about the sponsors' compensation, possible conflicts of interest, and any regulatory or legal actions taken against the SPACs and any related entities. The six recipients included some of the most prominent SPAC sponsors: Michael Klein of M. Klein & Associates, Inc.; Stephen Girsky of VectoIQ, LLC; Tilman Fertitta of Fertitta Entertainment, Inc.;

David Hamamoto of DiamondHead Holdings Corp.; Howard Lutnick of Cantor Fitzgerald; and Chamath Palihapitiya of The Social+Capital Partnership, LLC. Intended to "determine how Congress and regulators can best protect investors and ensure a fair and transparent marketplace," the letters are the clearest signal to date that elected officials are focusing on enacting more and better regulation in the SPAC space.
Motivating the letters is a concern that SPACs (and loopholes in regulations) create "misaligned incentives" that allow SPAC sponsors and early institutional investors (generally hedge funds and other sophisticated players) to profit handsomely while later (typically retail) investors fare poorly. As the letters note, between January 2019 and January 2021, the average SPAC sponsor enjoyed returns of 958%, while investors who sold shares or redeemed shortly before a merger (generally sophistical institutional investors) averaged a 40% return. On the other hand, those investors who stayed in after the merger (generally retail investors) lost big, with the median SPAC issued at $10 per share falling to $6.67 after the merger.

The letters identify several points in the lifecycle of a SPAC where SPAC sponsors and institutional investors can win big while retail investors lose. Pre-merger, SPAC sponsors face tremendous pressure to get a deal – any deal – done. As the letters point out, SPAC sponsors are typically required to merge with a private company within two years and, if they fail to do so, must return funds to investors. This creates a misalignment of incentives between SPAC sponsors eager to seal a deal and the investors on whose behalf they are negotiating. Moreover, before the merger occurs, perceived gaps in securities laws may permit sponsors to make overly rosy predictions about a company's health. In a traditional IPO, issuing companies, directors, and underwriters can be liable for misstatements and omissions regarding the firm's health. However, several pending class action suits seek to hold sponsors accountable alleging that sponsors have made false and misleading statements at the expense of investors. For example, the letters note that prominent SPAC sponsor Michael Klein's company MultiPlan is currently embroiled in a class action lawsuit, with investors alleging that the SPAC's board concealed information that the company was about to crater. The letters also cite two pending class action suits alleging misleading statements made by two separate electric truck companies (Nikola and Lordstown Motors) that went public via SPAC transactions.

In addition, as the letters point out, sponsors and institutional investors also can profit disproportionately at the merger stage. SPAC sponsors benefit because they typically receive as compensation 20% of a company's shares upon merge. This allows them to recoup (often several times) their original investment, regardless of the impact of the deal on the long-term health of the company, while also diluting the cash value of the share held by the other (typically retail) investors. Institutional investors also enjoy significant advantages vis-à-vis retail investors at the merger stage. At the IPO stage, early investors (typically institutional investors) purchase units, which consist of one share priced at $10, along with a warrant, which they receive for free, and which entitles the holder to buy additional shares at a higher price, typically $11.50 per share. This structure not only allows SPACs to skirt existing rules governing blank check companies with stock prices below $4 per share, but also allows institutional investors to shield themselves from losses while leaving the door open to substantial gains. As the letters note, 97% of hedge funds sold or redeemed their SPAC shares pre-merge, thereby insulating themselves from loss should the company fail. But, because these investors retain their warrants, if the company succeeds and the share price rises above $11.50, they can then sell for a handsome profit. The letters compare these warrants to lottery tickets that benefit institutional players but not the retail investors who typically hold their shares through the merger. Some prominent SPAC sponsors have found even more creative ways to profit from the deals. For example, Michael Klein's SPAC hired his own investment bank as

consultants to the tune of several million dollars in fees, while Tilman Fertitta's SPAC bought a division of his casino, Golden Nugget, and then agreed to pay half of Golden Nugget's debt as part of the deal.
Crucially, although the practices the letters describe are acceptable under existing regulations, the Senators clearly find them concerning, and the letters could mark the opening volley in a coming battle among SPACs, lawmakers, and regulators. Indeed, the letters are not the only evidence that lawmakers are increasingly skeptical of SPACs. In a hearing last month before the Senate Banking, Housing, and Urban Affairs Committee, Senator Brown pushed SEC Chairman Gary Gensler on SPACs and their impact on the market. Describing SPACs as "risky financial mechanisms" whereby "investors make their money and pull out, companies break promises and workers and communities pay the price," Senator Brown asked Chairman Gensler "what can we do about" the risks of the SPAC market. In response, Gensler indicated that the Commission is "looking at greater disclosures" and determining if "inherent conflicts" exist in advance of "notice and comments and rule-making." Given Chairman Gensler's comments and the Senators' open letter, laws or new regulations are coming. The shape any future regulations might take is still fuzzy. SPAC insiders would do well to be prepared for greater oversight.

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