June 13, 2022

Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Special Purpose Acquisition Companies, Shell Companies, and Projections (File No. S7-13-22, RIN 3235-AM90); 87 Fed. Reg. 29,458 (May 13, 2022)

Dear Ms. Countryman:

Better Markets[1] appreciates the opportunity to comment on the above-captioned Proposed Rule ("Proposal" or "Release")[2] intended to enhance investor protections in initial public offerings by special purpose acquisition companies ("SPACs") as well in business combination transactions between SPACs and private operating companies ("de-SPAC transactions"). The Proposal, if adopted, would implement a variety of improvements in the regulation of the SPAC IPO model, which would further enhance disclosures to investors and more closely align regulations with those applicable to traditional IPOs.

First, the Proposal would require enhanced disclosures regarding information on sponsors, conflicts of interest, potential dilution, and certain information on prospectuses and summaries, and it would require specialized disclosures in de-SPAC transactions, including a fairness determination. Second, it would further align the disclosures investors receive in a SPAC IPO with those that investors receive in a traditional IPO, including financial and nonfinancial information. Third, it would require a target private operating company to be a co-registrant in business combination transactions. Fourth, it would clarify that the Private Securities Litigation Reform Act ("PSLRA") safe harbor for forward-looking statements does not apply in connection with SPACs.

1 Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system that protects and promotes Americans' jobs, savings, retirements, and more.

2 Special Purpose Acquisition Companies, Shell Companies, and Projections, 87 Fed. Reg. 29,458 (May 13, 2022)

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Finally, the Proposal would create a safe harbor for SPACs from compliance with the Investment Company Act of 1940.

Celebrity endorsements, high profile sponsors, the promise of exorbitant returns, and retail investors left holding the bag—this is largely the story of SPACs in the U.S. capital markets in 2020 and 2021. The Commission correctly identifies many of the deficiencies associated with the current SPAC IPO model, most notably the information asymmetries investors in SPAC IPOs receive relative to the information investors in traditional IPOs receive, as well as the presumed safe harbor from liability that SPAC sponsors believe exists under the PSLRA.

The Proposal effectively addresses many of the investor protection concerns surrounding SPACs, but it can and should be strengthened. The Proposal fails to adequately reconcile SPAC investors' ability to redeem their shares while simultaneously voting in favor of a de-SPAC transaction, something the Proposal recognizes as a form of "moral hazard." Additionally, the Proposal's safe harbor from compliance with the Investment Company Act conflicts with the plain text of the Act and past Commission regulations. While we support the overall framework of the Proposal, we believe the Commission must: (1) include a conversion threshold that would prohibit completion of a de-SPAC transaction if a certain percentage of SPAC shareholders redeem their shares; and (2) eliminate the safe harbor for compliance with the Investment Company Act.

BACKGROUND

A SPAC is an investment vehicle established by sponsors for the sole purpose of acquiring a private operating company. While a SPAC may be established to focus on a particular industry, its potential acquisition targets are generally unknown and unidentified at the time the SPAC is formed and trades publicly. SPACs are established by sponsors, persons generally responsible for the day-to-day management of the SPAC and searching for target private operating companies to complete what is known as a de-SPAC transaction. In exchange for their efforts, SPAC sponsors receive substantial compensation, typically 20 percent of the shares of the SPAC, otherwise known as the "promote." SPACs are funded by investors through the offering of "units," which include a share in the SPAC and a warrant to purchase additional shares upon completion of the de-SPAC transaction. The SPAC IPO model typically sells these units at an initial price of $10, although "after a certain time period, often 90 days following the IPO, the common stock and warrants trade separately."[3] The proceeds of the SPAC IPO are then deposited in an escrow account (invested in a combination of cash, Government securities, and Government money market funds) while the SPAC sponsors search for a private operating company to take public.

Once the SPAC IPO is completed, sponsors generally have two years to find a private operating company to complete a de-SPAC transaction before having to return funds to investors (less taxes but plus interest). In cases where sponsors are unsuccessful in completing a de-SPAC transaction, the sponsors do not receive their 20 percent compensation in the form of a promote and their efforts are essentially wasted and uncompensated. Thus, SPAC sponsors are incentivized

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3 Regulatory Notice 08-54: Guidance on Special Purpose Acquisition Companies, FINRA (2008), https://www.finra.org/sites/default/files/NoticeDocument/p117208.pdf.

to close a de-SPAC transaction prior to the 24-month deadline, even if it may be a bad deal for investors because 20 percent of a bad company is usually worth more than nothing, which is what the sponsor would otherwise receive.

If the sponsors are successful in targeting a private operating company to acquire, public shareholders in the SPAC will vote either in favor of or against the proposed deal. They also have the right to redeem their shares and receive a pro-rata share of the escrowed funds raised in the SPAC IPO, while retaining their warrants in the future company if the deals move forwards. Thus, SPAC shareholders have the opportunity and the incentive to vote in favor of a proposed deal, while simultaneously redeeming their initial investment and retaining their warrants in the future company. In fact, studies suggest that 58 percent of SPAC IPO shareholders redeemed their shares during the SPAC boom between 2020-2021.[4] However, in the early SPAC years, if redemptions exceeded 20 percent, the deal was prohibited from closing due to listing standards established by the stock exchanges.[5] These listing standards were subsequently removed by the exchanges in 2016 with the approval of the Commission.[6]

As a result of this redemption right, SPAC sponsors often need to make additional financing arrangements in order to ensure there is sufficient cash to consummate the deal either through contributing cash themselves or raising additional funds through private investment in public equity ("PIPE") investors. The more SPAC shareholders who elect to redeem their shares, the more leverage potential PIPE investors have in negotiating terms that are more favorable than those of the initial SPAC shareholders.[7] Once a SPAC has successfully navigated this process and completed a de-SPAC transaction, the result is a publicly traded operating company.

Despite the complexities and inherent conflicts of interest involved with the SPAC IPO model, there are no specific statutes or regulations that govern SPACs. As stated by Professor John Coates, "SPAC law is complex – they are governed by a mesh of contracts, listing requirements, common law and regulation, all full of many as-yet less-than-fully specified or tested standards."[8] The SPAC IPO model has not been specifically authorized by an Act of Congress nor any formal notice-and-comment rulemaking by the Commission. It is, rather, the by-product of a hodgepodge of legal loopholes. For example, one of these legal loopholes is the applicability of the safe harbor in the PSLRA for forward-looking statements. This safe harbor enables SPAC sponsors and underwriters to make future projections of the performance of the SPAC to investors with relative impunity. This legal loophole enables SPAC sponsors to sell investors on bold projections that

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4 Michael Klausner, Michael Ohlrogge & Emily Ruan, *A Sober Look at SPACs*, 39 Yale J. on Regul. 228, 243 (2022).

5 Usha Rodrigues and Michael Stegemoller, *Redeeming SPACs*, Univ. of Georgia Research Paper Series, Paper No. 2021-09, 23 (2021).

6 *See* Self-Regulatory Organizations; New York Stock Exchange LLC; Notice of Filing of Proposed Rule Change Amending Its Listing Standards for Special Purpose Acquisition Companies, Release No. 34-79676, 81 Fed. Reg. 96,150 (Dec. 29, 2016).

7 *See* Usha Rodrigues and Michael Stegemoller, *Redeeming SPACs*, U. of Georgia Research Paper Series, Paper No. 2021-09, 21 (2021).

8 John C. Coates, *SPAC Law and Myths* 2 (Feb. 11, 2022), archived at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4022809.

have little basis in reality. These legal loopholes, including the PSLRA safe harbor, among others, have created a regulatory arbitraged race-to-the-bottom IPO model that blossomed in 2020 and 2021.

The SPAC IPO model exploded in 2020 and 2021, with more than $80 billion raised in 2020 and $160 billion raised in 2021.[9] SPAC IPOs accounted for 60 percent of all IPOs in public markets in 2020 and 66 percent in 2021, compared to 34.5 percent in 2019 and 25 percent in 2018.[10] During this time, SPAC sponsors included the likes of notable financiers, athletes, former politicians, and celebrities. However, despite the pomp and circumstance surrounding these SPAC deals, the average performance of a SPAC IPO in the public markets has been nothing short of abysmal. Roughly 90 percent of the companies that completed SPAC deals during this boom currently trade below the SPAC's initial listing price.[11]

History has shown that the sponsors, underwriters, and shareholders that redeemed their shares but kept their warrants were not the investors that lost money in these transactions. Regrettably, the net losers ended up being the retail investors who held their shares at the time of the SPAC merger.[12] Specifically, the mean- and median-adjusted returns of SPAC shareholders that held through the SPAC merger were negative 64 percent and negative 88 percent, respectively.[13] Meanwhile, the sponsors and underwriters saw huge windfalls from these transactions, even when the SPAC failed to perform well in the public market. For example, SPAC sponsors have been known to make $140 million due to their promote compensation despite the shares of the underlying publicly traded SPAC being down 30 percent.[14] That is why the story of SPACs in 2020 and 2021 was not a story of wealth creation, but a story of immense transfer of wealth, from retail investors to wealthy sponsors and underwriters who lured them in with the prospect of handsome profits but failed to deliver. The current incentives and lack of regulations inherent in the SPAC IPO model explicitly enabled this reverse Robin Hood transfer of wealth at the expense of retail investors.

OVERVIEW OF THE PROPOSAL

The Commission has proposed new rules and amendments to enhance investor protection regarding SPACs and de-SPAC transactions. These new rules and amendments include, but are not limited to, disclosure requirements for compensation paid by sponsors, conflicts of interest,

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9 Release at 29,460.

10 Usha Rodrigues and Michael Stegemoller, *Redeeming SPACs*, U. of Georgia Research Paper Series, Paper No. 2021-09, 6 (2021).

11 Amrith Ramkumar, *Stock Selloff Crunches SPAC Creators as They Race to Find Deals*, Wall Str. J., May 18, 2022, https://www.wsj.com/articles/stock-selloff-crunches-spac-creators-as-they-race-to-find-deals-11652866380.

12 Michael Klausner, Michael Ohlrogge & Emily Ruan, *A Sober Look at SPACs*, 39 Yale J. on Regul. 228, 234 (2022).

13 *Id.* at 233.

14 Amrith Ramkumar, *SPAC Insiders Can Make Millions Even When the Company They Take Public Struggles*, Wall Str. J., April 25, 2021, https://www.wsj.com/articles/spac-insiders-can-make-millions-even-when-the-company-they-take-public-struggles-11619343000.

potential sources of dilution, and the fairness of business combination transactions. Additionally, the new rules and amendments would address business combination transactions by altering the reporting requirements of both the shell company and the private operating company. The new rules and amendments would also address the use of forward-looking projections in de-SPAC transactions. Finally, the new rules and amendments would create a safe harbor for SPACs from regulation under the Investment Company Act of 1940. More specifically, the proposal:

Enhanced Disclosures

- requires specialized disclosures for SPACs regarding sponsors, potential conflicts of interest, and potential sources of dilution, and certain disclosures on prospectus cover pages and summaries;

- requires specialized disclosures for de-SPAC transactions, including a fairness determination.

Aligning de-SPAC Transactions with IPOs

- requires disclosure of non-financial information about a target company in a de-SPAC transaction if they are not subject to the reporting requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934;

- requires that a prospectus and proxy and information statements be distributed to shareholders at least 20 calendar days prior to a shareholder meeting in connection with a de-SPAC transaction;

- requires a SPAC and the target company to be treated as co-registrants when filing Form S-4 and Form F-4 registration statements in connection with a de-SPAC transaction;

- requires a re-determination of smaller reporting company status after the completion of a de-SPAC transaction;

- amends the definition of "blank check company" for purposes of the PSLRA to clarify that forward-looking statements, or projections, made in connection with de-SPAC transactions do not fall within the PSLRA's safe harbor;

- clarifies that a person acting as an underwriter in a SPAC IPO and taking steps to facilitate the de-SPAC transaction will be deemed to be an underwriter in the de-SPAC transaction under certain conditions.

Business Combinations Involving Shell Companies

- deems any business combination of a reporting shell company and any other entity that is not a shell company to involve a sale of securities to the reporting shell company's shareholders under the Securities Act;

- codifies guidance to better align financial statement requirements required of private operating companies being acquired by shell companies with those requirements applicable in traditional IPOs.

Enhanced Projections Disclosure

- expands and updates existing Commission guidance on projections of future economic performance and whether or not they have a reasonable basis. The Proposal would also clarify that this guidance applies to forward-looking statements of target companies in SPAC business combination transactions.

Safe Harbor under Investment Company Act of 1940

- creates a safe harbor for SPACs from compliance with the requirements applicable to an investment company under the Investment Company Act of 1940. The safe harbor would apply if:

    - the SPAC's assets consist solely of cash items, government securities, and certain money market funds prior to completion of de-SPAC transactions;

    - the SPAC seeks to complete a single de-SPAC transaction and the surviving company will be primarily engaged in the business of the target company that is not an investment company; and

    - the SPAC seeks to enter into an agreement with a target company to engage in a de-SPAC transaction no later than 18 months and completes the deal no later than 24 months after registration of the SPAC.

COMMENTS

The Proposal corrects many deficiencies in the SPAC IPO model, strengthens investor protections, and narrows many opportunities for regulatory arbitrage in connection with bringing companies public in U.S. capital markets. However, the Commission should bear in mind the legal and regulatory history, or lack thereof, in connection with SPACs. As mentioned previously, Congress has never specifically authorized the SPAC IPO model through legislation and neither has the Commission through the use of formal notice-and-comment rulemaking. SPACs are in a sense a legal fiction resulting from a hodgepodge of legal loopholes not authorized by statute or regulation. Despite the investor protections established by this Proposal in connection with SPACs, with this Proposal the Commission is effectively authorizing an additional model for initial public offerings that is not, and never has been, authorized by Congress. In fact, as discussed below and by others, the SPAC IPO model may be fundamentally at odds with the Commission's existing securities framework and congressionally enacted securities laws, including notably the Investment Company Act. For those reasons, the Commission should re-evaluate its entire approach to SPACs. Meanwhile, the Proposal will at least help ensure that investors receive enhanced protections when confronted with these complex, risky, and often predatory investment opportunities.

I. The Proposal narrows the information asymmetries between SPAC transactions and traditional IPOs.

As mentioned earlier, the rise of initial public offerings conducted by SPACs in comparison to traditional initial public offerings should trouble the Commission. The usurping of the traditional IPO model, which has been at the heart of capital formation in the securities markets since the enactment of the securities laws in the 1930s, by the SPAC IPO model, suggests that market participants are engaging in regulatory arbitrage, electing a less regulated model of capital formation and evading the more traditional, regulated IPO model. This Proposal has many provisions that will better align the requirements of the SPAC IPO model with those of the traditional IPO model, which will enhance disclosures to investors and should place the U.S. IPO process on a more stable footing. Specifically, the following changes are important elements to be maintained in the final rule: (1) enhanced registration statement disclosure, deeming a private operating company a co-registrant, and requiring earlier dissemination of information to investors; (2) limiting access to the PSLRA safe harbor; and (3) increasing underwriter liability. Taken together, these changes will help to align the SPAC IPO model more closely with the traditional IPO model and narrow the regulatory arbitrage opportunities when bringing companies to the public markets.

A. Enhanced registration statements, deeming private operating company a co-registrant, and the earlier dissemination period will all help protect investors.

The Proposal would enhance disclosures provided to investors, specifically information about a SPAC's sponsors, potential conflicts of interest, dilution, and certain information on the prospectus cover page and in the prospectus summary. The disclosures should assist shareholders in understanding the compensation structures for SPAC sponsors; the inherent conflicts in the relationship between SPAC sponsor, underwriter, and shareholder; potential sources of dilution of their shares; and whether or not any fairness opinions were obtained by third parties in connection with the de-SPAC transaction. These enhanced disclosures will equip investors with information they can use to evaluate the wisdom of placing their money at risk in a SPAC. They will also more closely align the information provided in SPAC IPOs with the information provided to investors in traditional IPOs. All of this information will help to narrow the information asymmetries in the SPAC IPO model, which currently exists to the detriment of shareholders and potential investors.

The Proposal's treatment of the private operating company in a de-SPAC transaction as a co-registrant will further protect investors from material misstatements or omissions. Under current regulations, management and directors of a private operating company in a de-SPAC transaction are not required to sign Form S-4 or F-4.[15] Only the SPAC sponsors, officers, and directors are responsible for signing the registration statements.[16] This enables management and directors of the private operating company to limit or escape liability for material misstatements or omissions in a de-SPAC transaction, even though their company's operations will serve as the primary source of revenue following the completion of any transaction. The Proposal would rectify this loophole by requiring the private operating company to be treated as a co-registrant for purposes of filing a registration statement, requiring the private operating company's officers and directors to co-sign the registration statements. This provision of the Proposal would make both parties to the de-SPAC transaction liable for material misstatements and omissions to investors and shareholders, which should improve the reliability of the enhanced disclosures in the registration statement.

The Proposal's minimum 20-calendar day dissemination period for disclosure of proxy statements, prospectuses, and other information is necessary to enable SPAC shareholders to make informed decisions about whether or not to authorize the de-SPAC transaction. As the Proposal notes, there is no federally mandated minimum time period in which SPACs are required to provide shareholders with necessary information and disclosures regarding the nature of the transaction.[17] This information is especially critical for investors, since the ultimate purpose of a SPAC is to complete a de-SPAC transaction with an operating company. To make meaningful decisions, investors in a SPAC need the information regarding the proposed transaction in a timely manner. In the absence of a federally mandated minimum time period to disseminate information regarding the transaction, the potential for abuse is clear, as sponsors can rush a proposed transaction, leaving investors with a truncated period of time to review disclosures and make appropriate judgments in connection with the transaction. This is especially true in the context of a SPAC where de-SPAC transactions need to be completed within a 24-month time period and sponsors, underwriters, and warrant-holding shareholders are incentivized to complete a deal to avoid being required to return capital to shareholders. The 20-calendar day dissemination period will better enable investors to adequately assess the merits of a proposed de-SPAC transaction.

B. Closing the Private Securities Litigation Reform Act safe harbor is essential.

Perhaps one of the most important provisions in the Proposal is the provision clarifying that the statutory safe harbor in the PSLRA does not apply to forward-looking statements made in connection with a de-SPAC transaction. The Proposal notes the number of commentators that have raised concerns with the use of forward-looking statements or projections, that have been made in connection with de-SPAC transactions.[18] In fact, it is nearly impossible to ignore the research and findings of the wild and indiscriminate use of projections in de-SPAC transactions by sponsors with seemingly little care given to the accuracy or reality of those projections. One study of all SPAC transactions between 2004 through 2021 found that only 35% of post-merger SPACs met

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[15] Release at 29,479.
[16] *Id.*
[17] Release at 29,478.
[18] Release at 29,462 n.33.

or beat their projections.[19] The accuracy of their projections dropped significantly over the two-, three-, and four-year projections to 21%, 10%, and 0%, respectively.[20] That same study found that the ***projected*** average annual revenue growth rate for SPACs was 116%, nearly three times higher than the actual mean revenue growth of traditional IPO firms of 41%.[21] Additionally, analysis by the Wall Street Journal found that of the 63 companies with less than $10 million in trailing sales that went public via the SPAC IPO model in 2021, roughly half of those companies failed to meet their expected revenue projections for 2021.[22] In one concrete example, the electric vehicle company, Nikola, which went public via the SPAC IPO model in 2020, projected that it would earn $150 million in revenue in 2021.[23] Instead, the company earned $0 in 2021.[24]

It is clear that far too many SPAC sponsors have utilized the PSLRA safe harbor to paint bold and enticing pictures of the financial outlook of their post-merger companies that were divorced from reality. These studies and examples and the historically bad performance of SPACs, especially as compared to the projections of their sponsors, have left an indelible stain on the SPAC IPO model. The safe harbor from the PSLRA for forward-looking statements in de-SPAC transactions has fueled this trend, undermined public confidence in our capital markets, and harmed investors by enabling SPAC sponsors to make reckless projections about future financial performance. In any final rule, the Proposal must retain the clarification that the PSLRA safe harbor does not apply in connection with de-SPAC transactions.

C. Increasing underwriter liability is similarly important.

The proposed enhancement in the potential liability of underwriters in de-SPAC transactions will more properly align SPAC IPO liability requirements for underwriters with those requirements in traditional IPOs. The outcome will result in greater due diligence in SPAC deals as well as stronger investor protections. Specifically, proposed Rule 140a clarifies that an underwriter in a SPAC IPO that helps to facilitate the de-SPAC transaction is an underwriter in

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19 Elizabeth Blankespoor et al., *A Hard Look at SPAC Projections*, Mgmt. Sci. 3 (Forthcoming 2022), https://deliverypdf.ssrn.com/delivery.php?ID=980119000072117073120094092077025098118002064083044031109127065112110092005102005025056030043025033007124029100126116087126117061055008035004067119094099005071071001010073004006085115103085116004003024095104012028127119095126099087031005015004065024&EXT=pdf&INDEX=TRUE.

20 *Id.* at 10.

21 *Id.* at 3.

22 Heather Somerville and Eliot Brown, *SPAC Startups Made Lofty Promises. They Aren't Working Out.*, Wall St. J. (Feb. 25, 2022), https://www.wsj.com/articles/spac-startups-made-lofty-promises-they-arent-working-out-11645785031.

23 Matthew Fox, *Long-term projections by some SPAC stocks are proving to be wishful thinking as Virgin Galactic misses 2021 revenue target by 98%*, Bus. Insider (Mar. 3, 2022), https://markets.businessinsider.com/news/stocks/spac-stocks-revenue-projections-miss-risk-virgin-galactic-2022-3#:~:text=Finally%2C%20perhaps%20the%20poster%20child,million%20in%20revenue%20in%202021.

24 *Id.*

the context of the de-SPAC transaction.[25] For traditional IPOs, underwriters must not misstate or omit material facts in a securities offering registration statement, and they are subject to the civil liability provisions of Section 11 of the Securities Act of 1933 if they violate those prohibitions. Proposed Rule 140a will ensure underwriters take the necessary caution required by Section 11 of the Securities Act for SPAC IPOs, which is desperately needed.

Likewise, proposed Rule 140a will also help protect against the inherent incentive misalignment for underwriters in a SPAC IPO where a majority of their compensation is conditioned upon completion of the de-SPAC transaction. As the Proposal notes, underwriters generally receive 5 to 5.5 percent of the IPO proceeds in a SPAC IPO, with 3.5 percent conditioned on the completion of the de-SPAC transaction.[26] As discussed further below, this compensation structure places the underwriter's interest alongside the SPAC sponsors, creating a powerful incentive to complete a de-SPAC transaction prior to the expiration of the 24-month time frame. Here again, proposed Rule 140a would reduce the opportunities for regulatory arbitrage between traditional IPOs and SPAC IPOs and ensure critical investor protections against material misstatements and omissions.

II. <u>The Proposal requires disclosure of several conflicts of interest, but the misaligned incentives present in SPAC deals are incurable without a conversion threshold.</u>

The Proposal's requirement to disclose actual and potential conflicts of interest does not solve the numerous misalignments of incentives that are inherent with SPACs. There are three primary incentive misalignments that will remain in connection with any SPAC despite the reforms being made by this Proposal, including: (1) sponsor and underwriter incentives to close a deal, apart from its merits; (2) shareholders' ability to approve a de-SPAC transaction while simultaneously redeeming their shares; and (3) PIPE investors receiving preferred terms. While some of the provisions in the Proposal help to chip away at these incentive misalignments, they do not do enough to protect retail investors. For these reasons, the Commission should consider reinstituting a conversion threshold to help better align the incentives of all parties in connection with a de-SPAC transaction. The conversion threshold was an element of early de-SPAC transactions that had prohibited the completion of any de-SPAC transaction when more than 20% of shares were redeemed by shareholders. Establishing a similar conversion threshold would help narrow the misaligned incentives inherent in the SPAC IPO model.

A. Sponsors and underwriters have a powerful incentive to close a deal, any deal.

A SPAC is an attractive vehicle for sponsors and underwriters to take a private operating company public, in large part due to the rich compensation associated with the completion of a de-SPAC transaction. If a de-SPAC transaction is successfully completed, the SPAC sponsor usually receives roughly 20 percent of the SPAC's initial public offering in the form of shares and warrants.[27] Similarly, an underwriter will usually receive between 5 to 5.5 percent of the offering

[25] Release at 29,486.
[26] *Id.*
[27] Release at 29,460 n.11.

proceeds, with 3.5 percent conditioned on completion of the de-SPAC transaction.[28] SPAC sponsors and underwriters must complete a deal within a specified timeframe, generally 24 months, or else they receive no compensation and are forced to return the capital they raised from investors. As is plainly clear, this creates a powerful incentive for SPAC sponsors and underwriters to complete a de-SPAC transaction before the time comes when they must return assets to investors and lose their 25 percent commissions (20 percent for the sponsor and 5 percent for the underwriter). This incentive inherently built in to the SPAC model has led to many bad deals for investors, especially in de-SPAC transactions that are hastily completed just before the 24-month deadline.[29] While some of the provisions in the Proposal, such as those associated with underwriter liability and enhanced disclosures, will help to protect investors from rushed and superficially researched de-SPAC transactions, if the Proposal is finalized as is, this inherent incentive misalignment will remain.

B. SPAC shareholder's ability to vote for de-SPAC transactions and yet redeem their shares calls for a conversion threshold.

SPAC sponsors and underwriters are not the only persons involved in a SPAC incentivized to close a deal; the original shareholders also have a powerful incentive to close a deal, any deal, even if they plan to redeem their shares prior to the completion of the transaction. Typically, shareholders in a SPAC invest their funds with the sponsor, which are deposited in a trust account. The sponsor and their affiliates then go to work in search of a target company to acquire with those investor funds. If shareholders disagree with the sponsors in their selection of the proposed merger target in a de-SPAC transaction, they can redeem their shares for the same price they invested in the SPAC and walk away whole (less taxes and any underwriter fees, plus interest). This exit opportunity helps protect the shareholder and the SPAC from pursuing bad deals.

However, inexplicably, many SPACs allow shareholders to "vote for a business combination even while they are redeeming their shares. In effect, they can vote for an acquisition while walking out the door, paradoxically declining to take part in the very transaction they approved."[30] Redeeming shareholders also may retain warrants for shares in the entity resulting from any successful de-SPAC transaction. With this practice, shareholders are incentivized to vote for a deal, any deal, because they have the ability to redeem their initial investment, while maintaining warrants in the de-SPAC transaction. In effect, by redeeming their shares prior to the completion of the de-SPAC transaction and voting in favor of the deal, they eliminate their

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28 *Id.*

29 Lora Dimitrova, *Perverse incentives of special purpose acquisition companies, the "poor man's private equity funds,"* 63 Journal of Accounting and Econ. Issue 99, 100 ("I find strong evidence that much of SPAC value destruction through bad acquisitions is a result of certain contractual features that give SPAC managers incentives to pursue any acquisition over no acquisition. For instance, performance is worse when deals are completed just before the contractually specified deadline for a SPAC acquisition. This finding suggests that, as the deadline approaches, SPAC managers become desperate to do any acquisition, even a bad one, to avoid missing the deadline and having to liquidate the SPAC"); Usha Rodriques & Mike Stegemoller, *What All-Cash Companies Tell Us about IPOs and Acquisitions*, 29 J. Corp. Fin. 111, 119 (2014).

30 Usha Rodrigues and Michael Stegemoller, *Redeeming SPACs*, U. of Georgia Research Paper Series, Paper No. 2021-09, 3 (2021).

downside risk, while maintaining warrants that enable them to purchase shares in the future at a discounted rate, retaining any potential upside in a deal. This could be one of the main reasons why redemption rates are so high in the SPAC industry, yet SPACs continue to close deals at record rates.[31]

One of the bedrocks of U.S. securities law is public ownership of publicly traded companies and the ability of shareholders to hold management and corporations accountable. However, this important check is missing within the SPAC IPO model because of the ability of shareholders to vote in favor of a deal, while simultaneously redeeming their shares. It is unrealistic to expect shareholders to serve as a check on SPAC sponsors and underwriters, when they have economic incentives to vote for a deal, even a bad one, because they can always walk away and retain warrants in the future company. For this reason, the Commission must consider including a conversion threshold as a condition for SPAC deals to move forward.

A conversion threshold will help to combat the misaligned incentives inherent in SPACs. The conversion threshold would prohibit a de-SPAC transaction from listing on an exchange if more than a certain percentage of the shareholders redeemed their shares. This conversion threshold was a requirement established by the exchanges for early SPACs, but it was eliminated in late 2016 with the consent of the Commission.[32] In a letter sent to NASDAQ and ICE in April, the Commission's Investor Advocate urged the exchanges to reimplement a conversion threshold equal to 50 percent as a listing requirement to ensure SPAC shareholders had enough skin in the game to protect investors and the public interest.[33] It would be a missed opportunity if the Proposal

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31 *See* Release at 29,461 n.17 ("According to a study of SPAC initial public offerings between 2010 and 2018, an average of 54.4% and a median of 57.1% of shares issued in an initial public offering by a SPAC during this period were redeemed prior to the completion of a de-SPAC transaction. Usha R. Rodrigues and Michael Stegemoller, *SPACs: Insider IPOs* (SSRN Working Paper, 2021). Another analysis found that, between July 1, 2021, and Dec. 1, 2021, mean and median SPAC redemption rates were 55% and 66%, respectively. Michael Klausner, Michael Ohlrogge, and Emily Ruan, *A Sober Look at SPACs*, 39 Yale J. on Reg. 228 (2022)").

32 *See Going Public: SPACS, Direct Listings, Public Offerings, and the Need for Investor Protections Before the Subcomm. On Investor Prot., Entrepreneurship, and Capital Markets of the H. Comm. on Fin. Services*, 116th Congress (2021) (statement of Usha Rodrigues, M.E. Kilpatrick Professor of Corporate & Securities Law, University of Georgia School of Law); *see* New York Stock Exchange LLC; Notice of Filing of Proposed Rule Change Amending Its Listing Standards for Special Purpose Acquisition Companies, Release No. 34-79676, 81 Fed. Reg. 96,150 (Dec. 29, 2016) ("The Exchange also proposes to eliminate the requirement that the AC cannot consummate its Business Combination if public shareholders owning in excess of a threshold amount (to be set no higher than 40%) of the shares of common stock issued in the AC's initial public offering exercise their conversion rights in connection with such Business Combination…The amended rule would permit AC shareholders to make their own informed decisions as to whether they want to participate in the Business Combination").

33 *See* Rick A. Fleming, Letter to NASDAQ on listing standards for Special Purpose Acquisition Companies (Apr. 21, 2022), https://www.sec.gov/about/offices/investorad/recommendation-of-the-investor-advocate-nasdaq-spac-listing-standards-042122.pdf; Rick A. Fleming, Letter to NYSE and NYSE American on listing standards for Special Purpose Acquisition Companies (Apr.

failed to bring back the conversion threshold to combat the inherent incentive misalignment in SPACs. While many of the provisions of the Proposal are well-intentioned and address many shortfalls in the SPAC process, few would be as effective as the conversion threshold in correcting for the inherent incentives of the sponsors, underwriters, and early and sophisticated shareholders to get a deal done, any deal, at the expense of other retail investors who are lured into a SPAC without fully understanding the prospects of the investment, potential dilution of their shares, or their redemption options. This is a fatal flaw in the current SPAC IPO model that the Proposal would not correct in its current form.

C. A conversion threshold will also reduce reliance on PIPE investors.

An additional aspect of the de-SPAC transaction is "private investments in public equity," otherwise known as "PIPEs." This process involves the SPAC sponsors and underwriters marketing the proposed merger by targeting additional investors on a type of roadshow. This serves two fundamental purposes: (1) it attracts interest in the public market for the shares of the soon-to-be newly formed company; and (2) it attracts private investment for the proposed merger in the form of PIPE investors. Lining up PIPE investors becomes crucial to successfully completing the de-SPAC transaction in cases where large numbers of shareholders in the SPAC redeem their shares prior to completion of the de-SPAC transaction. This is because SPAC sponsors and their affiliates often need additional financing to complete the de-SPAC transaction—to acquire the target operating company—because a large number of their shareholders have redeemed their shares prior to completing the deal. Often, the PIPE investors step in and provide the financing necessary to complete the deal.

However, depending on how much additional financing sponsors need to raise to complete a deal, PIPE investors may receive a discounted price in the de-SPAC transaction. Studies have found that the median PIPE investor receives a 5.5 percent discount on the purported value of the SPAC share, with discounts of 10 percent or greater in more than a third of all SPACs with PIPE deals.[34] These discounts that PIPE investors receive put them on an unequal footing with their fellow shareholders in the de-SPAC transaction, as they further dilute the investment of existing shareholders. And with the large number of shareholders that redeem their shares in any given SPAC, PIPE financing often becomes desperately necessary to complete a deal so that sponsors and underwriters can receive their "promote" compensation. Thus, by requiring a conversion threshold to complete a de-SPAC transaction, the Proposal would reduce the reliance of sponsors and underwriters on PIPE investors because only a limited number of shareholders will be allowed to redeem their shares if a deal is to move forward. Therefore, sponsors and underwriters will be less incentivized to offer discounts to PIPE investors, to the disadvantage of other investors, because they will have the requisite financing from existing shareholders to complete the de-SPAC transaction.

21, 2022) https://www.sec.gov/about/offices/investorad/recommendation-of-the-investor-advocate-nyse-spac-listing-standards-042122.pdf.

[34] Michael Klausner, Michael Ohlrogge & Emily Ruan, *A Sober Look at SPACs*, 39 Yale J. on Reg. 228, 239 (2022).

III. <u>The Proposal's safe harbor for SPACs is not consistent with the Investment Company Act of 1940 and existing SEC regulations, and it must be eliminated.</u>

The Proposal's safe harbor provision is not consistent with Section 3(a)(1)(A) of the Investment Company Act of 1940 and past regulations and no-action letters issued by the Commission; therefore, it must be eliminated from the Proposal. If the safe harbor provision is included without changes to comply with existing law, it would undermine the purposes of the Act and also expose the entire Proposal to a greater risk of challenge in the courts.

In the Proposal, the Commission rightfully recognizes that "certain SPAC structures and practices may raise serious questions as to their status as investment companies."[35] In an effort to clarify these "serious questions," the Commission has proposed a safe harbor "to align with the structures and practices that [the Commission] believe[s] would distinguish a SPAC that is likely to raise these questions from one that would not."[36] However, despite the Commission's best intentions, the safe harbor provision is not consistent with our securities law framework that has been in place for more than eighty years. Because of this, the safe harbor must be eliminated from the Proposal. In short, the safe harbor does not ensure that a given SPAC will *not actually* be an investment company.

The Proposal seeks to establish Rule 3a-10, to provide SPACs a safe harbor from the definition of "investment company" under Section 3(a)(1)(A) of the Investment Company Act of 1940. Specifically, a SPAC complies with the safe harbor if:

1. its assets consist solely of Government securities, Government money market funds, and cash items prior to the completion of the de-SPAC transaction;[37]

2. it seeks to complete a single de-SPAC transaction as a result of which the surviving public entity, either directly or through a primarily controlled company, will be primarily engaged in the business of the target company or companies, which is not that of an investment company;[38] and

3. it files a report with the Commission announcing it has entered into an agreement with the target company (or companies) to engage in a de-SPAC transaction no later than 18 months following the SPAC IPO.[39]

The Proposal's safe harbor for SPACs as proposed, while well-intentioned, is not consistent with the Investment Company Act and past Commission regulations. As Professor John Coates has said, "nothing in the [Investment Company Act] itself nor SEC rules under it clearly exempts SPACs from the [Investment Company Act]. It is at least uncertain…at least plausible that they in

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35 Release at 29,497.
36 *Id.*
37 Release at 29,498.
38 Release at 29,499.
39 Release at 29,501.

fact are investment companies subject to the [Investment Company Act]."[40] The Commission cannot amend the text of the Investment Company Act through the formal rulemaking process. Despite its efforts in the Proposal, the proposed safe harbor is not consistent with the text of the Investment Company Act. For the reasons set forth below, the Commission should eliminate this safe harbor, which needlessly adds confusion to our securities law framework, sidelines the protections set forth in the Investment Company Act, and exposes the Proposal to judicial nullification in the courts.

A. The first provision of the safe harbor, allowing SPACs to invest in certain securities, conflicts with the Act.

The inclusion of certain securities, specifically Government securities and Government money market funds, in the first provision of the Proposal's safe harbor is not consistent with the letter or intent of the Investment Company Act. The safe harbor's first provision allows SPACs to invest assets in "Government securities, Government money market funds and cash items prior to the completion of the de-SPAC transaction."[41] Section 3(a)(1)(A) of the Investment Company Act defines an investment company as any issuer that "is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading securities."[42] Under a plain reading of this definition of an investment company, any issuer that "is…engaged primarily…in the business of investing securities" is an investment company. The first provision of the safe harbor is not consistent with the letter of the law because it enables SPACs to invest primarily in securities in the form of Government securities and Government money market funds. Under a plain reading of the Act, and to avoid triggering application of the Act, SPACs should only be allowed to hold investor assets in cash prior to a de-SPAC transaction.

For purposes of this provision of the safe harbor and the question of whether or not Government securities and Government money market funds are securities under the Investment Company Act, we cannot look at the plain text of Section 3(a)(1)(A) in a vacuum. Section 3(a)(2) of the Act states "'investment securities' includes all securities except (A) Government securities…."[43] It is notable that Section 3(a)(2) specifically exempts Government securities from consideration as "investment securities," because Section 3(a)(1)(A) does not use this term. Instead, Section 3(a)(1)(A) very distinctively uses the broader term "securities" instead of "investment securities." The only logical conclusion is that Congress intended for Section 3(a)(1)(A) to apply broadly to all securities, including Government securities.

Confirming the point, in past no-action letters, the Commission has acknowledged that government securities and money market fund securities are securities under Section 3(a)(1)(A), even if they are not "investment securities" under Section 3(a)(2).[44] Commentators have

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40 John C. Coates, *SPAC Law and Myths* 35 (Feb. 11, 2022), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4022809.

41 Release at 29,498–29,499.

42 15 U.S.C. § 80a-3(a)(1)(A).

43 15 U.S.C. § 80a-3(a)(2).

44 *See Credit Suisse First Boston Corp.,* SEC No-Action Ltr., 1998 WL 799305, at *3 (Sept. 9, 1998) ("If a trust is engaged primarily in the business of investing in securities, it is an investment

subsequently adopted this view in the context of SPACs, finding that while holding government securities is in compliance with other sections of the Investment Company Act, it is not consistent with the requirements of Section 3(a)(1)(A).[45] Therefore, the first provision of the safe harbor that enables SPACs to hold Government securities and Government money market funds is inconsistent with the letter and intent of Section 3(a)(1)(A) of the Investment Company Act of 1940.

B. The second provision of the safe harbor, limiting SPACs to a single de-SPAC transaction, does not negate the "primarily engaged" element in the Act.

The second provision of the safe harbor in the Proposal ignores a key word in the Investment Company Act, which focuses on present activities. The safe harbor's second provision limits SPAC activities to only those "that seek to complete a single de-SPAC transaction."[46] Again, however, this provision is not consistent with Section 3(a)(1)(A) of the Investment Company Act because it does not recognize the present status of the SPAC prior to a de-SPAC transaction. Prior to entering a de-SPAC transaction, the SPAC's entire business is that of an investment vehicle, holding cash and securities while it seeks out a target company. At this stage of the SPAC, the business "is…engaged primarily…in the business of investing, reinvesting, or trading securities" as defined under Section 3(a)(1)(A) of the Act. The Commission has stated that "an issuer generally is deemed to be engaged primarily in the business of investing in securities if most of its assets are securities and most of its income is derived from securities."[47] Prior to a de-SPAC transaction, a SPAC's only income is derived from securities and depending on how the SPAC has invested its assets, it is possible, if not probable that in most cases a SPAC will invest most of the investors' assets in securities while it seeks a target company to acquire. Hence, the second provision of the safe harbor ignores the fact that prior to a de-SPAC transaction, a SPAC "is…engaged primarily…in the business of investing, reinvesting, or trading securities."

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company even if it holds only government securities"); *Willkie Farr & Gallagher*, SEC No-Action Ltr., 2000 WL 1585635, at *6 (Oct. 23, 2000) (warning that although market fund securities are not "investment securities" under section 3(a)(1)(C), they are "securities" under section 3(a)(1)(A)).

45 *See* Michelle Celarier, *In Deleted Tweets, SEC's New Head of Investment Management Sides With Professors Suing Bill Ackman's SPAC*, Institutional Investor (January 13, 2022) (In a since deleted tweet, then-Professor William Birdthistle stated, "holding only government securities might have helped evade 'investment company' status under Section 3(a)(1)(C), which does not count government securities towards the 40 percent threshold for inadvertent investment company status. But under Section 3(a)(1)(A)…engag[ing] primarily in holding any securities would also trigger investment status"); *see also* Interview by David Lat with William Birdthistle, Professor, Chicago-Kent College of Law (Sept. 2, 2021) (When Professor Birdthistle was asked if there was anything SPACs can do to avoid falling under the '40 Act, Professor Birdthistle replied, "If you're a SPAC, one simple change would be to hold all your money in cash. You don't trigger the '40 Act if you hold nothing but cash. If you park your money in treasuries and money-market mutual funds, as most SPACs do, then you're investing in securities").

46 Release at 29,499.

47 ICOS Corp., 1940 Act Release No. 19334, 58 Fed. Reg. 15,392, 15,393 (Mar. 22, 1993).

C. The third provision of the safe harbor, requiring a de-SPAC to occur within 18 months, should be amended to shorten the time frame to 12 months.

The 18-month time frame for a SPAC to enter into a de-SPAC transaction is counter to existing Commission precedent and should be shortened to 12 months if the safe harbor is not eliminated altogether. In the Proposal, the Commission acknowledges the existing framework under the Investment Company Act, including existing regulations and its past positions regarding such time periods.[48] While the Investment Company Act is silent on the grace period offered to a company before it should be considered an "investment company" under the Investment Company Act, the Commission has already created a regulatory grace period. In 1981, the Commission established Rule 3a-2, which provided "transient investment companies" with a 12-month safe harbor prior to being considered an investment company.[49] To be consistent with existing Commission regulations regarding safe harbors from the Investment Company Act already established in Rule 3a-2, the Proposal should shorten the 18-month time frame in the third provision of the safe harbor to 12 months, if it does not eliminate the safe harbor altogether.

CONCLUSION

We hope these comments are helpful as the Commission finalizes the Proposal.

Sincerely,

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48 Release at 29,501-29,502.

49 Transient Investment Companies, Release No. IC-11552, 46 FR 6,882 (Jan. 22, 1981).