WHAT'S THE DEAL?

Special Purpose Acquisition Companies ("SPACs")

Here's the deal:

- What is a SPAC?
- Why are SPAC IPOs popular?
- What is the typical capital structure of a SPAC after its IPO and prior to completion of the initial business combination or merger?
- Why should a private operating company consider merging with/into a SPAC?
- Are SPACs blank check companies or shell companies?
- How would this affect the ability of the SPAC to engage in roadshow and other outreach efforts?
- What securities law considerations should operating companies consider when evaluating a merger with a SPAC?
- What are some of the factors considered by the securities exchanges with respect to the number of holders of SPAC common stock and warrants?

What's the Deal?

Special purpose acquisition companies ("SPACs"), commonly referred to as "blank check companies," are public shell companies that use their initial public offering ("IPO") proceeds in order to acquire private companies within a specific timeframe (this acquisition is commonly referred to as an "initial business combination" and the merger or combination transaction is often referred to as the "de-SPACing transaction"). Although SPACs have existed for decades, merging into a SPAC has recently become an attractive alternative for private companies in lieu of undertaking traditional IPOs. Today, SPACs have higher quality sponsors, more blue-chip investors, bulge bracket underwriters, and better sponsor-investor alignment structures than the past. These factors have contributed to making SPACs more mainstream investment vehicles, and have now accounted for approximately 20% of IPO proceeds in 2019 and 38% of IPO proceeds in 2020 year-to-date. SPACs have raised approximately $19 billion through July 2020, which is much higher than 2019's record of approximately $13.5 billion.

How SPACs Work

Not all SPACs are the same. Some SPACs are focused on completing an acquisition in a particular geography or industry, while some have no such mandate. However, SPACs cannot identify specific private companies as targets pre-IPO. Post-IPO, SPACs place 100% of their IPO proceeds in an interest-bearing trust account, which is generally accessible only to complete an initial business combination or

redeem investors under certain conditions. In order to compensate investors for this illiquidity, SPACs offer investors units, each of which is comprised of common stock and whole or fractional warrants in order to acquire additional common stock in the future. The warrants are typically priced "out of the money," *i.e.*, at a higher price than the IPO offering price of the unit. Shortly following the IPO, the common stock and the warrants trade separately alongside the units.

In general, the sponsor receives 20% of the SPAC's common stock (the "founder's shares") following the SPAC's IPO for nominal consideration as compensation. The founder's shares typically are subject to a lock-up agreement until the initial business combination is completed. The sponsor also purchases warrants to fund the costs associated with the SPAC's IPO, such as underwriting fees, in a private placement occurring in conjunction with the IPO (the "at risk capital"). The nominal consideration used to purchase the founder's shares are held in a trust account. Sponsors typically do not receive management fees until the initial business combination is completed.

As mentioned briefly above, SPACs must use their IPO proceeds in order to acquire private companies, or its "targets", within a specific timeframe, which is typically 18-24 months. Although some SPACs may include an option to extend this deadline (*e.g.*, through a shareholder vote), SPACs must liquidate trust accounts and redeem investors (plus interest) should they fail to acquire a target within the specified timeframes. The founder's shares are not redeemed for cash upon liquidation, which encourages sponsors to find a suitable target.

Once a sponsor identifies a target, the SPAC requires shareholder approval to complete the proposed initial business combination. The SPAC also will offer investors the election either to redeem their common stock for the original purchase price plus interest, or to sell their common stock to the SPAC in a tender offer. Investors may redeem their common stock regardless of a vote for or against the merger, and investors may hold their warrants even if they redeem their common stock. Once a merger is announced, the sponsor will seek to obtain the required approvals for the proposed transaction, and the merger with the target company is generally referred to, as noted above, as "de-SPACing." Following completion of the merger, the operating company is the surviving public company.

Advantages for an Operating Company of Merging into a SPAC

For an operating company, merging with and into a SPAC may be faster than undertaking a traditional IPO; however, this will depend upon the nature of the negotiations between the SPAC and the operating company and the shareholder approval process. An operating company should take into account that merging with a SPAC will require significant management time and resources. The process entails the negotiation of a merger agreement and related ancillary documents, which will be time consuming. In addition, in connection with the solicitation of shareholder approval by the SPAC for the merger transaction, the operating company will be required to prepare disclosures about its business, including risk factors, operating results, and management. Following completion of the SPAC merger, the operating company will be required to comply with public company corporate governance requirements. For a private company, going public through a SPAC merger may provide greater certainty with respect to valuation than undertaking a traditional IPO. The merger consideration (and the valuation for the private company) is set when the merger agreement is executed. Although a repricing may be possible as a result of market volatility or for other reasons.

In connection with the SPAC merger, the SPAC will communicate with its shareholders and with other market participants regarding the merger. Given that these are business combination related discussions and not communications related to an IPO, there may be greater flexibility relating to the content and timing of the communications.

Disadvantages of SPACs

Historically, there has been concern regarding the alignment of interests between SPAC sponsors and SPAC shareholders. Given that sponsors generally receive 20% of a SPAC's common stock for nominal compensation, sponsors may profit even if a future acquisition proves unsuccessful. More recently, there have been some changes in the SPAC structure. Most notably, in the SPAC sponsored by Bill Ackman, the SPAC sponsor will forego all founder's shares.

SPACs also create significant arbitrage opportunities that can impede long-term investing. Traditionally, hedge funds invested in SPACs because SPACs allowed investors to keep their warrants even if they redeemed their common stock. Redemption rights also create inherent uncertainty about the amount of funds available to the SPAC to complete an acquisition. Recently, many SPACs have mitigated this concern by issuing additional equity or equity-linked securities usually contingent upon the merger closing in a private placement or a private investment in public equity ("PIPE") transaction. A capital-raising transaction also may provide additional capital for the operating company to deploy to fund its continued growth.

There is also the possibility that market participants may not like the proposed business combination. Over half of the companies that have emerged from a merger with a SPAC have experienced poor aftermarket performance. Over time, this trend may reverse itself as more SPACs are completed, and the more recent SPACs are larger and led by better known sponsor groups, which may lead to greater long-term success. The operating company also may want to consider how it will establish a relationship with investment banks that will be in a position to provide equity research coverage and make a market in the securities of the operating company following completion of the transaction. While a SPAC will undertake investor outreach in connection with soliciting shareholder approval of the merger transaction, these investor meetings may not be sufficient to develop a familiarity among institutional investors with the operating company. During a traditional IPO process, and perhaps in the private placements preceding many IPOs, the IPO issuer will have an opportunity to meet with and form relationships with institutional investors that are committed to or interested in the IPO issuer's sector. Last, SPACs will incur significant costs.

Securities Law Considerations for SPAC IPOs

Exemption from "Blank-Check Company" Status under Rule 419

SPACs are designed to avoid being classified "blank-check companies" under the securities laws. This is because under Rule 419 under the Securities Act of 1933, as amended (the "Securities Act"), a blank-check company must, among other things, deposit all proceeds and securities issued in its IPO into an escrow account, and there is a prohibition from transferring or trading the securities until after completion of a business combination. Although depositing funds into an escrow account has become market practice for SPACs, it would be a hindrance to restrict trading pending the completion of a business combination (the documentation for most SPACs allows up to 24 months for the SPAC to complete this process). To

be deemed a blank-check company, the issuer must issue "penny stock," as defined in Rule 3a51-1 under the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Exchange Act Rule 3a51-1(g) excludes from the definition of penny stock any security of an issuer that has been in operation for less than three years and has at least $5 million in net tangible assets. In order to benefit from this exclusion, the SEC requires that the issuer file a Form 8-K with an audited balance sheet as soon as practicable after the IPO demonstrating compliance. Generally, SPACs use the Exchange Act Rule 3a51-1(g) exclusion and avoid Rule 419's requirements.

Typically, a SPAC's IPO registration statement will state that the SPAC will file such a Form 8-K promptly after consummation of the IPO. If an overallotment option is exercised after the filing of this Form 8-K, the SPAC will need to file an additional Form 8-K with an updated audited balance sheet reflecting the overallotment exercise. The underwriting agreement also typically contains covenants that require the SPAC to file the Form 8-K.

SPACs as Shell Companies and Ineligible Issuers

While exempt from Securities Rule 419, a SPAC is considered a "shell company" under Securities Act Rule 405. As a consequence:

- A SPAC is an "ineligible issuer," as defined in Securities Act Rule 405, and thus may not use free writing prospectuses (without the benefit of the free writing prospectus rules, roadshow presentations are subject to additional restrictions, which are discussed below);
- Holders of the SPAC's securities may not rely on Securities Act Rule 144 for resales of such securities until one year after the SPAC has completed its initial business combination and filed current Form 10 information (the SPAC must also have filed periodic reports required by Section 13 or 15(d) of the Exchange Act (other than Form 8-K reports) for the prior 12 months (or such shorter period that the SPAC was required to file such reports));
- A SPAC cannot become a well-known seasoned issuer until three years have passed since its initial business combination; and
- A SPAC cannot use many of the communications safe harbors under the Securities Act.

Investment Company Act

The structure of a SPAC's trust account is designed to avoid the SPAC being classified as an "investment company" under the Investment Company Act of 1940, as amended (the "Investment Company Act"). Following its IPO, a SPAC is typically required to invest the IPO proceeds held in trust in either government securities or in money market funds that invest only in government securities. By doing so, a SPAC may rely on Rule 3a-1 under the Investment Company Act, which excludes companies with no more than 45% of the value of its total assets consisting of, and no more than 45% of the issuer's net income after taxes deriving from, securities (excluding government securities). There are also no-action letters in which the SEC Staff concurs with the view that securities in certain money market funds also can be excluded from these calculations.

Emerging Growth Company

A SPAC may be considered an emerging growth company ("EGC") as defined in Section 2(a)(19) of the Securities Act, and if so it will remain an EGC until the earlier of (i) the last day of the fiscal year (a)

following the fifth anniversary of the completion of the IPO, (b) in which the SPAC has a total annual gross revenue of at least $1.07 billion (adjusted for inflation every five years), or (c) in which the market value of its common equity held by non-affiliates exceeds $700 million as of the prior June 30 (or second fiscal quarter end if not a December 31 fiscal year end company) and (ii) the date on which the SPAC has issued more than $1 billion in non-convertible debt securities during the prior three year period. If following its initial business combination, the SPAC (newly deSPAC-ed) continues to qualify as an EGC under these rules, the company will continue to benefit from being an EGC.

Marketing and Offering Related Communications Considerations

Roadshows

Under Securities Act Rule 433 any roadshow that is a "written communication" is a free writing prospectus. As discussed above, SPACs are not able to use free writing prospectuses. Under Securities Act Rule 405 a "communication that, at the time of the communication, originates live, in real-time to a live audience and does not originate in recorded form or otherwise as a graphic communication, although it is transmitted through graphic means" does not constitute a written communication. A live, real-time roadshow to a live audience will not be considered a written communication, and therefore not a free writing prospectus. This means that for a SPAC IPO:

- Traditional roadshow presentations where the SPAC's management and the underwriters meet in person with prospective investors are acceptable; live telephone conference calls are also permissible;
- A roadshow presentation cannot be recorded; though broadcasts of live, real-time presentations at the time of transmission can be used;
- Roadshow decks may be passed out to meeting attendees but must be collected at the end of the presentation and attendees may not take the slides with them; slides can also be broadcast if they are viewable only during the presentation; and
- Roadshow decks may not be emailed to accounts or transmitted in any way that allows the recipient to keep the deck after the roadshow presentation is over.

Safe Harbor Analysis

As a shell company and an ineligible issuer, SPACs may not rely on the following communications safe harbors:

- Research report safe harbors – Securities Act Rules 137, 138 and 139
- Communications more than 30 days before a registration statement is on file – Securities Act Rule 163A

These restrictions expire three years after the SPAC completes its initial business combination.

A SPAC may rely on Securities Act Rule 134 for communications announcing an offering. Communications that comply with Securities Act Rule 134 are deemed not to be a "prospectus," as defined in Section 2(a)(10) of the Securities Act, or a free writing prospectus.

Additionally, SPACs may rely on the "access equals delivery" rules under the Securities Act.

Testing-the-Waters Communications

Under Section 5(d) of the Securities Act, EGCs and persons authorized to act on their behalf (*e.g.*, underwriters) are permitted to participate in oral or written communications with potential investors that are qualified institutional buyers ("QIBs") under Securities Act Rule 144A or institutions that are accredited investors ("IAIs") under Securities Act Rule 501 to determine if those investors may be interested in a potential securities offering. A SPAC may engage in "testing-the-waters" communications.

Nasdaq Considerations

One of the requirements of a Nasdaq Capital Market ("Nasdaq") listing is that [the] securities are held by at least 300 round lot holders (*i.e.*, holders of at least 100 shares of common stock) and that at least 50% of the 300 required round lot holders must hold unrestricted securities with at least $2,500 in value.

To ensure compliance with this listing requirement, Nasdaq typically requires a letter from the managing underwriter of the IPO to the effect that underwriters intend to sell the listed securities such that, following the IPO, there will be at least 300 round lot holders that are unrestricted securities and at least 50% of such round lot holders will hold unrestricted securities with a market value of at least $2,500.

Furthermore, Nasdaq often requests a list of all round lot holders within 15 days after closing of a SPAC's IPO. In order to provide proper evidence to Nasdaq, the SPAC will have to order non-objecting beneficial holder reports and a share range analysis from Broadridge and Mediant after the closing of the IPO.

Nasdaq's position with respect to accepting a share range analysis, without more detailed information, is as follows:

- If the share range analysis shows 300 round lot holders they will not be satisfied, as they will assume that some of the accounts are owned by the same holder.
- If the share range analysis shows 400 or more round lot holders, that is sufficient.
- If the share range analysis shows more than 300 but fewer than 400 round lot holders, that is a judgment call that the examiner will make.

In the event that Nasdaq is not satisfied, it will request that the underwriters provide more information about the investors that bought in the IPO to confirm that 300 different accounts purchased a sufficient number of securities in the IPO. It is unclear that Nasdaq would require this if the information is not available or there are legal or other restrictions on sharing the information.

In counting round lot holders, Nasdaq will not count as separate accounts those for relatives sharing a household. For this reason, the syndicate must coordinate book-building efforts so that they avoid duplicate investors and avoid the risk of not meeting the minimum 300 round lot holders. Underwriters are advised to aim for a 400 holder count in case there are inadvertent duplicate accounts.

Roles of Financial Intermediaries

The underwriter of a SPAC IPO may have various roles in relation to the SPAC once the SPAC has completed its IPO (*e.g.*, capital markets advisor, private placement agent, and M&A financial advisor). As an initial matter, every potential new role should be scrutinized for conflicts of interest. This is especially important as the underwriter stands to receive a portion of its underwriting discount (typically 35 basis

points to be split among the syndicate members) only if the SPAC completes an initial business combination. As a consequence, the underwriter should ensure that the board of directors of the SPAC and, if appropriate, investors are aware of this conflict of interest as the underwriter engages in any of the roles discussed below.

An underwriter of a SPAC IPO may be asked to assist in various capital markets related activities as the SPAC searches for, and completes, its initial business combination target. These may include: (i) wall crossing accounts to discuss their views on a potential qualifying transaction; (ii) arranging meetings with accounts prior to and during the proxy solicitation process; (iii) assisting the SPAC with the preparation of presentation materials. This role is sometimes described as a "capital markets advisor."

Assisting the SPAC in its communications with investors raises potential issues under the proxy solicitation rules and it is important that the capital markets advisor not be viewed as soliciting a proxy since the underwriter, acting as a capital markets advisor, will not have complied with the various rules and regulations applicable to those soliciting a proxy (including the rules contained in Exchange Act Regulation 14A). As a consequence, the capital markets advisor should consider limiting its activities to ministerial functions. In these ministerial communications the underwriter should consider including language disclosing that it stands to collect its deferred compensation should the SPAC complete its initial business combination.

The underwriter of a SPAC IPO may be asked to act as a placement agent in a PIPE, or to underwrite or arrange debt financing, in each case, that may be needed to complete an initial business combination. The underwriter should follow its normal practices for an engagement of this type including, if applicable, entering into a separate engagement letter, inclusive of an indemnification agreement. The engagement letter should include language disclosing that the underwriter stands to collect its deferred compensation should the SPAC complete its initial business combination. The underwriter should also consider including such language in materials sent to investors.

It is common for a former underwriter of a SPAC IPO to bring potential acquisition opportunities to the SPAC and, where the former underwriter either brings the potential acquisition opportunity to the SPAC or has relevant sector expertise, to act as financial advisor to the SPAC. If the former underwriter acts as M&A advisor to the SPAC in its initial business combination, the former underwriter should follow its normal practices for an engagement of this type including, if applicable, entering into a separate engagement letter inclusive of an indemnification agreement. The engagement letter should include language disclosing that the former underwriter stands to collect its deferred compensation should the SPAC complete its initial business combination.

The former underwriter may not want, or the SPAC may not want the former underwriter, to render a fairness opinion with respect to the initial business combination because of the conflict of interest disclosure that would be required in the fairness opinion.

It is less common for a former underwriter of a SPAC IPO to represent the target in an initial business combination. However, depending on the facts and circumstances, the underwriter's fairness committee may be comfortable representing a target and even issuing a fairness opinion (with the appropriate conflict of interest disclosures). This, presumably, would be much more likely where the target is a private company and no public disclosure of the target fairness opinion is required. If the underwriter represents the target in the SPAC's initial business combination, the underwriter should follow its normal practices for

an engagement of this type including, if applicable, entering into a separate engagement letter inclusive of an indemnification agreement.

Conclusion

Given that there are more and more well-regarded SPAC sponsors, and that SPACs have become a more mainstream investment vehicle, private companies considering an IPO or a direct listing may also want to consider merging into a SPAC. Nonetheless, as discussed throughout this article, not all SPACs are the same, and some structures are better, more transparent, and less expensive than others. Further, there are distinct securities laws and regulations to consider with respect to SPACs. As a result, private companies should consider all of the advantages and disadvantages above before deciding that a merger with a SPAC is the best option.

Checklist of Key Questions

- Has the operating company considered an initial public offering?
- Has the operating company undertaken any IPO readiness initiatives?
- Is the operating company prepared for the diligence to be undertaken by the SPAC in connection with the SPAC initial business combination transaction?
- Does the operating company have the necessary risk factor, business and management disclosures and the audited annual and reviewed interim financial statements that will be necessary for the SPAC's proxy statement?
- Has the operating company considered the time and expense required in connection with the negotiation of the initial business combination transaction and the stockholder approval process?
- Do the operating company stockholders understand the consequences, from a securities law perspective, of being a former shell company (former SPAC) and how these will affect the company's ability to raise capital or to provide liquidity opportunities to stockholders?

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