SPACs – Investor Risk Considerations, the "Dos," the "Don'ts" and the Disclosures

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In today's capital markets, Special Purpose Acquisition Companies (SPACs) are a popular way for privately held companies to raise capital and provide liquidity to founders and executives. According to SPACInsider.com, in 2020 248 SPAC initial public offerings (IPOs) raised a total of $83 billion; and through February 28th 2021, 207 SPAC IPOs raised a total of $65.6 billion. Clearly, investor interest is growing fast and with it comes heightened regulatory scrutiny. In fact, the U.S Securities and Exchange Commission (SEC) recently released two separate investor bulletins to help educate investors about the potential risks as well as potential opportunities[1].

Often referred to as a "shell company" or "blank check company," a SPAC issues common stock through an IPO. The sponsors use the capital raised to acquire a privately held company. The sponsors typically commit to identifying a target company within a certain specified timeline (e.g., two years). During the time the SPAC is raising funds through the IPO, the funds are held in a trust. Shareholders have the right to vote on whether to accept or reject an acquisition candidate. If shareholders vote not to acquire, the trust generally will return the funds to the investors with interest.

The sponsors who organize the SPAC typically have the right to purchase "founders' shares" at a relatively low price. They also receive warrants to purchase additional shares in the company after an acquisition is completed. These securities can result in significant profits to the sponsors.

Those contemplating a SPAC investment should consider the following issues:

The Dos:

- *Understand the Conflicts of Interest*: Given the profit potential for SPAC sponsors, they may be incentivized to move quickly to identify and acquire a company. This can lead to acquiring an unprofitable company or overpaying for the acquisition target, which could reduce the value of the SPAC's common stock and therefore cause losses for the investors. Investors should conduct due diligence on the SPAC sponsors and management to gain an understanding of such sponsors' background and business history. Disclosures should be read carefully.

- *Consider Valuation Reasonableness:* Given that the shareholders' only power is to vote for or against the acquisition and there is little oversight about the company a SPAC may acquire or its valuation, shareholders should understand the basis for the valuation. In addition, since **the sponsors must** make an acquisition before the two-year period ends, they may overpay for a company, which could result in lower returns to the shareholders.

- *Corporate Governance:* The SEC rules and regulations governing a Board of Directors take effect when the target company is acquired. There should be no delay in the implementation of required finance and accounting requirements, maintenance of internal controls, proper cybersecurity and technology systems implementation and proper board independence compliance. The Board of

[1] https://www.sec.gov/oiea/investor-alerts-and-bulletins/what-you-need-know-about-spacs-investor-bulletin
https://www.sec.gov/oiea/investor-alerts-and-bulletins/celebrity-involvement-spacs-investor-alert

Directors is also required to be independent from the organization and such members must possess an appropriate level of experience.

- *Suitability:* When an investment advisor recommends that a client purchases shares in a SPAC before the acquisition target is announced, the advisor should consider the suitability of the investment for the client. Often, SPAC investors invest based on the track record of the sponsors. This can be helpful information but the information about the SPAC's business would not be disclosed until the SPAC announces a particular acquisition target.

The Don'ts:

- *Don't Just Jump on the Band Wagon:* Although SPACs are highly publicized, there are always risks associated with investing of which a potential investor should be cognizant. Investors should consult with their financial professionals and tax advisors to understand the specific situation under consideration and how it will affect their financial and tax position. Investors should also confirm that their expectations, including timing of liquidity or an investment exit, align with that of the SPAC.

- *Don't Rush into a SPAC Acquisition:* Many private companies anticipating an IPO spend years planning for the transition. SPACs can take a private company public much faster, thereby reducing time spent preparing to conform with the regulatory requirements.

The Disclosures:

- *Risk of Investing:* For SPAC sponsors, it's critical to communicate to your prospective investors the actual, as well as potential, conflicts of interest associated with investing in a SPAC.

- *Conflicts with Other Clients:* Those who manage other vehicles or client portfolios with similar investment strategies must communicate any conflicts regarding the allocation of investment opportunities among clients (including the SPAC) as well as any expenses incurred while conducting due diligence on a potential SPAC investment.

- *Unequal Economics across Share Classes:* In a SPAC, typically there are different share classes, fee structures and warrants. When the sponsors purchase shares in the SPAC, they generally can do so at a price lower than the IPO price. In addition, the sponsors receive warrants to purchase additional stock in the SPAC. These differing terms and conditions create different economics across share classes. Therefore, it is possible that should the acquired company not grow or turn a profit, the sponsors might profit while the other shareholders might lose money.

Conclusion

A SPAC is a flexible product that could allow a company with strong fundamentals to grow quickly. It is vital to ensure proper due diligence is done, and that the sponsor is an appropriate partner for the target company. The investors make money based on the growth of the company, which is contingent upon a qualified management team as sponsor. With SPACs continuing to gain in popularity, both sponsors and investors can potentially benefit from these investment structures; understanding the conflicts, governance, risks and disclosure requirements is key to a successful outcome.

Contact Us

We invite you to contact us for additional information.

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