SPACs

What are they and why are they a potential source of non-financial risk?

Risk Universe
by Risk Business

WHAT IS A SPAC?

Special Purpose Acquisition Companies (SPACs) are being used mainly in US equity markets to facilitate initial public offerings (IPOs). These publicly traded "shell companies" raise capital in an IPO process and then use that capital to merge with or acquire a privately held business, usually within a set period of time. Some commentators have likened them to a blank cheque designed solely to merge with another company. By using a SPAC, a private company can go public without going through the traditional IPO process. However, if a SPAC doesn't conduct a merger or acquisition in a period of time (in the US, it's two years), they have to liquidate.

Because a SPAC is registered with the jurisdiction's regulator and is a publicly-traded company, the general public can purchase shares in it before the merger or acquisition takes place. This is, in part, what has led to their surging popularity, as retail investors view them as a way to get involved in private equity-style deals that would only have been open to professional investors and wealth managers in the past.

Another reason they have become so popular is that there is less regulation around the disclosures that have to be performed. According to a speech given by John Coates acting director, division of corporation finance at the US SEC, "Some – but far from all – practitioners and commentators have claimed that an advantage of SPACs over traditional IPOs is lesser securities law liability exposure for targets and the public company itself. They sometimes specifically point to the Private Securities Litigation Reform Act (PSLRA) safe harbour for forward-looking statements, and suggest or assert that the safe harbour applies in the context of de-SPAC transactions [when the SPAC merges with or acquires a company] but not in conventional IPOs. This, such observers assert, is the reason that sponsors, targets, and others involved in a de-SPAC feel comfortable presenting projections and other valuation material of a kind that is not commonly found in conventional

IPO prospectuses." Issuers feel more comfortable disclosing certain times of information, such as projections, which is why these have become particularly popular with tech start-ups in recent years. Investors feel they are getting access to information they are not normally privy to with normal shares.

So, SPACs are an unusual type of investment vehicle that enables those who use them to raise capital and perform an acquisition or merger seemingly without many of the rules around traditional IPO issuance – often designed with investor protection in mind – in place. Investors in SPACs, in turn, see them as a way to invest in the kinds of transactions that only "insiders" would have had access to in the past.

A SPAC BUBBLE?

SPAC investment has been on a bit of a roll. In 2020, $79.3bn flooded into SPACs, which was a record. That record was smashed in the first three months of 2021 and by May 2021, more than $100 billion had been raised globally by SPACs. Things slowed down as 2021 progressed though, and by the end of the year $162 billion had been raised in the US alone. Nearly 200 US transactions closed in 2021, according to Refinitiv SPAC Research data. Another 117 announced deals were awaiting completion at year end. Meanwhile, 575 of the vehicles were still seeking their merger or acquisition target.

> **The Netherlands commands 41% market share across Europe for SPACs**

SPACS began to take off in Europe too, led by the Netherlands, where SPAC IPO values surged from $496 million in 2020 to $8.56 billion in 2021. The Netherlands commands 41% market share across Europe for SPACs. The listing rules in that country mirror regulations in the US market in most ways, including by permitting SPAC shareholders to continue trading shares in a SPAC after a deal target has been selected.

The UK has been relatively late to the SPAC boom, with the Financial Conduct Authority (FCA) changing the rules to be more SPAC-friendly in July 2021, also permitting SPAC shareholders to continue trading shares in a SPAC after a deal target has been selected. However, a Dutch-style SPAC boom did not follow, because of what has been called the regulator's "safety first" approach to the controversial instruments. In the UK, the rules are less generous than they are in other jurisdictions, with the FCA putting out a release at the time of the rule change, saying it had strengthened investor protection around SPACS. Nonetheless, the UK did six SPAC IPOs in 2021, giving it 16% of total European market share.

So, overall SPAC volumes have been rising at staggering rates recently – and as most seasoned non-financial risk professionals know, this is the first sign that risks are beginning to accumulate within both firms and the financial system as a whole. For example, there was a tremendous boom in collateralised debt obligations (CDOs), collateralised mortgage obligations (CMOs) and related products that soon led to the Global Financial Crisis of 2008, triggered by the entire US mortgage market going into recession. One academic study says that SPACs are a form of reverse merger and history shows that reverse mergers have been through boom and bust periods before.

The SPAC tied to former President Donald Trump minted a phenomenal gain of more than 400%

WHY ARE THERE SPAC CONCERNS?

A top concern is that investors – particularly less sophisticated retail investors – in SPACs are being bilked. A recent academic study on SPACs that merged between January 2019 and June 2020 found that "SPAC costs are not born by the companies they take public, but instead by the SPAC shareholders who hold shares at the time SPACs merge. These investors experience steep post-merger losses, while SPAC sponsors profit handsomely."

Another concern is the growing involvement in celebrities promoting SPACs. According to a recent article in Fortune magazine, "Not counting the SPAC tied to former President Donald Trump, which minted a phenomenal gain of more than 400%, the rest of the group [of celebrity SPACs] averaged an 11% drop through Dec. 13 [2021], with rapper Jay-Z's 84% plunge the worst of the bunch. Only two managed gains of more than 10%, trailing far behind the S&P 500's 24% rally." Other SPAC celebrities with negative return SPACs include home style guru Martha Stewart, tennis star Serena Williams and Microsoft founder Bill Gates. Regulators are worried that celebrity endorsements – often promulgated through social media – can mean investors are unduly swayed to engage with the investment.

Another concern is that regulators and more traditional asset managers – who have considerable "fair treatment" regulations to abide by – fear that investors are not wholly aware of the risks involved in engaging with a SPAC. According to one asset manager, these include:

- Not knowing the SPAC's investment strategy during the initial IPO
- Having to rely on the SPAC's management team to find a suitable target company
- Being in the dark about the intended target company
- Recent regulatory scrutiny by the SEC
- Dilution of SPAC share value due to compensation of the SPAC management team

Some of these are the kinds of risks that normally only professional investors are allowed to engage with. There are concerns that it is only a matter of time before retail investors cry foul, generating a regulatory backlash and media coverage that could result in reputational damage not just to celebrity backers, but to the financial firms that helped bring the SPACs to market.

In summary, it's not just the volume of SPACs that are raising red flags, it's also how they are being marketed, the level of returns that retail investors can expect because of the way SPACs are structured and marketed and the overall lack of transparency for investors.

REGULATORY REACTION

The popularity of SPACs, as well as the risks and concerns that are emerging, are causing regulators to begin to consider reigning them in. In the US, Securities and Exchange Commission (SEC) Chair Gary Gensler warned companies against using SPACs as a way to avoid the red tape associated with a more traditional public offering. He has also spoken of introducing new rules tightening marketing practices and disclosure requirements, as well as boosting liability obligations for those in SPAC gatekeepers roles, such as sponsors, financial advisors and other bookkeepers. In addition, he has said that he would want to see regulations that require SPACs to deliver more information about fees, expected equity dilution and conflicts to investors. He also wants to give SPAC investors better access to information before an investment is made. Gensler, in a series of public speeches reported in the media over 2021 and early 2022, has made no bones about his desire to regulate SPACs more to improve investor outcomes – it seems likely that this will be an SEC priority in the months ahead. Indeed, some observers of the SPAC market attribute the lower levels of activity in the second half of 2021 to Gensler's remarks.

As previously mentioned, in July the UK FCA removed a key legal inhibitor of SPAC deals – the presumed suspension of trading in a SPAC's shares after it announces a potential acquisition. And at the same time, the FCA issued final rules to strengthen investor protections around SPACs. Under the rules, financial firms should carefully consider why a client wishes to use a SPAC, as well as their own compliance obligations, particularly around misselling to investors. Also in the UK, neither the sponsor nor anybody who is invested in the sponsor's share in the SPAC's post-IPO equity is permitted to vote for a proposed acquisition – a key difference that is meant to help redress the balance of power among the different classes of SPAC participants. Given the overall SPAC climate, it seems unlikely that the FCA will be liberalising more SPAC rules in the near future.

In short, regulatory change seems likely to come in the SPAC sphere over 2022 and beyond, as the SEC, FCA and others look to ensure that these instruments do not cause a risky capital bubble, harm retail investors, or destabilise the financial system.

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LOOKING TO THE FUTURE

For the financial services industry, SPACs have the kind of risks that they should be well familiar with by now. Some key things to potentially explore include:

- **New product risk** – Have the SPAC teams been through the kind of new product processes and rigour that other products and services go through? Although SPACs have been around for a while, their sudden popularity might make it worth putting them through the new product approval process to tease out potential risks.
- **Regulatory change risk** – It's pretty clear that regulators are going to be clamping down on SPACs in the US

Firms may wish to consider if there could be potential grounds for shareholder lawsuits

and that other jurisdictions are likely to follow. Firms should examine Gary Gensler's remarks closely and see how the suggested regulations might impact their business models.

- **Ethical risks** – Although firms may be acting within the letter of the law at the moment, it's worth considering how things may look if the popular view on SPACs shifts over the next 24 months. For example, how might a celebrity endorsement on an underperforming SPAC look to retail investors and how could those negative feelings be projected on the financial firm involved in the SPAC?
- **Legal risk** – Firms may wish to consider if there could be potential grounds for shareholder lawsuits, or class action lawsuits around SPACs in the future. Although the disclosure rules for SPACs are much looser than those for traditional IPOs, fraud is still fraud. SPAC creators might want to carefully consider the recent case of Theranos, a blood testing high tech start-up, where the CEO was recently convicted of fraud for misleading investors.
- **Reputational damage** – All of the above should make boards of directors and senior management think more carefully about the potential impact of SPACs on the reputations of their firms. A SPAC scandal, on top of all of the recent issues that firms have suffered since the 2008 Financial Crisis, would not help the recovery of the industry's credibility.

In conclusion, while SPACs may be appropriate investment vehicles under certain circumstances, it's clear that there is a real risk that SPACs may be being used in more risky ways. Firms should carefully consider their current engagement with SPACs and how they may wish to modify their approach in the future.

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