Regulatory Notice 08-54

Guidance on Special Purpose Acquisition Companies

Executive Summary

Special purpose acquisition companies (SPACs) are shell companies that raise capital in initial public offerings (IPOs) for the purpose of merging with or acquiring an operating company. The SPACs market has undergone rapid growth in recent years. In 2007, 22 percent of all initial public offerings in the United States were issued by SPACs totaling over $12 billion in raised capital. While SPACs' percentage of the capital raised in the IPO market so far in 2008 declined to 12 percent, they continue to be significant vehicles for raising capital in the public market. SPAC IPOs differ significantly from traditional equity IPOs, with unique conflicts of interest and incentives for SPAC managers, underwriters and financial advisors. Firms and their customers who invest in SPACs should be aware of these differences before participating in a SPAC IPO.

This *Notice* provides guidance on the structure, trends and conflicts of interest associated with SPACs and reminds firms[1] of their suitability and disclosure obligations when participating in this market.

Questions regarding this *Notice* should be directed to: Joseph E. Price, Vice President, Corporate Financing, at (240) 386-4623 or Lisa Jones Toms, Counsel, Corporate Financing, at (240) 386-4661.

Background & Discussion

SPACs are companies without any revenue or operating history that use investors' funds to acquire or merge with an operating company. SPACs can operate as blank check companies, which the SEC defines as companies that either have no specific business plan or purpose, or have indicated that their business plan is to engage in a merger or acquisition with an unidentified company or companies, and are issuing "penny stock" as defined in Exchange Act Rule 3a51-1. If a SPAC meets the definition of a blank check company, it would be required to comply with Rule 419

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Notice Type

- Guidance

Suggested Routing

- Advertising
- Compliance
- Corporate Finance
- Registered Representatives
- Senior Management
- Trading
- Training

Key Topics

- IPO
- Secondary Market Trading
- Special Purpose Acquisition Companies

Referenced Rules & Notices

- SEA Rule 419
- SEA Rule 3a51-1
- SEA Section 11
- NASD Rule 2720

FINRA™ Financial Industry Regulatory Authority under the Securities Act of 1933, which requires investors' funds to be held in escrow, filing of a post-effective amendment upon execution of an acquisition agreement, and the return of the escrowed funds if an acquisition has not occurred within 18 months of the effective date of the initial registration statement. Most SPACs, however, are not required to comply with Rule 419 because they are structured so that they can rely on an exception from the definition of "penny stock" or they meet other exceptions for listed companies.

In a traditional IPO, the prospectus focuses on historical facts about the issuer and its past performance. Underwriters market the offering after announcing an initial price range. The price at which shares are offered to the public should reflect both demand for the shares and estimates of future performance of the issuer. Underwriters conduct significant and thorough due diligence on the issuer and assume liability under section 11 of the Securities Act for the information disclosed in the prospectus.

By contrast, SPAC securities are offered at a unit price, typically $6, $8 or $10 per unit. SPACs do not "pre-identify" possible acquisition targets and the underwriters do not undertake any due diligence on acquisition targets. While some SPACs are specific about the industries or regions in which they will seek an operating company, others are open-ended.

A SPAC typically must complete an acquisition within 18 to 24 months, and must use at least 80 percent of its net assets for any such acquisition. If it fails to do so, then it must dissolve. When a SPAC dissolves, it returns to investors their pro rata share of the assets in escrow. In most cases, investors will receive nearly all of their principal invested, but will not share in any of the returns generated from the funds held in escrow as such proceeds are used to cover the operating expenses of the SPAC.

This 18- to 24-month deadline is designed to help investors by forcing a timely return of most of their capital if a suitable acquisition is not completed. However, it also puts SPAC management under severe time pressure to identify a target and complete a transaction.[2]

If a SPAC's managers can identify an appropriate acquisition target, they must then obtain approval through a shareholder vote. Investors are sent proxy materials disclosing the details of the proposed acquisition. A SPAC's public shareholders may vote in favor of the acquisition, or vote against the acquisition. If the shareholders vote against the acquisition, they may elect to have their shares converted into a pro rata portion of the IPO proceeds, which are held in an escrow account.

While the proxy statement sent to SPAC shareholders contains current audited financial information and other material information about the acquisition target, there are significant differences in the liability and disclosure obligations regarding a company that becomes public by acquisition by a SPAC and one that becomes public through a traditional IPO. In a traditional IPO, underwriters conduct significant and thorough due diligence on a company and assume liability for the information disclosed in the registration statement. There may be no similar "gatekeeper" function by underwriters in connection with the acquisition target of a SPAC.

SPACs present different risks depending on what point in the SPAC "life cycle" the investor purchases shares. We discuss below some of the risks that a firm must consider at the various stages of a SPAC's life cycle if it recommends SPAC securities to its customers.

Initial Public Offering

During the IPO stage, investors purchase units representing one or more shares of common stock and one or more warrants exercisable for one share of common stock at a discount to the offering price. Typically, a SPAC will trade as a single unit following the IPO. After a certain period, often 90 days following the IPO, the common stock and warrants trade separately.

SPAC IPOs have certain risks, which must be disclosed to investors and which must be the subject of the broker-dealer's suitability analysis. For example, SPAC IPOs present the following two risks:

- The risk that SPAC managers are unqualified or incompetent, a risk made more pronounced by lack of any operating history or past performance of the SPAC.
- The risk that no acquisition will occur and the SPAC will be liquidated. The SPAC structure, which requires most of investor's funds to be held in escrow and returned if an acquisition is not completed, does provide some downside protection. Moreover, investors may be able to sell their SPAC units in the secondary market. However, investors must either bear the opportunity cost of waiting for a determination about whether an acquisition will occur or sell in the secondary market before the outcome is determined.

Of the approximately 149 SPACs that have been issued as of May 31, 2008, only 48 have completed an acquisition. Moreover, many SPACs, including most of the SPACs that have gone effective since 2003, have not completed an acquisition.[3]

Whenever a firm recommends SPAC securities to investors it must ensure that all registered persons understand the features of the securities in order to perform a suitability analysis before executing a transaction. Investors, particularly retail investors if they are offered SPAC securities, should fully understand the risks associated with SPACs.

FINRA rules require firms to have reasonable grounds for believing that a recommendation for a securities transaction is suitable for its customers. In meeting their suitability obligations, firms should consider whether they should adopt any special suitability guidelines for SPACs.

Firms also must ensure that marketing materials used by the firm provide an accurate and balanced description of SPACs. Some of the marketing materials reviewed by FINRA staff have referred to the potential for price appreciation in SPAC shares based on a change in valuation from a private to public company. Firms that distribute these marketing materials must ensure that they provide a fair description of all risks associated with the investment, including the risk that the acquisition may not occur or that the customer's investment may decline in value even if the acquisition is completed.

Escrow Account

Following the IPO, nearly all of the SPAC proceeds are held in an escrow account to be used to complete an acquisition. The escrow account typically invests in money market funds or short-term U.S. government securities. The SPAC assets are released from escrow when the shareholders approve an acquisition or the SPAC is dissolved.[4]

If a SPAC fails to complete an acquisition within the specified time period, it must dissolve. When a SPAC dissolves, it returns to investors their pro rata share of the assets in escrow. In most cases, investors will receive nearly all of their principal invested, but will not share in any of the returns generated from the funds held in escrow as such proceeds are used to cover the operating expenses of the SPAC.

Secondary Market Trading

A SPAC unit typically has two components: shares of common stock and a warrant, which trade separately within weeks of the IPO. The common shares often trade at a discount to the cash held in escrow. Warrants are exercisable only upon successful completion of an acquisition and typically will expire worthless if the SPAC is liquidated.

Purchasing the common stock and warrants in the secondary market raises different issues. The characteristics of the common stock likely depend on whether the stock is purchased before or after an acquisition target has been announced. Naturally, an investment before the announcement of an acquisition is a bet on whether an acquisition target will be announced and whether it is an attractive investment.

However, there can be much uncertainty concerning any future acquisition. Even after an acquisition target is announced, there typically is a delay, which can be weeks before audited financial statements regarding the acquisition target are available through the preliminary proxy filing. In addition, the acquisition terms and arrangements may change during the proxy filing and review period.

Purchasing warrants in the aftermarket is a highly speculative investment that is generally suitable only for sophisticated investors who can assume and understand the risk that an acquisition will not be completed and the warrants will expire worthless. Purchasing warrants after the announcement of an acquisition may present special risks. FINRA research indicates that SPAC share prices slightly outpace the market on the day an acquisition target is announced.

The release of more complete information occasionally leads to a decline in the price of the SPAC's common stock. Investors who purchase in the secondary market after an acquisition announcement may suffer a loss if the value of the shares subsequently declines. FINRA research indicates that most SPAC share prices significantly lag the market after the acquisition is completed.

Proxy Solicitation

The announcement of a potential acquisition is a critical stage in a SPAC's life cycle. SPAC management stands to gain a significant equity interest in the target company but must first market the deal and gain approval from a majority or supermajority of its shareholders before it can close on the acquisition. For underwriters, one-half of the underwriter's fee can be contingent upon completion of the acquisition and often the underwriter will receive a separate fee for services as an adviser to the acquisition.

If a SPAC's management identifies an appropriate acquisition target, it must then seek a shareholder vote. An acquisition by a SPAC typically requires the approval of at least 60 percent of the shareholders and some deals require 80 percent. Investors are sent proxy materials disclosing the details of the proposed acquisition.

An investor who votes against an acquisition is entitled to a pro rata return of the funds held in escrow. If the investor decides that he will vote against the acquisition and the SPAC's securities are trading at a premium in the secondary market, however, it may be in the investor's best interest to sell his securities in the secondary market.[5]

SPAC underwriters generally should not engage in proxy solicitation if payment of part of the underwriting fee or an advisory fee is contingent upon the successful completion of the acquisition. In such a case, a SPAC underwriter would have a conflict of interest if it recommended that a customer vote "yes" on the proposed acquisition.

Completion of an Acquisition

SPAC sponsors, unless they have purchased shares of the SPAC's common stock, do not receive a pro rata distribution from the escrow account if an acquisition is not completed. In addition, they are typically prohibited from selling their shares in the secondary market prior to completion of the acquisition. These mechanisms, along with their 20 percent equity stake in the SPAC, may help to align management and investors' interest in completing an acquisition. However, SPAC managers have a strong incentive to buy a company, even at inflated values, since they will get 20 percent of the company at a nominal price.

At the acquisition stage of a SPAC's life, firms are required to disclose these incentives and all of the conflicts that the firm may face as a sponsor or adviser of a SPAC prior to recommending the sale or purchase of SPAC shares to its customers. The firm must also consider the implications under FINRA's conflicts of interest rule, NASD Rule 2720, if the acquisition is successful.[6]

Endnotes

1 This *Notice* refers to broker-dealers and their associated persons collectively as “firms” unless otherwise specified.

2 Some recent SPACs have adopted automatic extensions of six months or longer if an acquisition is announced before the deadline, and have decreased the percentage of “yes” votes required to approve an acquisition from 80 percent to 60 percent.

3 For more information about the SPAC market, *see* “State of the SPAC: A Flight to Quality, A Primer for a Growing Industry,” SPAC Research Partners (April 9, 2008).

4 A portion of the interest earned in the account may be withdrawn to pay some of the SPAC’s working capital expenses prior to an acquisition.

5 Even if the shares are not trading at a premium, by selling in the market the customer would earn a quicker return of capital than if he votes “no” and exercises his redemption rights.

6 NASD Rule 2720 requires a qualified independent underwriter to conduct due diligence in an offering in which a participating member has a conflict of interest or offerings in which the issuer proposes to acquire a broker-dealer that would become publicly owned as a result of the acquisition.