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A Brief Explainer on SPACs

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What is a SPAC?

The term SPAC stands for "Special Purpose Acquisition Company." A SPAC does not have any business or commercial operations, and instead it exists only for the purpose of acquiring an existing unspecified company or business. The value of a SPAC is fixed unless it acquires a business. This note is an introduction to how SPACs that lack a current business, whose future business depends on one or more unspecified acquisitions, and whose value is fixed unless that unspecified acquisition(s) is completed became one of the hottest types of IPOs on Wall Street in the early 2020s.

A brief history of SPACs

The predecessor of the SPAC emerged as so-called "Blank Check companies" decades ago. In the 1990s, the Congress and the U.S. Securities and Exchange Commission (SEC) acted to adopt rules to regulate Blank Check companies.[1] SPACs subsequently arose having many of the same features as Blank Check companies while avoiding many of the requirements of Rule 419 of the Securities Act of 1933. The New York Stock Exchange and Nasdaq both adopted rules permitting the listing of SPACs in 2008. Nevertheless, a SPAC remained a niche product until the late 2010s when both the number of SPACs and the capital raised by SPACs greatly increased.

A SPAC is essentially a type of Initial Public Offering ("IPO") as will be more fully explained later in this note. Consequently, it makes sense to evaluate the popularity of SPACs as a percentage of the number of IPOs in the United States. Until 2016, SPACs represented 1 to 12 percent of the IPO activity in the U.S., except for 2008 when SPACs were initially eligible to list on the two major exchanges and there were very few conventional IPOs due to the global financial crisis. Beginning in 2017, SPAC issuance increased rapidly before peaking at over 50% of U.S. IPO activity from 2020 through 2022. In 2021, SPACs raised over $160B, twice the amount raised in 2020 and more than one-half the total amount raised by SPAC offerings between 2008 and 2023. 2023 saw a decrease in the number of SPAC IPOs and an even greater decrease in the capital raised by SPACs to $3.8B.[2]

How to create a SPAC

As mentioned in the preceding paragraph, the creation of a SPAC is a type of IPO. A SPAC is organized as a company without any current business or operations but intends to acquire one (or more) unidentified operating companies (the de-SPAC transaction) within a set time frame, typically two years. A SPAC then completes an underwritten IPO that raises capital which will be used to complete the SPAC's acquisition(s) or returned to investors. The capital raised from investors is placed in

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[1] SEC Rule 419, Blank Check Offerings, Release No. 33-6932 (Apr. 13, 1992) [57 FR 18037 (Apr. 28, 1992)]. Rule 419 requires a blank check company to meet certain disclosure and investor protection requirements in registered offerings of securities.

[2] Statistics on SPAC volume from SPAC Analytics. *SPAC and U.S. IPO Activity*. Retrieved January 21,2024 from https://www.spacanaltyics.com

escrow in what is known as a unit trust. During the designated time frame, the SPAC strives to complete one or more acquisitions, leading to the termination of the SPAC, called a de-SPAC transaction. If the SPAC fails to complete any acquisitions, or if the investor doesn't wish to continue holding shares after the de-SPAC transaction, the investor can get their money back, plus interest. Often, additional capital is raised as part of the de-SPAC transaction. So, what do the different types of major participants in the SPAC process find attractive (or unattractive) about SPACs?

Why create a SPAC?

One type of major participant is the Sponsor of a SPAC. The Sponsor is responsible for the development of the SPAC's business plan, filling out the team including the Board of Directors, and conducting the SPAC's IPO. The management team and the Board are responsible for completing the acquisitions leading to the de-SPAC transaction. Compensation for the Sponsor typically takes the form of receiving shares and warrants after the successful completion of the de-SPAC transaction. Therefore, the Sponsor is strongly incentivized to assemble a Board and a business plan that leads to the successful completion of the de-SPAC transaction, although the SPAC process is not without risk.

The operating companies that form acquisition Target(s) of the SPAC are another type of major participant in the SPAC process. SPAC Targets are private firms that have previously raised capital from venture capitalists and have grown to the point of being able to consider an IPO to raise additional capital. For the Target, being acquired by a SPAC may be quicker, more flexible, and less expensive than the standard IPO process. The Target will have more certainty about the amount of capital raised and have access to the management team and Board installed by the SPAC Sponsor. There are downsides to a Target merging with a SPAC as well as risk, so not every potential Target will choose to merge with a SPAC.

The Investors are the third and final type of major participant in a SPAC. A SPAC may have many types of Investors. The easiest way to divide them is to consider the original Investors who provide initial capital to the SPAC and the Investors who decide to hold shares following the de-SPAC transaction. The initial Investors in the SPAC are often private equity firms that specialize in this type of activity. These Investors may continue to hold shares following the de-SPAC transaction or they may redeem their shares for a refund. Other Investors, including institutional and retail investors, may choose to invest before or after the de-SPAC transaction. Both the initial Investors and the subsequent Investors realize that holding shares is not without risk.

Controversies and Regulatory Initiatives around SPACs

The fact that there are controversies around SPACs is not surprising considering the meteoric rise in the number of SPAC offerings and the large amounts of capital raised by SPACs. The primary controversies revolve around the information available to ordinary investors considering investing in SPACs following the de-SPAC transaction and whether Sponsors and original Investors receive a disproportionate allocation of returns from successful SPACs. The information controversy is because the Target of a SPAC is required to provide less information and faces less liability for the information it does provide than if the Target had undertaken an IPO. Secondarily, there is a controversy about high-profile individuals encouraging individuals to invest in SPACs. The allocation of returns controversy is more complex. In simplest terms, the controversy can be stated as alleging there is a “heads we win, tails you lose” allocation between Sponsors/Original Investors and other subsequent investors.

In a 2022 proposed release, the SEC sought to address these controversies and requested comments from interested parties. Numerous parties have commented on the SEC’s proposals and the SEC is expected to act on its proposals in January 2024

Future of SPACs

This note is intended to be an introduction to SPACs and has glossed over many of the complexities that are part of the SPAC process. The recent collapse in the number of SPACs and the capital they have raised could be a reflection of the market realizing that a SPAC is indeed a niche product, or the collapse could be due to regulatory uncertainty surrounding the future of SPACs. Time will tell.