SEC Commissioner Crenshaw Speaks on SPACs

A few weeks ago, SEC Commissioner Crenshaw delivered a **speech** on SPACs that's worth reading. Agree or disagree, it's an excellent summary of the policy considerations behind the SEC's recent rule proposal regarding SPAC IPOs - and a helpful reminder of the challenges to keep in mind for those navigating a SPAC transaction. Here's the **SEC's proposing release** - and the **fact sheet**.

Here are five takeaways from the speech:

1. **Areas of Concern:** Though SPACs may offer certain competitive advantages to the traditional IPO model, there are several areas of concern: (a) misaligned incentives when it comes to reviewing the quality of a target, (b) dilution that may disproportionally impact retail investors, and (c) a lack of liability that may create unjustified advantages when compared to the traditional IPO.
2. **Voting Issues:** The mechanisms for shareholder voting, namely allowing a shareholder to both vote to redeem one's shares *and* vote in favor of completing a de-SPAC, eliminates the incentive for shareholders to consider whether a proposed de-SPAC is actually worthwhile. Allowing for SPACs to consummate a de-SPAC even when a substantial majority of shareholders redeem its shares creates and contributes to poor incentives, increases potential for dilution and raises investor protection concerns.

   Commissioner Crenshaw cites a study that found that, with respect to de-SPAC transactions occurring from January 2019 through June 2020 (before the "bubble" of Q4 2020 and Q1 2021), redemption rates averaged 58% - and reporting indicates that redemptions from the first quarter of 2022 are even higher.

   The SEC's recent proposal on SPACs has warned that double dipping to allow both an approval vote and a redemption of shares can present "a moral hazard problem, because these redeeming shareholders would not bear the full cost of a less than optimal choice of target."
3. **Exchange Listing Standards:** It may be appropriate for stock exchange listing standards to revisit requiring a redemption threshold, "to reconsider the balance of equities in light of the recent experience with SPACs, the high-rates of redemption, and a de-SPAC merger approval vote that increasingly seems pro-forma rather than an actual check that helps ensure only well-considered acquisitions proceed."

   Commissioner Crenshaw notes this issue as one on which she would like to understand the perspectives of different market participants. She also points to a recent recommendation from the SEC's Office of the Investor Advocate, which notes that the lack of a redemption threshold requirement in current exchange listing standards contributes to "an inherent conflict of interest in the consummation of the SPAC's proposed business combination…permit[ing] these [de-SPACs] to occur even when assets are depleted by significant exercise of redemption rights, and early investors have economic incentives to allow deals of questionable quality to occur."

   The Investor Advocate has urged all exchanges that list SPACs to implement a conversion threshold of at least 50 percent - meaning holders of publicly traded SPAC shares who do not redeem - to ensure that there's enough "skin in the game" left.

4. **Fundamental Investing Differences:** There are several fundamental differences when it comes to investing in a SPAC IPO compared to investing in equity shares of publicly listed companies: (a) the optionality of the redemption, (b) additional layer of diligence required to understand the private company that the shell company targets, and (c) potential for dilution and the opaqueness of making this determination.
5. **Complexity and Dilution Concerns:** Commissioner Crenshaw reminds us that SPACs are complex - and it's hard to disagree with that! - and asserts that some of the purported benefits, such as a cheaper and more efficient path to the public markets for private companies, have been questioned, noting that studies have found that the cost of going public via SPAC may actually be higher than a traditional IPO.

   She points to the calculation of dilution as a prime example of this complexity, noting the many considerations that will impact dilution, including the amount of redemptions, the sponsor's promote, the equity overhang from warrants, and the negotiating dynamics of the PIPE investors - a tough challenger for even the most sophisticated investors.

   The SEC's rule proposal on SPACs seeks to address concerns around dilution through enhanced disclosures, including a table showing the potential for dilution based upon percent of redemption, a requirement to disclose each material potential source of additional dilution that non-redeeming shareholders may experience, and greater information about financing arrangements.

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