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Robert Jackson and John Morely

Abstract

This essay argues that SPACs bear a striking resemblance to investment funds. SPACs invest in the same assets as investment funds, putting all of their money into securities as they search for deals. And they adopt the same pattern of organization as investment funds, relying entirely on management by external sponsors and advisers, many of whom also manage investment funds. This resemblance creates in SPACs many of the same unique agency conflicts that the regulation of investment funds was designed to address. In fact, we argue that many SPACs have been violating the Investment Company Act of 1940, the main law that governs investment funds. We show that soon after we filed a series of lawsuits alleging that some SPACs were violating the ICA in August 2021, new SPACs significantly changed their practices in ways that reduced their risk under the statute. We offer some suggestions to improve the SEC's recent proposal to address the status of SPACs under the ICA and show how the proposal can help to protect investors.

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SPACs as Investment Funds

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This essay argues that SPACs bear a striking resemblance to investment funds. SPACs invest in the same assets as investment funds, putting all of their money into securities as they search for deals. And they adopt the same pattern of organization as investment funds, relying entirely on management by external sponsors and advisers, many of whom also manage investment funds. This resemblance creates in SPACs many of the same unique agency conflicts that the regulation of investment funds was designed to address. In fact, we argue that many SPACs have been violating the Investment Company Act of 1940, the main law that governs investment funds. We show that soon after we filed a series of lawsuits alleging that some SPACs were violating the ICA in August 2021, new SPACs significantly changed their practices in ways that reduced their risk under the statute. We offer some suggestions to improve the SEC's recent proposal to address the status of SPACs under the ICA and show how the proposal can help to protect investors.

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† Professor of Law, Yale Law School. john.morley@yale.edu. The authors serve as co-counsel, along with attorneys from Susman Godfrey L.L.P., Berstein Litowitz Berger & Grossmann LLP, and RM Law P.C., to a plaintiff in three lawsuits in the U.S. district court for the Southern District of New York. The lawsuits allege, among other things, that certain SPACs are investment companies within the meaning of the ICA.

Introduction

On Wall Street, it is often said that a SPAC is a kind of "poor man's private equity fund."[1] This essay shows just how true that observation is. Though the belief that SPACs resemble investment funds is widespread,[2] the intuition behind it has never progressed beyond a kind of folk wisdom—obvious to casual observers, but never precise enough to carry much economic or legal meaning. In this essay, however, we show that as one presses on the comparison between SPACs and investment funds, the similarities become remarkably strong. SPACs resemble investment funds as a matter of both economics and law and they raise the same unique conflicts of interest that the regulation of investment funds was designed to address. The resemblance goes so deep that many SPACs are subject to the Investment Company Act of 1940 and have been violating the regulations it places on investment funds.

The resemblance between SPACs and investment funds runs along two dimensions: *assets* and *organization*. Like an investment fund, a SPAC's *assets* consist entirely of securities. And like an investment fund, a SPAC's *organization* makes it entirely dependent on the management of an external sponsor. A SPAC has no employees or operational resources of its own, placing the same reliance on outside investment professionals that a private equity, venture capital, hedge, or mutual fund places on its adviser. This combination of assets and organization creates in a SPAC many of the same unusual agency conflicts that trouble the operations of investment funds.

This thesis has two implications. First, the same conceptual and economic models we use to make sense of investment funds can also make sense of SPACs. SPACs and their managers adopt many of the same organizational features as investment funds, including external managers, redemption rights, depositary trusts, and a pattern of serial creation of new vehicles. The economic logic of these features in SPACs is similar to the logic in private equity, hedge, venture capital, and mutual funds.

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[1] *E.g.*, Lora Dimitrova, *Perverse Incentives of Special Purpose Acquisition Companies, the "Poor Man's Private Equity Funds*," 63 J. ACCT. & ECON. 99 (2017); Andrew Ross Sorkin, *The Poor Man's Private Equity: Gambling on Unknown IPOs*, N.Y. TIMES (Feb. 12, 2008), https://www.nytimes.com/2008/02/12/business/worldbusiness/12iht-deal.1.9962658.html.

[2] Byrne Hobart, *SPACs as a Call Option on Hype*, The Diff (July 17, 2020) ("To the SPAC investor, it's a subpar money market fund with a Kinder Surprise Egg-style option attached…."), *available at* https://www.thediff.co/p/spacs-as-a-call-option-on-hype.

Second, many SPACs have been breaking the law. The principal regulation for investment funds in the United States is the Investment Company Act of 1940 ("ICA"). It applies to any company that is "engaged primarily" in the business of investing in securities. Because SPACs invest 100% of their assets in securities prior to their acquisitions, many of them qualify as investment companies under this definition. We show that under the ICA, a SPAC can be an investment company even though its investments in securities are only temporary and even though it plans to acquire an operating business in the future.

The thesis that SPACs resemble investment funds provided the motivation for a series of lawsuits we helped to bring under the ICA against the sponsors of several SPACs in August of 2021. We partnered with co-counsel from leading law firms to recover for investors some of the excessive fees claimed by SPAC sponsors that violate the ICA. [3] We show for the first time that immediately after we filed these suits, new SPACs significantly changed their terms in ways that lessened their risk under the ICA. Though the change could be a coincidence, the timing and manner suggest a link to the SPAC industry's growing awareness of its problems under the ICA.

Our thesis that SPACs resemble investment funds has also become the basis of a new rule proposed by the SEC, which will, if adopted, be known as Investment Company Act Rule 3a-10 (the "Rule"). The Rule would threaten a SPAC with enforcement under the ICA by raising "serious questions" about its status as an investment company unless the SPAC complies with regulatory limits on the timing and manner of its search for an acquisition target. We argue that the Rule offers significant benefits for investors and offer some suggestions to improve it.[4]

This Article proceeds as follows. We begin by explaining how SPACs resemble investment funds, first as a matter of economics and then as a matter of law. We then explain how the SPAC industry changed after the filing of our lawsuits. We identify the potential benefits of the SEC's new proposed Rule and offer suggestions for improving it and then close by showing how the descriptive model that one of us has elsewhere developed to understand the organization and behavior of investment funds can also be used to understand SPACs.

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[3] The authors serve as co-counsel along with attorneys from Susman Godfrey L.L.P., Berstein Litowitz Berger & Grossmann LLP, and RM Law P.C. The first of these lawsuits was *Assad* v. *Pershing Square Tontine Holdings, Ltd. et al.*, No. 1:21-cv-06907-AT-BCM (S.D.N.Y. Aug. 2021).

[4] These arguments draw from and build upon comments we submitted to the Commission during the Rule's comment period. *See* Letter to Vanessa A. Countryman, Sec'y, U.S. Sec. & Exch. Comm'n from Professor Robert J. Jackson, Jr. & Professor John Morley (June 13, 2022).

I. Organization

SPACs resemble investment funds along two dimensions: assets and organization. These two dimensions of resemblance correspond, respectively, to the law and policy of the Investment Company Act of 1940, the principal statute that regulates investment funds in the United States. The possession of certain assets is what triggers the statute's application as a matter of law; the construction of a certain pattern of organization is what motivates the statute's policy.

A. The Divided Structure

We begin with a SPAC's organization and its implications for policy. Like an investment fund, a SPAC adopts what one of us has elsewhere called a *divided structure*.[5] The divided structure includes three characteristics: (1) the use of *separate legal entities* to hold the assets of an investment vehicle and its management firm; (2) the recruitment of *separate groups of owners* for the investment vehicle and the management firm; and (3) the establishment of governance arrangements that allow the business and affairs of the investment vehicle to be *dominated by the management firm from the outside*.

Consider as an example the Fidelity Magellan mutual fund, which is managed—or, in the language of investment funds, "advised"—by the investment advisory firm Fidelity. The Magellan fund possesses each of the three features that define the divided structure. The fund and Fidelity use *separate legal entities* because the fund has its own legal existence as a business trust independent of the Fidelity advisory company.[6] The fund and Fidelity also have *separate owners* because Fidelity is owned by its founding family, whereas the Magellan fund is owned by members of the general public. And Fidelity *dominates the business and affairs of the fund from the outside* through Fidelity's role as the fund's investment adviser. Fidelity provided the entrepreneurial energy to organize, establish, and market the fund, and Fidelity now controls the operations of the fund through a contract by which the fund delegates to Fidelity nearly complete authority over the fund's day-to-day affairs, including the investment of its portfolio. The fund's dependence on Fidelity is so extreme that the fund does not have any employees or other

[5] John Morley, Houses Divided: The Inner Workings of Investment Funds (Mar. 10, 2021) (unpublished manuscript) (on file with author); John Morley, *The Separation of Funds and Managers: A Theory of Investment Fund Structure and Regulation*, 123 YALE L.J. 1228 (2014) [hereinafter Morley, *Separation of Funds and Managers*].
[6] Fidelity Magellan Fund, Registration Statement (Form N-14) (Dec. 30, 2020).

operational resources of its own.[7] Fidelity profits from this arrangement by charging the fund regular fees. Fidelity has replicated this arrangement across hundreds of other investment funds.

This pattern appears not only in mutual funds like the Magellan fund, but also in every other type of enterprise that we commonly think of as an investment fund, including private equity, venture capital, closed-end, exchange-traded, and hedge funds. These other funds vary the pattern in small ways. But they all keep the three essential features the same.

SPACs represent another variation on this pattern. Consider, as an example, GS Acquisition Holdings Corp., a $600 million SPAC that Goldman Sachs sponsored in June of 2018 and which closed a business combination in February of 2020.[8] In the same way that an investment fund relies on an external adviser, GS Acquisition Holdings relied on an external manager that it called a "sponsor."[9] Like an investment fund, the SPAC was a *separate legal entity* from its sponsor. The SPAC and its sponsor also had *separate owners*. The sponsor was a subsidiary of Goldman, whereas the SPAC traded publicly on the New York Stock Exchange, with a stock listing completely separate from Goldman's. Also like an investment fund, the SPAC was *dominated from the outside by its sponsor*. The SPAC had no full-time employees of its own and no operational resources. The entrepreneurial energy to start the SPAC came from Goldman Sachs Asset Management, or "GSAM," the unit of Goldman that—not coincidentally—also operates as an investment adviser to Goldman's private equity, hedge, and mutual funds. Just as it does with these other types of investment funds, GSAM supplied to the SPAC all of the resources the SPAC needed for its management and operational needs, including deal sourcing, investment decision-making, marketing, administration, office space, and the fund's "GS" brand name. And just as GSAM has scaled up its investment advisory operations by starting many different investment funds, it also scaled up its SPAC sponsorship business by organizing another SPAC two years later with an almost identical name.[10]

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[7] Morley, *Separation of Funds and Managers*, *supra* note 5.
[8] GS Acquisition Holdings Corp, *Prospectus* (June 8, 2018), *available at* https://www.sec.gov/Archives/edgar/data/1674101/000119312518188236/d586855d424b4.htm
[9] In the early days of the investment fund industry, managers were also commonly known as "sponsors," just as they are in SPACs today. *E.g.*, Note, *The Investment Company Act of 1940*, 50 YALE L. J. 440, 442 (1941) (citing *Hearings Before Subcomm. of Sen. Comm. on Banking and Currency*, S.3580, 76th Cong., 3d Sess. 34, 783 (1940)).
[10] GS Acquisition Holdings Corp II, *Prospectus* (July 1, 2020), *available at* https://www.sec.gov/Archives/edgar/data/1809987/000119312520185202/d915164d424b4.htm.

The similarities between a SPAC and an investment fund run so deep that many of the biggest names in private equity and hedge fund management have also recently sponsored SPACs, including not only Goldman, but also Apollo, Softbank, Fortress, Cerberus, and Pershing Square, to name just a few. Like any other industry, the investment advisory industry has steadily added new types of products over the years to diversify its offerings, starting with closed-end funds and continuing to mutual funds, hedge funds, private equity funds, venture capital funds, search funds, exchange-traded funds, and interval funds. SPACs are simply the newest products on this already expansive shelf.

B. Unique Agency Conflicts

As one of us has elsewhere explained, the divided organizational structure creates or aggravates several types of agency conflict that are unique to SPACs and investment funds.[11] These conflicts differ from those that appear in ordinary operating companies and they provide a principal motivation for investment funds' distinctive regulation.

One challenge created by the divided structure is the disempowerment of investors. Because they do not own the entity that employs a fund's managers, a fund's investors lose all direct control over those managers. The board of directors of a mutual fund cannot remove the chief portfolio manager who selects the fund's investments, for example, because that portfolio manager does not work for the fund—she works for the adviser. A closely related feature is the tendency among investment funds to make up for this lack of control by granting investors rights to redemption or periodic liquidation. Redemption and liquidation rights help investors by substituting exit in place of voice, but in so doing they create new problems, such as the risks that these exit rights will be postponed, manipulated, or abused.

Another problem is the divided loyalties of a fund's managers, who work for a separate entity that often has a large number of separate clients in addition to the original fund. Managers of investment funds have loyalties not only to themselves (as managers of operating companies also do), but also to the separately owned management companies that employ them and to the many other clients that the management companies serve in addition to the original funds. Each of a manager's various funds competes with one another for investment opportunities, managerial attention, and resources.

[11] Morley, *Separation of Funds and Managers*, *supra* note 5.

Yet another problem is the risk that the partition between a fund and its manager will grow porous, with the manager using its dominance over the fund to take the fund's assets for the manager's own purposes.

A SPAC raises many of these same problems. Like an investment fund, a SPAC grants its investors no direct control over the manager that dominates it from the outside, thereby cutting off the possibility that SPAC shareholders might remove or control their managers by voting or representation on the board. Like an investment fund, a SPAC offers redemption rights as a way of compensating for this lack of control, thereby raising the risk that these rights will be ignored, postponed, or misused. Like an investment fund, a SPAC can tempt its outside management firm to ignore the partition that separates it from the SPAC. And like an investment fund, a SPAC competes with its manager's other clients, potentially sharing business opportunities, managerial attention, and other resources with the sponsor's private equity funds, hedge funds, and other SPACs.[12] SPACs even offer redemption rights as a substitute for direct control over management, much as hedge funds and open-end mutual funds do.

These unusual agency conflicts are the central policy concern of the ICA. The ICA regulates an investment fund's relationship with its adviser in a host of ways. It governs how an adviser is compensated,[13] the circumstances under which an adviser can trade with its funds,[14] the compensation the adviser can accept from its other clients,[15] the share classes a fund can issue and the voting rights the different classes can have,[16] the content and format of an advisory agreement,[17] the renewal and renegotiation of the advisory agreement,[18] the sale or assignment of the advisory agreement,[19] the level of an adviser's fees,[20] the disclosure and contracting of an adviser's fees,[21] the kinds of people who can become advisers,[22] the way the fund segregates its

[12] The investment adviser Pershing Square Capital Management, for instance, took an investment that was originally planned for its SPAC and shifted the investment to its hedge funds. *Infra* note 83 and accompanying text.
[13] *E.g.*, 15 U.S.C. §§ 80a–22(g), 23(a) (2018). Section 5 of the Investment Advisers Act also regulates performance fees charged to registered investment companies. 15 U.S.C. §§ 80b–5(a)-(b) (2018).
[14] *E.g.*, ICA § 17(a).
[15] *E.g.*, *id.* § 17(e).
[16] *E.g.*, *id.* § 18(i).
[17] *E.g.*, *id.* § 15(a).
[18] *E.g.*, *id.* § 15(c).
[19] *E.g.*, *id.* § 15(f).
[20] *E.g.*, *id.* § 35(b).
[21] *E.g.*, *id.* § 15(a).
[22] *E.g.*, *id.* §§ 9, 10.

assets from those of its adviser,[23] the kinds of securities the fund can issue,[24] the voting rights of fund investors,[25] the prices at which the fund issues shares and processes redemptions,[26] and the disclosure of the fund's portfolio and performance.[27] Because a SPAC shares many of the same agency conflicts as investment funds, these regulations could likely achieve many of the same benefits in SPACs as they achieve in investment funds.

II. Assets

In addition to their organization, SPACs also resemble investment funds in terms of their assets. Although the ICA and its regulations are overwhelmingly concerned with regulating an investment fund's organization, the statutory definition that determines whether the ICA applies focuses on the character of a company's assets. To put it simply, the ICA says that it applies to any company that qualifies as an "investment company." And the statute defines "investment company" to include any company that invests a lot of its assets in *securities*.

SPACs have a problem under this definition because between the time of their IPOs and the time they complete their business combinations, they invest 100% of their assets in U.S. government securities.[28] If we examine only its balance sheet prior to its acquisition, a SPAC is almost indistinguishable from a Treasuries-focused mutual fund.

To be precise, the ICA contains two different definitions of an investment company. Each focuses on investments in securities, but each is slightly different, and each is independently sufficient to qualify a company as an investment company.[29] SPACs have a clear and successful strategy for avoiding the first definition, but many of them are triggering the second.

A. The 40 Percent Test

Let us begin with the first definition—the one that most SPACs successfully avoid. Section 3(a)(1)(C) of the ICA provides:

> (A)(1) When used in this subchapter, "investment company" means any issuer which—
> . . .

[23] *E.g.*, *id.* § 17(f).
[24] *E.g.*, *id.* § 18.
[25] *E.g.*, *id.* § 16(a).
[26] *E.g.*, *id.* §§ 11(a), 22(b).
[27] *E.g.*, *id.* § 29.
[28] Many SPACs also invest in the stock of money market mutual funds that invest in government securities. They do so in order to provide competitive returns to investors during the time before their business combinations—that is, for the same reason investment companies invest in securities.
[29] ICA §§ 3(a)(1)(A), (C).

> (C) Is engaged or proposes to engage in the business of investing . . . in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis.

This definition is quickly followed in the statute by another definition that helps to make sense of it. Section 3(a)(2) declares, "As used in this section, 'investment securities' includes all securities except (A) Government securities . . . ."[30] The term "Government securities" is then defined elsewhere in the statute to mean only securities issued by the government of the United States.[31] Together, section 3(a)(1)(C) and its companion provisions provide that a company cannot put too many of its assets into "investment securities" without becoming an investment company. If the ratio of "investment securities" to "total assets" is higher than 40 percent, the company becomes an "investment company." We call this the 40 Percent Test.

For a SPAC, the key part of the 40 Percent Test is the exclusion in section 3(a)(2) for government securities. Government securities do not count toward the 40% total. This is why a SPAC puts all of its assets into government securities.[32] By so doing, it avoids holding any "investment securities" and its ratio of investment securities to total assets becomes 0%.[33]

B. The Primary Business Test

[30] ICA §§ 3(a)(1)(C), (a)(2) (emphasis added). Prior to 1996, § 3(a)(1)(C) was designated as § 3(a)(3). *See* National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416, 3435.

[31] ICA § 2(a)(16).

[32] In addition to investing in treasuries, many SPACs also invest in the shares of money market mutual funds. The SEC staff treats money market fund shares as the equivalent of cash for purposes of the 40 percent ratio, which means that shares of money market funds are excluded from the numerator and the denominator of the 40 percent ratio like government securities. Willkie Farr & Gallagher, SEC No-Action Letter, 2000 WL 1585635, at *6 (Oct. 23, 2000).

[33] An interesting question is why a SPAC keeps its ratio of government securities to total assets at 0%. Given that section 3(a)(1)(C) allows a company to hold up to 40% of its total assets in securities that are not government securities, why does a SPAC not try to improve its investment returns by putting 10%, 20%, or 39% of its trust account into securities with better returns than government securities?

The answer is that section 3(a)(1)(C) excludes government securities not only from the definition of "investment securities," but also from the calculation of "total assets." Put differently, the statute pulls government securities from the *denominator* of the 40% calculation as well as the *numerator*. Because a SPAC has no hard assets that are not securities, such as factories or raw materials, once the government securities are pulled from both the numerator and the denominator, there is nothing else to balance out the value of any "investment securities" the SPAC might hold. If the SPAC were to hold any securities that qualified as "investment securities," those securities would also be the only thing comprising "total assets." The investment securities would have to be divided by themselves. Even one dollar held in investment securities would make the ratio of investment securities to total assets equal 100%.

SPACs thus have a sound strategy for avoiding the 40 Percent Test. But many of them have no such strategy for avoiding the second definition of an investment company, which is independently sufficient to qualify them as investment companies.

i. Statutory Definition

Section 3(a)(1)(A) of the ICA provides:

> (a) (1) When used in this subchapter, "investment company" means any issuer which—
> (A) is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities . . . .[34]

Unlike the test in section 3(a)(1)(C), the test in section 3(a)(1)(A) is a standard rather than a rule. It has no numerical threshold. Instead, it leans on the phrase "engaged primarily" to distinguish between an investment company that makes investing its primary business and a conventional operating company that merely invests its extra cash in securities on the side. We call this the "Primary Business Test."

For a SPAC, the most important difference between the Primary Business Test and the 40 Percent Test is that the Primary Business Test does not exclude government securities or money market fund shares. The reason is a subtle difference in the statute's wording. The 40 Percent Test in section 3(a)(1)(C) calculates its ratio by reference to "*investment* securities," but the Primary Business Test in section 3(a)(1)(A) determines a company's business by reference to the simpler term "*securities*." Whereas section 3(a)(2) of the Act defines the term "investment securities" to exclude U.S. government securities,[35] section 2(a)(36) defines the term "securities" to include them.[36]

Thus, the courts, the SEC, and the SEC staff have said many times that a company that invests in U.S. government securities may be an investment company under section 3(a)(1)(A)

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[34] 15 U.S.C. § 80a–3(a)(1)(A) (2018). Prior to 1996, this section was designated as section 3(a)(1). *See* National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, 110 Stat. 3416, 3435.

[35] 15 U.S.C. § 80a-§ 3(a)(2).

[36] Section 2(a)(36) of the ICA defines the term "security" to mean "any note, stock . . . or, in general, any interest or instrument commonly known as a 'security.'" 15 U.S.C. § 80a-2(a)(36). The SEC has long interpreted this definition to include government securities. *See, e.g.*, J.D. Gillespie, Tr. for Cleo George, 13 S.E.C. 470, 475 n.4 (1943) ("The broader term 'securities' used in section 3(a)(1)[A] obviously includes Government obligations.").

Section 3(a)(1)(A) also includes a SPAC's stock in money market funds. In the same no-action letter in which the SEC staff said it would treat money market fund shares as cash items for purposes of the 40 Percent Test in section 3(a)(1)(C), the staff warned that it would continue to treat money market fund shares as securities for purposes of the Primary Business Test in section 3(a)(1)(A).Willkie Farr & Gallagher, 2000 WL 1585635, at *6.

even though its assets would not count as "investment securities" under the 40 Percent Test in section 3(a)(1)(C).[37] This is why, for instance, a money market mutual fund that invests solely in U.S. government securities must register as an investment company under the ICA, even though it holds no "investment securities" within the meaning of the 40 Percent Test.

ii. The Temporary Investment Company Problem

It is thus clear that a SPAC invests 100% of its assets in "securities." And by any standard, an activity that soaks up 100% of a company's assets is plainly enough to qualify as its "primary" business. The real question, then, is whether a SPAC's hope to purchase a different kind of asset in the future changes the character of its business. Does a SPAC's ambition to acquire an operating business at some point after its IPO excuse its concentration in securities in the interim?

The answer is no—at least not if the SPAC invests all of its assets in securities for too long. As one might imagine, the question of whether a company can invest in securities temporarily has come up many times in the eight-decade history of the ICA. SPACs are not the first companies to say that they are investing in securities only temporarily. Each time the argument has come up, the SEC and the courts have reached the same conclusion, which is that "temporary" investments in securities cannot go on forever. At some point, the law has to draw a line. And over and over again, the courts and the SEC have drawn that line so that it never goes beyond about *one year*. Many SPACs, however—especially the older ones that went public prior to our lawsuits—give themselves two years or more.

The one-year time limit is evident in the extensive legal doctrine that has developed specifically to address acquisition companies. Acquisition companies that invest in securities as they seek to buy control of operating companies are not a new phenomenon—they are nearly as old as the ICA itself. They have appeared in all manner of industries, including transportation, manufacturing, mining, and real estate.[38] In addressing the ICA questions raised by these

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[37] *E.g.*, SEC v. Am. Bd. of Trade, Inc., 751 F.2d 529, 536 (2d Cir. 1984) (holding an issuer that invested solely in government securities to be an investment company under § 3(a)(1)(A)); Baker, Watts & Co., SEC No-Action Letter, 1982 WL 29238, at *1 (May 6, 1982) ("[A]n issuer could invest exclusively in Government securities, thereby owning no investment securities, and yet be an investment company under section 3(a)(1)[A] of the Act."); Credit Suisse First Boston Corp., SEC No-Action Letter, 1998 WL 799305, at *3 (Sept. 9, 1998) ("If a trust is engaged primarily in the business of investing in securities, it is an investment company even if it holds only government securities.").

[38] *Siimes v. Giordano*, 1992 WL 301622 (D.N.J. Oct. 8, 1992) (manufacturing); *SEC v. Fifth Ave. Coach*

acquisition companies, the courts and the SEC have held each time that if an acquisition company goes on investing in securities for more than about a year, it is clearly an investment company under the ICA, regardless of its hopes for an acquisition in the future. This pattern—temporary securities investing in anticipation of a future acquisition—has repeated itself so many times under the ICA that Judge Frank Easterbrook, a former University of Chicago Law Professor and major figure in the economic analysis of corporate law, addressed it directly in an important judicial opinion. He held that the very "model" of an "inadvertent investment company" is a company that invests the bulk of its assets in securities while it "purports to be looking for acquisitions."[39]

iii. The *Tonopah* Factors

Like all analyses under the Primary Business Test, analysis of the temporary investment company problem begins with the SEC's response to an early request for an order by a company called the Tonopah Mining Company of Nevada.[40] The request required the SEC to interpret a provision of the ICA very similar to the Primary Business Test of section 3(a)(1)(A).[41] Tonopah Mining Co. was a company much like a SPAC. It invested most of its assets in securities as it tried to acquire control of an operating business. The SEC set out five factors to determine which aspect of the company's business counted as "primary." The factors are: "1) the company's historical development; 2) its public representations of policy; 3) the activities of its officers and directors; and, *most important,* 4) the nature of its *present* assets; and 5) the sources of its *present* income."[42]

Of these factors, both the courts and the SEC have declared the last two—the sources of "present assets" and "present income"—to be the "most important."[43] In practice, these factors have carried far greater weight than the others.[44] And because *Tonopah* dealt with a company

Lines, 289 F. Supp. 3 (S.D.N.Y. 1968) (bus lines); *Tonopah Mining Co. of Nev.*, 26 S.E.C. 426 (1947) (mining); *Arizona Property Investors, Ltd.*, SEC No-Action Ltr., 1979 WL 14220 (Aug. 9, 1979) (real estate).

[39] *Nat'l Presto Indus., Inc.*, 486 F.3d at 313.

[40] Tonopah Mining Co. of Nev., 26 S.E.C. 426 (1947).

[41] *Tonopah* interpreted section 3(b)(2) of the ICA, 15 U.S.C. § 80a-3(b)(2), and its use of the phrase "primarily engaged."

[42] 26 S.E.C. at 427 (1947) (emphasis added).

[43] *Id.*

[44] ROBERT H. ROSENBLUM, INVESTMENT COMPANY DETERMINATION UNDER THE 1940 ACT § 6.3.1 n. 17 and accompanying text (2003).

that promised to acquire an operating business *in the future*, the wording of the test was chosen carefully to make clear that what matters is only the sources of income and assets *in the "present*."

Although *Tonopah* did not specify exactly what percentage of assets and income is sufficient to tip a company over the threshold, *Tonopah* itself and the cases it spawned have made clear that a SPAC's tendency to derive 100% of its assets and income from securities is too much. Under *Tonopah* and the law that has followed it, an issuer generally is deemed to be engaged primarily in the business of investing in securities so long as *a mere majority* of both its assets and income are derived from securities.[45] The SEC staff has also refused to grant a no-action letter under section 3(a)(1)(A) to any issuer that derives more than 45% of its assets and income from securities.[46] In every case in which a company has been deemed not to be an investment company under the test in *Tonopah*, the company managed within less than a year to derive more than half of its assets, income, or revenues from actual operations.[47]

iv. Public Perception

Another factor to consider is the way the public perceives a SPAC. Public perception matters both because *Tonopah* looks at a company's "representations" and because Judge Easterbrook emphasized the general importance of public perceptions in applying *Tonopah*.[48]

One aspect of public perception is what an issuer says about itself. But due to the obvious risks in letting a company decide for itself whether it thinks the law should apply, the courts and

[45] *ICOS Corp.*, 1940 Act Rel. No. 19334, 58 Fed. Reg. 15 (March 22, 1993).
[46] *Financial Funding Group, Inc.*, SEC No-Action Ltr., 1982 WL 28965, at *1 (Mar. 3, 1982).
[47] In *National Presto*, the issuer invested only 60% of its assets in securities and derived only 50% of its net income and a mere 10% of its gross revenues from securities. 486 F.3d at 313-314. In *Moses v. Black*, the issuer derived only 49% of its assets from securities and less than 10% of its income. 1981 WL 1599, at *7 (S.D.N.Y. 1981). In *In re Warner Bros.*, 11 S.E.C. Docket 2214, 1977 WL 175217 (Apr. 5, 1977), securities comprised 40% of assets and 21% of income. *Id.* at *1 n.1, *2. In *In re George W. Helme Co.*, 9 S.E.C. 16, 1941 WL 37265 (Apr. 11, 1941), securities comprised 46.48% of assets and 21% of income. *Id.* at *1. In *Snowflake* and *Lyft*, the issuers proposed for securities to comprise a relatively large portion of their total assets (89% for Snowflake and 68.8% for Lyft), but only a sliver of their revenues (4% to 9% for Snowflake and 2% to 3% for Lyft). *In re Snowflake, Inc.*, Rel. No. IC – 34049, 2020 WL 5993059, *4 (Oct. 9, 2020); *Lyft, Inc*., Release No. IC – 33399, 2019 WL 1199584 (Mar. 14, 2019). In *Pacificare of Arizona, Inc.*, the level of the company's assets and income in securities varied, but its revenues from securities comprised only 1% of total revenue. 83 S.E.C. Docket 3191, 2004 WL 2403824, *5 (Oct. 25, 2004).
[48] SEC v. Nat'l Presto Indus., Inc., 486 F.3d 305, 315 (7th Cir. 2007).

the SEC have tended to accord a company's own representations very little weight.[49] Almost every company that has ever lost a fight under the Primary Business Test has gone down having claimed to the public that it was not an investment company.[50] What matters in practice is not whether a company tells the public that it is an investment company—it almost never does—but whether the public reasonably perceives the company to have the objective characteristics that determine investment company status.

For a SPAC, this objective analysis of public perception is damning. A SPAC has two features that make it look more like an investment company than even the many other acquisition companies that have already been deemed to be investment companies. The first is the pattern of organization described above: a SPAC is managed like an investment company and often even carries the name of the investment fund advisory firm that sponsors it.

The second unique feature is redemption. Just before a SPAC completes its acquisition, a shareholder can hand her shares back to the SPAC and receive in exchange the net asset value of the SPAC's portfolio of securities. In so doing, a SPAC shareholder becomes like a shareholder in a mutual or hedge fund, who can also redeem in almost exactly the same way. Crucially, the shareholder gains a pure exposure to a portfolio of securities, with no necessary exposure to a SPAC's future as an operating company. The price at redemption is solely a function of the value of the SPAC's portfolio of securities at the moment of redemption. It bears no relationship to the success or failure of the SPAC's future efforts as an operating company. The redemption price is completely independent of the SPAC's business combination.

Redemption thus holds out the possibility that an investor might treat a SPAC as a substitute for a mutual fund. The SPAC promises exposure to government securities without any necessary exposure to the SPAC's hoped-for future business as an operating company, just like a mutual

[49] SPACs and their counsel, like unregistered investment companies before them, have sought to escape the ICA by asserting that the public does not perceive SPACs to be investment companies. *See, e.g.*, Pershing Square Tontine Holdings, Amended Registration Statement on Form S-1 (July 16, 2020), at 60 ("We do not believe that our anticipated principal activities will subject us to the Investment Company Act"). These descriptions cannot possibly be the end of the analysis. If a company could avoid the ICA merely by saying that the statute doesn't apply, then the ICA would be a dead letter. A company cannot avoid becoming an investment company merely by saying it isn't one—a fact SPACs appear to understand, as they disclose the risk that they may be deemed to be investment companies. *See, e.g., id.* at 59 (disclosing the risk that the SPAC may be "deemed to be an investment company under the Investment Company Act").

[50] *See, e.g.*, *Fifth Ave. Coach Lines*, 289 F. Supp. at 27-28, 30; *Siimes*, 1992 WL 301622, at *1.

fund would. In the words of one commentator, the redemption right ensures that "[t]o the SPAC investor, [a SPAC is] a subpar money market fund with a Kinder Surprise Egg-style option attached…."[51] And a money market fund with an option attached is still a money market fund.

None of the many other acquisition companies that have already been held to be investment companies has ever promised to isolate the returns on its portfolio of securities in so brazen a way. Buying a share in one of these companies necessarily meant gaining exposure to *both* its securities investments and future operations.[52] A SPAC, by contrast, offers securities investing *à la carte*.

To see which aspect of a SPAC's business investors tend to weigh most heavily, we need only look at what investors actually do. In their prominent study of SPACs that closed business combinations between January 2019 and June 2020, Klausner, Ohlrogge, and Ruan found that in the median SPAC, *nearly three quarters of investors chose to redeem*, and in a quarter of SPACs, *nearly all shares chose to redeem*.[53] Redemptions declined briefly in early 2021 as the SPAC craze reached its crest. But they have since returned to very high levels again in late 2021 and early 2022.[54] *A SPAC's portfolio of securities is thus the only source of return that the great majority of investors will ever receive.*

The prices at which SPACs trade on stock exchanges reflect this truth. It is a basic axiom of law and finance that in a thick market, a company's share price indicates how investors perceive the company's future value.[55] A SPAC's common stock thus almost always trades close to the worth of the only source of value most of its investors ever expect to receive: its portfolio of securities. Because the value per share of a SPAC's portfolio of securities is commonly close to $10, SPAC shares almost always trade at approximately the discounted present value of $10.

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[51] Byrne Hobart, *SPACs as a Call Option on Hype*, The Diff (July 17, 2020), *available at* https://www.thediff.co/p/spacs-as-a-call-option-on-hype.
[52] *Nat'l Presto*, 486 F.3d at 313 (observing that returns on company's operations and securities portfolio were inseparable and therefore holding the company to be an operating company).
[53] Michael Klausner, et al., A Sober Look at SPACs, 16 tbl. 1 (Jan. 2022) (showing that in the median SPAC, 73% of investors redeem), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3720919.
[54] Amrith Ramkumar, *The SPAC Ship is Sinking, Investors Want Their Money Back*, WALL ST. J. (Jan. 21, 2022), https://www.wsj.com/articles/the-spac-ship-is-sinking-investors-want-their-money-back-11642761012?mod=hp_lista_pos4.
[55] Basic, Inc. v. Levinson, 485 U.S. 224, 241-247 (1988).

Hedge funds and other sophisticated traders therefore tend to treat SPACs as substitutes for investments in treasuries.[56]

A SPAC might argue that treasuries offer only a modest investment return. But this is no matter. Many mutual funds also invest in treasuries that offer the same modest return. And there is no question that these mutual funds must register under the ICA. The SEC staff has also said many times that "an issuer could invest exclusively in Government securities, thereby owning no investment securities, and yet be an investment company under section 3(a)(1)[A] of the Act."[57] In any case, as interest rates increase in mid-2022, so will the return on treasuries.

v. The One-Year Limit

The fact that a SPAC invests 100% of its assets in securities does not necessarily end the inquiry. If a SPAC made these investments for only a brief time, it could avoid the ICA under a doctrine that has been specially developed to address the needs of so-called "temporary investment companies." The problem for a SPAC is that the time limit many SPACs claim for themselves is too long. Before we filed our lawsuits in August 2021, most SPACs allowed themselves two years or more to complete their business combinations. But under long-established doctrine, the outer limit for temporary investments has generally been no more than one year.

The temporary investment company doctrine first appeared in 1968 in *SEC v. Fifth Avenue Coach Lines*, a case in which the Second Circuit and Southern District of New York considered a company whose assets had been seized in a condemnation proceeding.[58] The proceeds of the condemnation award left the company in a position similar to a SPAC, with a pool of cash that it invested in securities as it sought to acquire control of an operating business.[59] The court held that although the company had a brief grace period before its securities investments became its "primary" business, this period was not unlimited. "The time must eventually come," the court held, "when a corporation initially possessed of cash and no real business, by spending its cash becomes engaged in a business of some sort"—i.e., the business of investing in securities.[60] The

[56] Sam Goldfarb, *Some Investors Find Stability in SPACs*, Wall St. J. (Oct. 12, 2021), https://www.wsj.com/articles/some-investors-find-stability-in-spacs-11634007742; Lauren LaCapra, *Hedge Funds Find Arb Opportunity in SPACs*, THESTREET (Apr. 7, 2009, 7:49 AM), https://www.thestreet.com/investing/funds/hedge-funds-find-arb-opportunity-in-spacs-10482888.
[57] *Baker, Watts & Co.*, SEC No-Action Ltr., 1982 WL 29238, at *1.
[58] 289 F. Supp. 3 (S.D.N.Y. 1968) *aff'd* 435 F.2d 510 (2d Cir. 1970).
[59] *Id.* at 30.
[60] *Id.* at 29.

grace period the court allowed was nine months, at which point, the court said, the company became an investment company.[61]

Since *Fifth Ave. Coach Lines*, the grace period has often been extended to one year. This is the amount of time the SEC staff has commonly granted in no-action letters to companies that propose to invest the bulk of their assets in securities as they seek to build or acquire operations.[62] And it is also the amount of time the SEC has written into a safe harbor available to all companies under ICA Rule 3a-2.[63]

In adopting Rule 3a-2, the SEC made clear that although in principle some companies might be allowed to go beyond one year under special circumstances, these circumstances were rare. The release adopting the rule declared, "The Commission stresses that a company's inability to become engaged primarily in a non-investment company business within the rule's one-year period would raise serious questions concerning the applicability of the Act to that company."[64]

There is no reason to give a SPAC more than the usual one-year limit. A SPAC invests a far greater share of its assets in securities than other companies that have avoided the ICA and it may exceed the usual one-year period by far longer. It is also organized like an investment company and offers redemption rights in a portfolio of securities like an investment company—characteristics that have no parallel in the extant cases and administrative actions under the Primary Business Test. To our knowledge, no court case or action by the SEC has ever knowingly allowed any company—let alone one with a SPAC's divided structure and redemption rights—to derive 100% of its assets, income, and revenue from securities with no full-time employees or other present operations for more than one year without becoming an investment company. What SPACs are doing is literally unprecedented.

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[61] *Id.*

[62] *E.g., Medidentic Mortgage Investors*, SEC No-Action Ltr., 1984 WL 45320 at *2 (May 23, 1984) ("We would generally consider a period of up to one year to be temporary."); *Florida First Equities Corp.*, SEC No-Action Ltr., 1980 WL 14869 (Sept. 11, 1980) (similar); *Arizona Property Investors, Ltd.*, 1979 WL 14220 (similar).

[63] 17 C.F.R. § 270.3a-2(a) (2020); Transient Investment Companies, 46 Fed. Reg. 6882, 6882 (Jan. 22, 1981). In adopting Rule 3a-2, the SEC made clear that it intended only a safe harbor. The Rule does not supplant the grace period that had developed under the statute prior to the rule's adoption. A company may receive a one-year grace period on the same terms as under prior law even if the company does not comply with the procedural requirements of Rule 3a-2. *See, e.g.*, *Medidentic Mortgage Investors*, SEC No-Action Ltr., 1984 WL 45320 at *2 (May 23, 1984) (no-action letter applying a one-year grace period three years after the adoption of Rule 3a-2.)

[64] 46 Fed. Reg. at 6883.

vi. The SEC's Inaction

In response, SPACs and their lawyers have argued that SPACs are their own precedent. Prior to proposing the new ICA Rule 3a-10, the SEC pointedly avoided ever making any direct statement about a SPAC's legality under the ICA. But the SEC nevertheless allowed many SPACs to go public by permitting their registration statements to become effective under the Securities Act of 1933. The SEC also approved applications for rule changes by the stock exchanges allowing SPACs to list under the Securities Act of 1934 and granting SPACs up to 36 months to complete their acquisitions. The SPAC industry thus says the SEC has tacitly indicated the industry's legality under the ICA.

The problem with this argument is that these SEC actions—or, more accurately, *inactions*—carry no legal significance under the ICA. The registration of a company's securities offering under the Securities Act has no meaning under the ICA because the ICA is a different statue from the Securities Act. And even under the Securities Act, the SEC has made clear that the effectiveness of a registration statement is no guarantee of the registration statement's accuracy or completeness or the legality of the issuer's business.[65] The approval of stock exchange listing rules likewise carries no meaning under the ICA because these approvals have never interpreted or even discussed any aspect of the ICA.

More generally, the SEC's inactions carry no meaning under the doctrine the Supreme Court has developed to determine when a court should defer to the actions of a federal administrative agency. Though the law is complicated, it clearly states that to warrant deference from a court, the action of an agency must, at a minimum, involve an interpretation of the statute at issue, speak with the force of law, and be backed up by valid and thorough reasoning.[66] Because prior to proposing Rule 3a-10 the SEC had never spoken with the force of law on the status of a SPAC under the ICA or offered any kind of reasoning in this regard, the SEC's purported action or inaction cannot warrant judicial deference.

John Coates, a professor at Harvard Law School and the former general counsel of the SEC and Acting Director of the SEC's Division of Corporation Finance, has summarized the issue succinctly. In a recent paper, Coates, based on reasoning similar to our lawsuits, dismissed as a

[65] Investing in an IPO 1, Off. of Inv. Educ. & Advoc., Sec. & Exch. Comm'n, *available at* https://www.sec.gov/files/ipo-investorbulletin.pdf.
[66] *See generally* United States v. Mead Corp., 553 U.S. 218 (2001); Chevron USA v. Natural Res. Def. Council, 467 U.S. 837, 844 (1984); Skidmore v. Swift & Co., 323 U.S. 134 (1944).

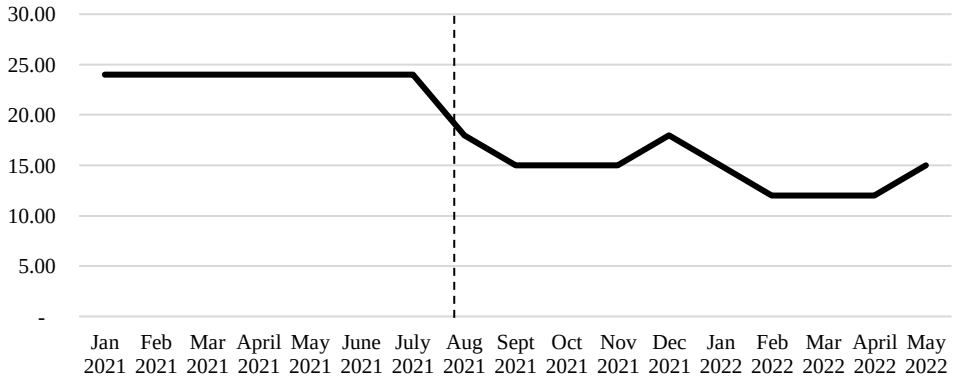
"myth" the notion "that the ICA clearly . . . does not apply to SPACs."[67] Coates argued that the SPAC industry's arguments about the SEC's inaction amounts to nothing more than the claim that a "regulatory agency with a limited budget should be held to legally have given up authority if it does not bring an enforcement action when it could."[68] In Coates' view, as in ours, non-enforcement is not the same as legal interpretation.

III. The Shortening of SPAC Lifespans

Despite the protests from many in the SPAC industry, new SPACs have already begun to change in ways that lessen their risk under the ICA and draw them closer to the temporary investment company doctrine. Though we cannot say for certain, there is reason to think that this change was a consequence of our lawsuits and SPACs' growing awareness of the ICA.

Figure 1 indicates the median durations of new SPACs between January 2021 and May 2022.[69] The figure shows the median number of months a SPAC's certificate of incorporation provided at the time of the SPAC's IPO for the SPAC to announce or complete a deal before it was required to liquidate.

FIGURE 1. MEDIAN NEW SPAC PROPOSED ACQUISITION PERIODS BY MONTH, 2021-PRESENT



[67] John C. Coates, *SPAC Law and Myths*, at 37-38 (working paper 2022), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4022809 ("[M]ajor law firms and their clients in the SPAC industry" are "invested" in the "myth" "that the ICA clearly . . . does not apply to SPACs"). *But see* Ropes & Gray LLP, *Over 60 of the Nation's Leading Law Firms Respond to Investment Company Act Lawsuits Targeting the SPAC Industry* (Aug. 27, 2021). *Cf.* Coates, *SPAC Law and Myths*, at 35-36 (noting that this statement "contains no reasoning at all").

[68] Coates, *supra* note 67, at 36.

[69] *See* SPAC IPO INSIDER, SPACINSIDER.COM (providing data). We note that many of the termination dates reflect the timelines to *announce* an acquisition rather than to *complete* it. Many SPAC termination dates extend automatically if a SPAC announces a transaction within the original time limit. Even if we take Figure 1 to indicate only the time limits for announcements, however, it is consistent with a significant shortening of SPAC durations.

The most striking feature of Figure 1 is the sudden drop it shows in the durations of new SPACs starting in August of 2021. The timing is significant because the middle of August 2021 was when we filed our lawsuits. The durations of new SPACs thus began dropping at the exact moment the SPAC industry began to seriously confront its problems under the ICA.

The decline in SPAC duration reduced the industry's risk under the ICA. Under the temporary investment company doctrine, a shorter duration is less problematic than a longer one. And the duration at which the market finally settled—12 months, as of March and April 2022—is the exact period granted by the safe harbor in ICA Rule 3a-2. It is also the amount of time our lawsuits argued that a SPAC had to complete a deal before it became an investment company.

Of course, we cannot say with certainty that our suits *caused* the decline in SPAC duration. The SPAC market is not a controlled experiment—many factors changed in the industry at the same time awareness of the ICA issues was growing. The decline in SPAC duration may be connected to the same forces that compelled a more general tightening of SPAC terms in early 2021. In the first two months of 2021, the market's enthusiasm for SPACs was tremendous. But starting in March of 2021, the market cooled. And as it did, SPAC sponsors tried to make many SPAC terms more attractive to IPO investors, increasing the number of warrants granted to IPO investors and overfunding trust funds.[70] One might argue that the decline in SPAC duration was one instance of this more general phenomenon.

There may still be room in the story for the ICA, however. The decline in SPAC duration did not occur until months after the slowdown in the industry began and the decline in duration lagged well behind other changes in SPAC terms. Figure 2 shows the dollar volume of new SPAC IPOs in each month from the beginning of 2021 to May of 2022. It indicates that the cooling in the SPAC market began in March of 2021—five months before our lawsuit forced the SPAC industry to confront its problems under the ICA.

FIGURE 2. DOLLAR VALUE OF NEW SPAC IPOS BY MONTH, JANUARY 2021-MAY 2022

[70] *See, e.g.*, Michael Klausner & Michael Ohlrogge, *SPACs are Evolving—and Getting even Worse for Long-Term Investors* (working paper June 7, 2022) (documenting these changes).

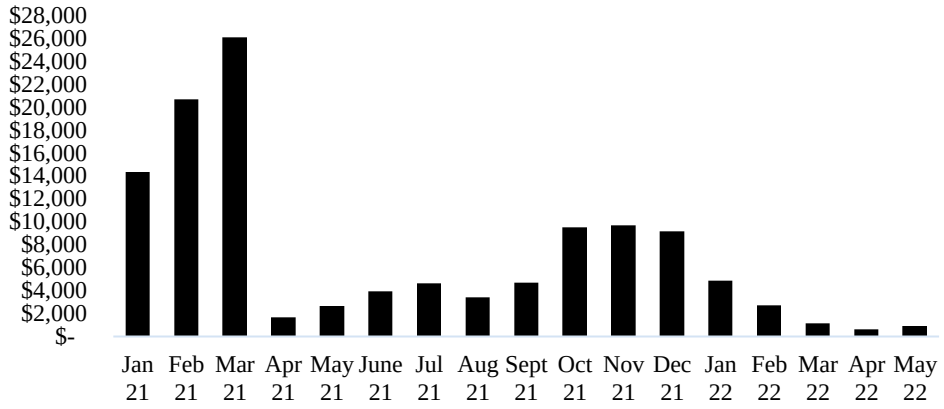
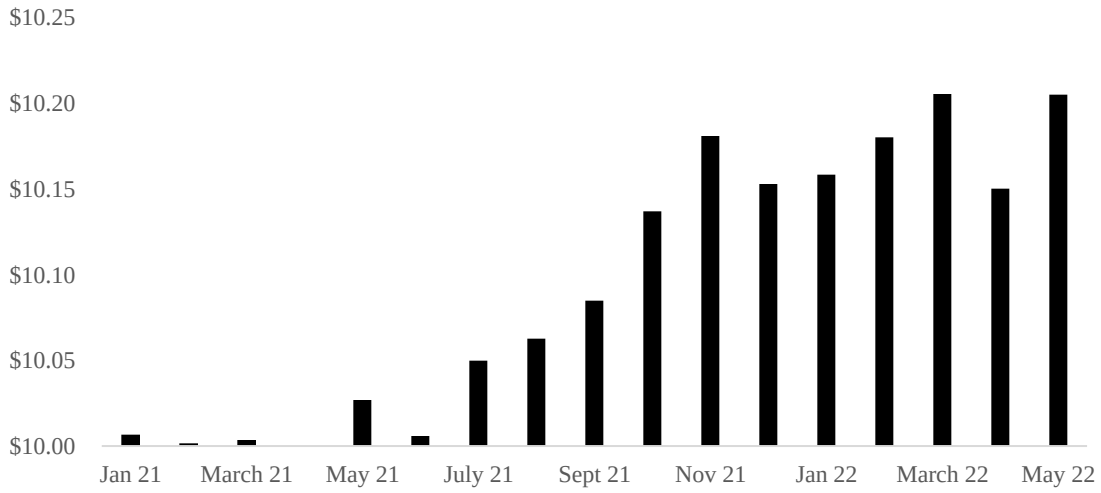


Figure 3 documents the tightening of SPAC terms by showing the median rate of sponsor overfunding for new SPACs that completed IPOs between January 2021 and May 2022. When a sponsor overfunds, it contributes some of its own money to a SPAC's trust fund, thereby increasing the value of the pool of securities available for redemption by common stockholders above the price at which the common stock was originally issued, which for nearly all SPACs is $10). The goal is to make the SPAC more attractive to IPO investors by granting them an instant return. Figure 4 shows that, like the decline in trading premiums and offerings, the move toward overfunding began months before the reduction in duration.

FIGURE 3. MEDIAN SPAC TRUST PROCEEDS PER UNIT, JANUARY 2021-MAY 2022



Taken together, this evidence suggests that, although it is possible that the decline in SPAC duration that immediately followed the filing of our lawsuits was a coincidence, it is also possible that the decline was at least partially a response to the industry's sudden grappling with its problems under the ICA. The decline in duration did not begin until well after the SPAC

market cooled and other SPAC terms began to tighten and only after our lawsuits forced the industry's attention to the ICA.[71]

That SPACs may have chosen to reduce their ICA risk matters for two reasons. First, it suggests that, notwithstanding its public claims to the contrary, the SPAC industry knows it has a problem under the ICA. Second, it suggests that the SPAC industry is capable of living in compliance with the law.

IV. SEC Rule 3a-10

On March 30, 2022, the SEC expressly addressed the status of SPACs under the ICA for the first time by proposing to adopt ICA Rule 3a-10.[72] As of June 2022, the SEC had finished collecting comments on the Rule and was deliberating about whether to formally adopt it. Rule 3a-10 was one of several new regulations on SPACs that the SEC proposed at the same time.[73]

If adopted, the Rule would significantly raise the risk that a SPAC becomes an investment company if it fails to comply with the Rule's conditions. Formally, the Rule is structured as a safe harbor. Any SPAC that complies with its conditions is guaranteed by the terms of the Rule to avoid becoming an investment company. Crucially, however, the proposed Rule also cautioned that any SPAC that sails outside of the safe harbor faces grave risks. The release declares that "SPACs may fail to recognize when their activities raise the investor protection concerns addressed by the Investment Company Act."[74] It then makes clear that any SPAC that fails to comply with the Rule's conditions faces "serious questions" about its status as an investment company.[75] The release repeats the warning about "serious questions" four times.[76] This phrase—"serious questions"—is common in SEC safe harbor rules under the ICA, such as ICA Rule 3a-2,[77] which grants many issuers a 12-month safe harbor from becoming investment

[71] It is also possible that existing SPACs chose not to extend their lifespans based on the risk posed by the ICA and our litigation. When Pershing Square Capital Management, announced that its SPAC, Pershing Square Tontine Holdings, would liquidate after failing to find a deal, it expressly attributed the failure partly to the risks posed by our litigation. Pershing Square Tontine Holdings, Letter to Stockholders from the Chief Executive of the Company, Exhibit 99.2 to Current Report, 2 (Form 8-K) (July 11, 2022), https://www.sec.gov/Archives/edgar/data/1811882/000119312522191391/d305715dex992.htm.
[72] Securities and Exchange Comm'n, Proposed Rule, *Special Purpose Acquisition Companies, Shell Companies, and Projections*, Rel. Nos. 33-11048, 34-94546, IC-34549, File No. S7-13-22 (March 30, 2022) [hereinafter, the "Rule"].
[73] *See id.*
[74] *Id.* at 135.
[75] *Id.* at 136.
[76] *Id.; see also id.* at 138, 155, and 155 n.3.
[77] Transient Investment Companies, 46 Fed. Reg. at 6882.

companies under the ICA.[78] The phrase "serious questions" thus signals serious risks. The Director of the SEC's Division of Investment Management emphasized as much in the SEC's open meeting regarding Rule 3a-10.[79]

A. Transaction Structure

As proposed, the Rule contains several conditions to avoid these serious questions, of which two stand out as the most important. The first would regulate the structure of a de-SPAC transaction. A SPAC must complete its de-SPAC as a single transaction and as a result of this transaction, the surviving entity must (a) be engaged directly in the business of the target company; and (b) have at least one class of securities listed on a national securities exchange.

The Rule's conditions related to a SPAC's post-transaction engagement in a target company's business may seem confusing until one understands their origins. Though the SEC did not say it, these conditions are in part a response to the de-SPAC transaction initially proposed in June 2021 by Pershing Square Tontine Holdings ("PSTH"), the largest SPAC in history and the first of the three SPACs whose sponsors we sued.[80] Like so many other SPACs, PSTH is the product of a prominent investment fund management firm. In the summer of 2021, that management firm, Pershing Square Capital Management, arranged an unusual deal by which PSTH would have acquired an interest in Universal Music Group ("UMG"), the recorded music company, which was then in the process of conducting an IPO in Europe. Rather than merging with UMG, as most SPACs do with their targets, PSTH agreed to acquire a large number of shares of stock representing a minority interest in UMG at the time UMG did its IPO in Amsterdam. PSTH would then have transferred the shares to a temporary special purpose vehicle

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[78] The SEC has also coupled safe harbors with warnings about the risks of noncompliance in contexts other than the definition of an investment company. *E.g.*, Securities and Exchange Comm'n, *Notice of Adoption of Rule 144*, Release No. 33-5223, 1972 WL 121583 (Jan. 11, 1972) (imposing a "substantial burden of proof" on issuers that fail to comply with the safe harbor conditions in Securities Act Rule 144).

[79] Comments by William Birdthistle, SEC Open Commission Meeting (Mar. 30, 2022), https://www.youtube.com/watch?v=t6qX8FGiI_8(discussion at 43:25-44:45). ("For SPACs that are able to satisfy the conditions of the safe harbor with respect to their activities, the holdings of their portfolio, and the duration of their project, then they would enjoy a certain amount of certainty with respect to their situations. For those SPACs that aren't, that do not satisfy those conditions, we would expect that those SPACs should be consulting closely with their advisers and considering carefully their compliance obligations. And finally, I would just say, certainly for those SPACs that also fall outside the safe harbor, I would expect that the staff would also be taking a look at them.")

[80] *See* Pershing Square Tontine Holdings, Ltd., Schedule TO Exh. (a)(1)(i), Offer to Exchange (July 8, 2021) [hereinafter, "Pershing Offer to Exchange"].

before causing the vehicle to distribute the shares as a dividend to PSTH's investors.[81] PSTH would have used only about 72% of its assets on this deal, leaving the rest of PSTH's money unused and available to complete other deals. After several weeks of behind-the-scenes conversations with the SEC, PSTH withdrew from the transaction, possibly in part because the SEC expressed concern about the deal's legality under the ICA.[82] In a confirmation of our thesis about the fundamental similarity between SPACs and investment funds, Pershing Square then took the shares in UMG that PSTH had originally intended to purchase and put them instead into Pershing Square's hedge funds, which were managed by the same Pershing Square employees who also managed the SPAC.[83]

The UMG deal would have made for an ICA double-whammy: in addition to investing in securities temporarily as it searched for a deal (as other SPACs do), PSTH would also have devoted the final use of the great bulk of its assets to a permanent purchase of still more securities in the stock of UMG. Securities investing would have become not just PSTH's temporary business, but its permanent one. PSTH would have violated both the Primary Business Test and the 40 Percent Test for investment company status.[84]

The Rule's conditions on de-SPAC structure thus speak directly to each aspect of the PSTH-UMG deal.[85] The Rule requires one transaction (instead of several); it requires the surviving company to have a class of securities listed on an exchange in the United States (instead of in Europe); and it requires the surviving company to be engaged in operating the business of the target (rather than merely holding a minority chunk of the target's stock).

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[81] Pershing Offer to Exchange, *supra* note 80, at 10.

[82] *See* Letter Regarding Pershing Square Tontine Holdings from U.S. Sec. & Exch. Comm'n Division of Corporation Finance (July 16, 2021), at 2 ("Please explain whether [the UMG] transaction would also result in PSTH meeting the definition of investment company under Section 3(a)(1)(A) of the Investment Company Act.").

[83] *See, e.g.*, *Bill Ackman rejigs Universal Music Deal After Regulators Probe SPAC Plan*, Reuters (July 19, 2021).

[84] PSTH itself agreed that it would briefly violate the 40 Percent Test under the terms of its proposed transaction. *See, e.g.*, Offer to Exchange, *supra* note [77], at 86 ("If the UMG Business Combination is consummated, our purchase of UMG Shares . . . will result in our temporarily becoming an investment company within the meaning of section 3(a)(1)(C) of the Investment Company Act of 1940[.] This is because we will own investment securities (i.e., the UMG Shares) the value of which exceeds 40% of our total assets, exclusive of government securities and cash items[.]").

[85] *See, e.g.*, Rule at 139 (noting that a SPAC would raise concerns about its ICA status if the SPAC "did not seek to engage in a business combination but instead sought to acquire a minority interest in a target company with the intention of being a passive investor").

B. Duration

The Rule's second set of key conditions would restrict the amount of time a SPAC has to announce and complete a deal. A SPAC must announce a deal with a target company within 18 months of the SPAC's IPO and close that deal within 24 months of the IPO.[86] A SPAC that fails to satisfy either deadline must liquidate and distribute its assets "in cash to investors as soon as reasonably practicable."[87] By limiting how long a SPAC can invest all of its assets in securities, the Rule would bring SPACs closer to the limits existing law places on temporary investment companies.

The 18/24-month deadline combination in the proposed Rule is more generous than existing law, however. As explained above, the clearest statement of existing law is Rule 3a-2, which uses almost the exact same language and conceptual scheme as Rule 3a-10, coupling a safe harbor with "serious questions" about those who go beyond it. But Rule 3a-2 grants only 12 months. Moreover, there is no precedent for the SEC or a court ever knowingly and expressly allowing any issuer to invest all of its assets in and derive all of its income from securities for more than one year while avoiding investment company status under the temporary investment company doctrine. The choice of the 18/24-month limit thus appears to be based not on existing law, but on the awareness that, as indicated in Figure 1, 24 months used to be the median lifespan of a SPAC and 6 months is approximately the amount of time it takes to close a deal after announcing it.[88]

Notwithstanding the Rule's comparative generosity, it still has the potential to change the way SPACs do business. A SPAC can no longer attempt the kind of deal proposed by PSTH. And many SPACs will be forced to liquidate earlier than they would have otherwise. New SPACs will have trouble giving themselves lifespans of longer than 24 months, as PSTH did when it went public.[89] And existing SPACs will be unable to continue their searches for deals after 18 months or extend their lifespans beyond 24 months by obtaining shareholder votes.

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[86] ICA Rule 3a-10(a)(3)(ii)-(iii).
[87] ICA Rule at 3a-10(a)(4)(ii).
[88] The release proposing the Rule noted that in 2021, the average SPAC proposed an acquisition period of just over 20 months. Rule Release, *supra* note 3, at 186 & tbl.2.
[89] PSTH's certificate of incorporation allowed it to operate as a SPAC for up to 30 months if it signed a deal with a target within 24 months.

The impact on existing SPACs will be especially pronounced because as the SPAC boom ages, many SPACs are aging along with it. As of mid-June 2022, 49 SPACs holding more than $18 billion were still searching for deals more than 18 months after their IPOs.[90] By Thanksgiving 2022, there will be 279 SPACs holding more than $97 billion in this position.[91] It is unlikely that many of these SPACs will complete deals due to the general decline in the stock market in mid-2022, the huge volume of SPACs competing for a limited number of plausible targets, the withdrawal of major investment banks from the SPAC market, and the SEC's newly proposed regulations.[92] Rule 3a-10, which is the only aspect of the SEC's new regulatory package that expressly limits a SPAC's duration, could thus force the many aging SPACs to return their money to investors rather than waiting until they liquidate or seeking extensions by vote.

In fact, the proposed Rule and the legal reasoning behind it have already had an effect. In April of 2022, the SEC staff declined to declare effective the proxy statement for an acquisition by a SPAC that had been searching for nearly three and a half years.[93] SEC Commissioner Hester Peirce wrote a public statement criticizing the move and attributing it to the staff's concerns that the SPAC had exceeded its time limit under the temporary investment company doctrine.[94] She quoted the SEC's Director of the Division of Investment Management to observe that, if adopted, Rule 3a-10 will be interpreted to reach existing SPACs as well as new ones.[95]

The potential benefits to limiting SPAC lifespans are significant. Most importantly, limiting lifespans would discourage SPACs from going public in the first place. The compensation of a SPAC sponsor is structured like an option: it only pays off if the SPAC

[90] We calculated these figures by drawing data on SPAC search status and initial public offering dates from SPAC IPO INSIDER, *supra* note 23.
[91] *Id.*
[92] *See, e.g.*, Crystal Kim & Tom Contiliano, *Do-Nothing SPACs Sag, Offering Investors a $1.1 Billion Return*, BLOOMBERG (April 5, 2021) (quoting University of Florida finance scholar Jay Ritter for the prediction that as many as half of current SPACs will eventually liquidate and return funds to investors).
[93] Alberton Acquisition Corp., Exhibit 99.1 to Current Report (Form 8-K) (Apr. 14, 2022), https://www.sec.gov/Archives/edgar/data/0001748621/000121390022019701/ea158435ex99-1_alberton.htm.
[94] Commissioner Hester M. Peirce, *Statement Regarding SPAC Matter* (April 15, 2022), https://www.sec.gov/news/statement/peirce-spac-20220415#_ftnref4.
[95] *Id.* ("[C]ertainly for those SPACs that . . . fall outside the safe harbor . . . the [S]taff w[ill] also be taking a look at them") (quoting William Birdthistle, Director, Division of Investment Management).

completes a deal.[96] And like any option, the option of a SPAC sponsor increases in value with the length of its term. A shorter term will therefore discourage sponsors from starting SPACs. Given the SPAC industry's dismal record of poor performance and fraud, investors may benefit from these effects of the Rule.

The desire to discourage SPACs from producing poor returns for investors is an appropriate motivation for regulation under the ICA. Unlike the Securities Act and Securities Exchange Act, the ICA is not merely a disclosure statute—it is a substantive regulatory statute. It regulates not only what an investment company says about itself, but also how it conducts its business. A mutual fund cannot issue debt securities to the public or pay for an adviser's services in shares of stock, for instance, even if the terms of these transactions are accurately disclosed.[97] The adviser of an investment company even faces judicial scrutiny for the substantive reasonableness of its fees, again even when these fees are fully disclosed.[98] The ICA regulates the substance of a company's operations on the conviction that certain forms of business are simply bad for investors, whether or not the investors know what is going on. If SPACs are violating the ICA, then the fact that they are harming investors is a valid reason for discouraging their growth.[99]

Aging SPACs are also wasting the time value of their money. A SPAC's investments in treasuries yield lower expected returns than many alternative investments and lower returns even than other vehicles that invest in the same things. A SPAC becomes especially wasteful near the end of its lifespan, when it becomes little more than a zombie, lacking sufficient time to sign and close a deal and merely waiting for its liquidation date to arrive. The Rule's 18-month deadline

[96] *See* Brief of Accounting and Financial Economics Scholars in *Assad* v. *E.Merge Technology Acquisition Corp.*, No. 1:21-cv-07072-JPO (November 2021), at 6-7 (explaining, on behalf of more than thirty scholars of accounting and finance, that SPAC sponsor compensation is "economically equivalent to contingent compensation," the value of which depends in part upon the time the holder has for the contingency to be realized).
[97] 15 U.S.C. §§ 80a-18(f), 22(g).
[98] 15 U.S.C. § 80a-35(b); Jones v. Harris Associates L.P., 559 U.S. 335 (2010).
[99] This is a point that appears to have eluded those members of the bar who continue to advocate that SPACs are not subject to the ICA. *See, e.g.*, Davis Polk & Wardwell LLP, *SPACs Remain in the SEC's Crosshairs*, HARV. L. SCH. F. ON CORP. GOV. (April 24, 2022) (contending that the Rule is "consistent with [that Firm's apparent concern that] the SEC is effectively seeking to act as a merit regulator and prohibit certain activity, an expansion of its historical mission of investor protection through disclosure requirements").

for announcing a deal will liberate cash from many of these zombies months before they reach their built-in 24-month or 30-month termination dates.

Finally, as SPACs get older, they tend to do worse deals. Most SPACs that find deals tend to do so in their first year post-IPO.[100] Allowing SPACs to go on longer than this wastes investors' time and money so that the value of the sponsor's option can be maximized. Additionally, the very-worst performing post-SPAC companies tend to be those acquired late in a SPAC's search.[101] This is consistent with a SPAC sponsor's incentive to prefer a low-quality transaction over no transaction, as a failure to complete a transaction results in the sponsor receiving no compensation.[102]

We offer some suggestions for improving the Rule. First, both deadlines should be reduced by six months, granting only 12 months to announce a deal and 18 months to complete it. These shorter timelines would still be more generous than current law. And Figure 1 shows that the SPAC industry can live within them. These shorter timelines will also do more to discourage the creation of new SPACs, reduce the amount of time that investors' money gets wasted, and reduce the odds of SPACs completing bad deals.

Second, the Rule should further clarify the status of SPACs under the ICA by stating definitively that a SPAC that fails to comply with the Rule is an investment company. Some members of the SPAC bar have shown a disinclination to take the "serious questions" in Rule 3a-10 seriously.[103] The SEC should put all doubt to rest by stating directly that a noncompliant SPAC is an investment company.

V. Descriptive Insights

[100] Rule at 186 tbl.2 (noting that the average amount of time from IPO to acquisition closing of SPACs that completed IPOs between 2016 and 2021 was about 8.5 months).

[101] *See, e.g.*, Lora Dimitrova, *Perverse Incentives of Special Purpose Acquisition Companies, the "Poor Man's Private Equity Funds,"* 63 J. ACCT. & ECON. 99 (2017).

[102] Rule Release, *supra* note 3, at 204 & n.454 (citing Dimitrova, *supra* note 26)).

[103] After the Rule was proposed, some practitioners carefully acknowledged the import of the "serious questions" around noncompliant SPACs under the Rule, see SULLIVAN & CROMWELL LLP, *supra* note 18; SIDLEY, *Expansive New SEC Rule Proposals Seek to Rewrite the SPAC Playbook* (April 2022), but others failed to mention them, see WHITE & CASE, *supra* note 18, and others openly advised SPACs that cannot comply with the Rule that the ICA does not apply to them, DAVIS POLK, *SPACs Remain in the SEC's Crosshairs*, HARV. L. SCH. F. ON CORP. GOV. (April 2022) ("For those SPACs that are unable to complete a business combination within the . . . period required by the safe harbor, the proposed safe harbor does not otherwise amend or modify the existing SEC rules regarding investment companies, which as noted above, we and the law firm community continue to believe do not apply to SPACs.").

Whether or not SPACs ought to be regulated as investment companies, we can still use the analogy between SPACs and investment funds to discover insights that aid our descriptive understanding. The model that makes sense of the divided structure in investment funds can also help us understand it in SPACs.[104]

Consider first the tendency of many SPACs to be sponsored by private equity and hedge fund advisers. This tendency makes sense because SPAC management and investment fund management are essentially the same business. Although the analytical skills required of SPAC and hedge fund managers differ slightly, the structure of the business model is virtually identical. Indeed, one way to understand the SPAC craze is to see it as one instance of asset managers' larger encroachment into the traditional domains of bankers.[105] Much as private equity and mutual fund managers used loan funds and money market funds to swallow pieces of the commercial lending and retail banking businesses, private equity and hedge fund managers are now using SPACs to swallow the business of IPO underwriting.

The model also explains elements of SPAC structure. SPACs' use of redemption rights recalls the use of similar rights in mutual funds and hedge funds. In mutual and hedge funds, redemption rights compensate for the absence of meaningful control. Since these funds do not employ their managers, they cannot control their managers directly.[106] The right to exit by redemption thus substitutes for the right to voice. SPACs follow a similar logic, using redemption rights to compensate for the limits on investor voting rights. De-SPAC transactions follow the same logic in reverse. Unlike SPACs, the operating companies that survive mergers with SPACs do not use the divided structure, instead employing their managers directly and offering some subset of the shareholders control. The reason is that once a de-SPAC transaction is done, the right to redemption expires and control becomes a necessity. Exit stops substituting for voice, making voice a necessity.

SPACs' legal separation from their sponsors also makes sense. Because an investment fund adviser often promotes many different funds over time, the use of distinct entities for the adviser and each of its various funds helps to keep all of the income and liability streams distinct. When Lehman Brothers went bankrupt, the only reason the assets of its hedge funds did not get

[104] [Morley, Separation of Funds and Managers.]
[105] Andrew F. Tuch, *The Remaking of Wall Street*, 7 HARV. BUS. L. REV. 315 (2017). .
[106] Morley, Separation of Funds and Managers.

dragged into the bankruptcy estate of the bank was that the hedge funds and the bank's advisory subisidiary each used separate entities with separate owners. SPAC sponsors employ separate entities for their SPACs for similar reasons.

SPACs also use depository trusts to hold their assets as they search for deals. This is consistent with the tendency of registered investment companies such as mutual funds to do the same.[107] The separation is useful because it keeps the external fund manager that controls a fund or SPAC from raiding the vehicle's assets for its own purposes.

A further similarity is SPACs' tendency to raise horizontal conflicts of interest akin to investment funds. When a fund manager operates several vehicles at the same time, the interests of those vehicles often conflict.[108] Two investment funds cannot both take the same investment opportunity at the same time. SPACs raise similar problems. The PSTH-UMG transaction dramatized these conflicts with special clarity, after Pershing Square caused its hedge funds to take the investment opportunity in UMG that Pershing Square had originally negotiated for its SPAC.

SPACs also produce many of the same struggles inside of their sponsors that investment funds produce inside of their advisers. Employees of private fund advisers often come into conflict with one another about the ownership of opportunities to create new funds. Once an adviser has successfully closed one venture capital fund, its employees often want to leave to start new venture capital funds, creating a conflict over who owns the opportunity to do so. We understand that SPAC sponsors and their employees often face similar conflicts. These conflicts are connected to the tendency of investment fund advisers and SPAC sponsors to promote many vehicles serially over time, which in turn is deeply connected to the use of a divided structure that allows management firms to outlast their funds and forces the managers to serially return to investors for more investments in a cycle that promotes accountability.[109]

VI. Conclusion

[107] The use of trusts is required in registered investment companies by the ICA. 15 U.S.C. § 80a-17(f).
[108] William A. Birdthistle & M. Todd Henderson, *One Hat Too Many: Investment Desegregation in Private Equity Funds*, 76 U. CHI. L. REV. 45 (2009); William W. Clayton, *Preferential Treatment and the Rise of Individualized Investing in Private Equity*, 11 VA. L. & BUS. REV. 249 (2017); John Morley, *Too Big to be Activist*, 92 S. CAL. L. REV. 1407 (2019);
[109] PAUL GOMPERS & JOSH LERNER, THE VENTURE CAPITAL CYCLE, 8 (2d ed. 2004); Morley, *supra* note 5.

The legal and economic resemblance between SPACs and investment funds is clear. SPACs rely on external managers like investment funds, invest in the same assets as investment funds, are operated by many of the same people as investment funds, and are vulnerable to the same unique agency conflicts as investment funds. The knowledge of this resemblance offers two insights: first, that SPACs must comply with the laws governing investment funds; and second, that the same economic and conceptual models that make sense of the organization of investment funds can also make sense of SPACs.