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John Coates Calls for SPAC Myth-Busting

WRITTEN BY

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In a recent interview with *Law360*[i], Harvard Law Professor and former U.S. Securities and Exchange Commission official[ii] John Coates expressed the need for regulators to be more aggressive in disputing myths perpetuated by the special purpose acquisition company (SPAC) industry and promoters.

Coates' SPAC Study

Coates' interview follows the study he published last month, titled "SPAC Law and Myths."[iii] The study begins boldly, stating: "[SPACs] were the financial-legal hit of 2021, before they weren't." Coates' study describes how SPACs spiked over the past year, in large part due to how SPAC promoters described both SPACs' financial attributes, as well as applicable governing law. Many of these lofty descriptions touted by the promoters, Coates opines, were myths — and those myths have been debunked.

The "myths" Coates describes include the promoters' claims that:

1. Securities regulations ban projections from being used in conventional IPOs;

2. Liability related to projections was lower and more certain in SPACs than it was and is;

3. The SEC's registration process makes going public through an IPO slower than through a SPAC;

4. The SEC changed SPAC accounting rules in early 2021;

5. These accounting changes were the primary reason the SPAC wave slowed and peaked; and

6. The Investment Company Act of 1940 (the 40 Act) does not apply to SPACs.

Coates expresses concern that these myths were not understood by the general unsophisticated public, but instead to "business journalists, sophisticated SPAC sponsors and owner-managers of SPAC targets." The harm in this, Coates argues, includes the exploitation of the "credence good" character or professional advice, the perpetuation of "deep fraud," and market distortion. What is Coates' solution to these serious ills? He urges regulators to speak "frequently and clearly" about the SPAC law and all its uncertainties.

The Interview

In his interview with *Law360*, which took place over email, the interviewer asked Coates what his paper means by "deep fraud."[iv] Coates responded that, with that term, he is "trying to convey the way that promoters of financial products deploy legal (and other) myths to generate fees. It's 'deep' fraud because it's not ordinary fraud — they aren't lying directly to a client to get a fee."

The interviewer also asked about Coates' perceived myth that SPAC target companies can more freely discuss projections, while conventional IPOs do not foster such open discussion. Coates explained that the "myth" lies in the implicit assumption that projections cannot be freely discussed with respect to conventional IPOs — there is, in fact, no SEC rule prohibiting such discussions. "If projections are being discussed 'more freely' in SPACs," Coates explained, then "that is only because that is a choice made by issuers and their professionals."

In April 2021, the SEC issued guidance, advising that SPAC warrants may need to be classified as liabilities rather than equity, which Coates argued was held out by promoters as a "change in SEC policy" — another "myth" according to Coates. When asked about this, Coates responded that *guidance* from the *staff* at the SEC is not the same thing as *SEC* guidance. This is important, Coates argues, because "SEC statements have the force of law," and "staff statements do not." Further, Coates stated that "the Staff statement simply applied long-standing Financial Accounting Standards Board standards to specific warrant facts," an analysis that would have been the same had it been conducted five years ago prior to the SPAC boom.

When asked to what extent regulators are responsible for the alleged myths that SPACs are more legally advantageous than they actually are, Coates responded that while "it is not illegal for people to spread myths," the SEC has a responsibility to engage in "counter speech," which it has done for some time and continues to do. The primary responsibility, Coates wrote, lies with the capital markets professionals trusted to advise "companies, investors, and entrepreneurs correctly in our market system."

A focal point of Coates' study is the industry's insistence that the 40 Act does not apply to SPACs. In the interview, Coates reiterated his study's assertion that the issue is not as clear-cut as the belief of 60 law firms that endorsed a statement (claiming that SPACS are not investment companies). The "short version" of Coates' argument is that "there is no statute, or rule, or previous SEC statement that the law firms cite to support their position, and there are at least some court cases and staff statements that suggest their analysis may be wrong." Coates notes, however, that he is not asserting whether SPACs actually are investment companies — he merely states that the issue is not clear-cut.

The interviewer pointed out that SPACs' surge in popularity may indicate that companies wishing to go public prefer alternatives to traditional IPOs, and asked Coates about the benefits, if any, that SPACs can provide. Coates described these benefits, including enhancing "competition in the primary capital formation and listing process," as well as allowing for "better matching among managers, board members, anchor investors, and private businesses." However, Coates urges that these benefits should be considered *separately* from any "mythical claims that [SPACs] allow for regulatory arbitrage or which attribute their success or failure to over- or under-regulation."

Taking a no-nonsense approach to his thesis, Coates writes: "Ultimately SPAC market participants themselves would be better off dropping the legal nonsense and emphasizing the economic reality of what might make the product a good one."

Keeping an Eye on the SEC

The SEC has stated its plans to increase disclosure requirements for SPACs, having made them the subject of staff guidance and statements, as well as recommendations by the SEC's Investor Advisory Committee.[v] Coates seems to choose not to tackle how the SEC should respond — aside from his recommended "counter speech." He wrote: "Whether and how the full suite of regulations governing all forms of capital raising should be modified is a big topic, and one that I hope to return to."

Troutman Pepper's SEC Enforcement practice will be closely monitoring developments in this area. Anyone with questions on this topic should feel free to contact the authors of this article.

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[i] Any references to, our quotes from, the *Law 360* interview were sourced from the interview itself, which is available here: https://www.law360.com/compliance/articles/1472054/ex-sec-official-urges-regulators-to-counter-spac-myths-?nl_pk=faff73c1-64e5-4df5-993d-278057f54715&utm_source=newsletter&utm_medium=email&utm_campaign=compliance.

[ii] At the SEC, Professor Coates previously served as the acting director of the division of corporation finance and as general counsel.

[iii] Any references to, our quotes from, Coates' study were sourced from the study itself, which is available here: file:///C:/Users/geiserlh/Downloads/SSRN-id4022809.pdf.

[iv] *See* https://www.law360.com/compliance/articles/1472054/ex-sec-official-urges-regulators-to-counter-spac-myths-?nl_pk=faff73c1-64e5-4df5-993d-278057f54715&utm_source=newsletter&utm_medium=email&utm_campaign=compliance.

[v] Guidance: https://www.sec.gov/corpfin/disclosure-special-purpose-acquisition-companies; Statements: https://www.sec.gov/news/public-statement/spacs-ipos-liability-risk-under-securities-laws; Recommendations: https://www.sec.gov/spotlight/investor-advisory-committee-2012/draft-recommendation-of-the-iap-and-iao-subcommittees-on-spacs-082621.pdf.

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