Special Purpose Acquisition Companies – The Evolving Regulatory Regime

V.K. Unni

SPACs (Special Purpose Acquisition Companies) have become popular during the last few years, with a large number of SPAC Initial Public Offerings (IPOs) on US stock exchanges in the first three quarters of 2020 which is almost the same number of non-SPAC IPOs on those exchanges in the same time span. There could be many reasons for the recent interest involving SPAC activity and SPACs tend to become more attractive when markets are experiencing a lot of uncertainty in the wake of the Covid-19 pandemic. Even though it is very early to predict whether current interest in SPACs will continue or not, recent trends seem to suggest that there exists ample space in the market for SPACs as a viable option for taking private companies public.

SPAC- The U.S. Model

A SPAC is, in fact, a shell company that undertakes an IPO to raise capital with the objective of utilizing the funds so raised to complete a business combination with another company having some operations. The entire funds raised from the IPO are safely kept in a trust/escrow account and are only made available to the SPAC when it completes a business combination. After the completion of the IPO, a SPAC generally has about 18-24 months to acquire one or more operating businesses with a value equal to at least 80% of the value of the funds in the trust account. But on many occasions, SPACs often target larger operating companies so as to offset the potentially dilutive impact of the SPAC capital structure, which is a mix of the public shareholders of the SPAC and the SPAC sponsor with the legacy shareholders of the operating business. As a result of the 80% rule, relatively smaller companies are generally not considered suitable acquisition targets for larger SPACs, even though on some occasions the target is combined with one or more additional targets to comply with the 80% threshold. However, such multi-target business combinations are not common.

Shareholders of the SPAC will need to approve the business combination, and they have the opportunity to redeem their SPAC shares for a pro-rata share of the funds in the trust account, i.e., the IPO investment plus interest, instead of having those shares rollover into shares of the combined business. If for some reason the SPAC is unable to execute a business combination transaction within the prescribed timeline, the SPAC will be liquidated and funds in the trust account will be refunded to its shareholders. The underwriting discount is structured in such a manner that the underwriters usually receive 2% of the gross proceeds at the time of closing the SPAC IPO. Along with this, another 3.5% shall be deposited in the trust account and will be paid to the underwriters only upon, and subject to, successful execution of the business combination.

According to the regulations, SPACs may not identify acquisition targets before the closing of the IPO. In case a target is under consideration at the time of the IPO, then by definition, the offering is *not* a SPAC IPO. SPACs are generally sponsored by a financial sponsor or investment team, who would be having a track record of acquiring growth companies and thereafter realizing value through the public markets. The sponsor shall be responsible for providing capital for IPO expenses and other operating expenses during the search for a business combination target and would be allotted shares in the SPAC which generally represents about 20% of the shares outstanding post-IPO.

Once a target is identified, the SPAC will acquire the target through a transaction which is generally termed "de-SPAC". In case additional funds are needed to pursue the acquisition, the SPAC will evaluate options to raise funds from private equity investors. After a successful de-SPAC, the target company will become the subsidiary of the SPAC or a new holding company whose shares will be listed on the stock exchange.

For the last two decades, SPACs have been around in the US. However, their popularity has grown manifold in recent years for various reasons, such as well-established and highly credible sponsors involved in SPAC transactions, high growth potential of the target businesses, shorter timelines compared to traditional IPOs, etc. According to a Harvard Law School study, the year 2021 saw 679 SPAC IPOs globally worth US$172.2 billion.

Indian Scenario

In India, SPAC deals are still at a very early stage. Before India can emerge as a sought-after destination for SPAC transactions, more clarity is required on certain legal and regulatory issues. In August 2021, India's largest renewable energy company – Renew Power started trading on NASDAQ through a SPAC listing and this has naturally generated a lot of interest in SPACs from Indian investors.

In March 2021, the Securities and Exchange Board of India (**SEBI**) constituted an expert committee to evaluate the feasibility of bringing regulations for SPACs in India. The SEBI has recently informed the Parliamentary Standing Committee on Finance that it is having widespread discussions about building a dedicated framework for SPACs in the Indian capital markets.

Apart from SEBI, the Ministry of Corporate Affairs (Government of India) in its Company Law Committee Report published in March 2022 has made some interesting observations on SPACs. The Committee recommended introducing an enabling provision to recognize SPACs under the Companies Act 2013 and allow entrepreneurs to list a SPAC incorporated in India on domestic and global exchanges. The Committee further recommended some changes in the Companies Act 2013, such as relaxing the requirement to carry out businesses before, and laying down the provisions on exit options to the dissenting shareholders of a SPAC if they disagree with the choice of the target company identified. The Committee also noted that foreign listing of Indian SPACs could be considered under Sections 23(3) and 23(4) of the Companies Act, 2013, which allows certain classes of companies to list their securities on stock exchanges in permissible foreign jurisdictions.

IFSCA (Issuance and Listing of Securities) Regulations, 2021

In 2019, India passed the International Financial Services Centres Authority Act **(IFSCA Act)**. The regulator set up under the said statute, i.e., the International Financial Services Centres Authority (IFSCA) has come up with IFSCA (Issuance and Listing of Securities) Regulations, 2021, to enable SPACs in IFSCs like GIFT City. According to the Regulations, in order to be eligible for raising money through an IPO in an IFSC stock exchange, a SPAC must not have identified the target business combination prior to the IPO and should adhere to certain provisions for redemption and liquidation in line with the regulations. Furthermore, the sponsors of a SPAC should have a good track record in SPAC transactions, business combinations, fund management, or merchant banking activities. As per the Regulations, a sponsor is a person who is sponsoring the formation of the SPAC and shall include persons holding any specified securities of the SPAC prior to the IPO. The Regulations prohibit the issuer from listing its securities if the issuer or any of its sponsors is – (a) debarred from accessing the capital market, (b) a wilful defaulter, or (c) a fugitive economic offender. As regards the timing of the offer, the Regulations specify that the offer shall be made by the issuer within a period of one year from the date of issuance of observations by IFSCA.

The IFSCA (Issuance and Listing of Securities) Regulations, 2021, also deals with the content of the offer document. As per this, the offer document shall contain all material disclosures which are true, correct, and adequate to enable the investors to take an informed investment decision. It shall be the responsibility of the lead manager to exercise due diligence and satisfy themselves about all aspects of the issue including the veracity and adequacy of disclosures in the offer document. The issue size shall not less be than $50 million and the sponsors shall hold between 15% and 20% of the post-issue paid-up capital. Furthermore, the sponsors shall also have an aggregate subscription in terms of amount in the SPAC company prior to or simultaneous to the IPO, amounting to at least 2.5% of the issue size or USD 10 million, whichever is lower.

With regard to pricing, the Regulations prescribe that the issue shall be undertaken through a fixed price mechanism, and the issuer shall determine the price in consultation with the lead manager(s). The price of the equity shares in the IPO shall not be less than $5 per share. The IPO shall be kept open for between three and ten working days. The minimum application size in a SPAC IPO shall be $100,000.

The Regulations state that the IPO will be successful only if the following conditions are satisfied: (a) The minimum subscription received in the issue shall be at least seventy-five percent of the issue size, and b) The minimum number of subscribers shall be 50. The Regulations also mandate that no single application shall be allotted more than 10% of the post-issue capital and the allotment to investors shall be on either a proportionate basis or a discretionary basis, as disclosed in the offer document.

The Regulations further stipulate that the SPAC issuer shall ensure that the entire proceeds of the IPO are kept in an interest-bearing escrow account controlled by an independent custodian until the consummation of the SPAC's business combination. The escrow funds shall be invested only in instruments disclosed in the offer document and shall include only short-term investment grade liquid instruments. The interest and other income derived from the amount placed in the escrow account may be withdrawn by the SPAC issuer for the following purposes: (a) Payment of taxes; and (b) General working capital expenses, subject to prior approval by way of a special resolution of the shareholders other than sponsors.

The SPAC shall seek prior approval by way of a majority of shareholders other than the sponsors, for the proposed business combination. In case any shareholder (other than the sponsors) has voted against the proposed business combination, then that shareholder shall have the redemption right for converting its securities into a pro-rata portion of the aggregate amount held in the escrow account. Similarly, if there is any change in control of the SPAC, the SPAC issuer shall provide the redemption option to the shareholders (other than the sponsors) for converting their securities into a pro-rata portion of the aggregate amount held in the escrow account. The SPAC issuer shall complete the business combination within the timeline disclosed in the offer document and in any case, within 36 months from the date of listing on a recognized stock exchange.

If the business combination is not completed within the permitted time frame, the escrow account shall be liquidated. In the event of liquidation and delisting, the sponsors shall not participate in the liquidation distribution. It shall be the duty of the SPAC issuer to ensure that the businesses acquisition shall have an aggregate fair market value equal to at least 80% of the aggregate amount deposited in the escrow account, excluding deferred underwriting commissions held in escrow and any taxes payable on the income earned on the escrowed funds. The SPAC and the sponsors shall also ensure that there is no related party transaction or connection of the sponsors or any of their associates with the business combination.

With respect to the post-business combination, the Regulations specify that the *resulting issuer* shall immediately disclose details regarding the completed transaction to the recognized stock exchange. The resulting issuer is the resultant entity that trades on the stock exchange after the completion of a business combination by a SPAC. The resulting issuer shall be required to meet the listing eligibility criteria set out in these regulations within 180 days, in order to continue listing on the recognized stock exchange. The shareholding of the sponsors of the SPAC in the resulting issuer shall be locked up for a period of one year from the date of closing of the business combination. The shareholding of the promoters, promoter groups, controlling shareholders, directors, and key managerial personnel of the resulting issuer shall also be locked up for a period of one year from the date of closing of the business combination.

The regulations also contain some detailed provisions if any warrants are issued as part of the IPO. In such cases involving the issuance of warrants, the SPAC ensures the following

a) Each unit may consist of one share and no more than one share purchase warrant;

b) The exercise price of the warrants shall not be lower than the price of the equity shares offered in the IPO;

c) The warrants may be detached from the equity shares and traded separately (from the equity shares) on the recognized stock exchanges provided that details have been appropriately disclosed in the offer document;

d) The warrants shall not be exercisable prior to the completion of the business combination;

e) In case of liquidation of SPAC, the warrants shall expire; and

f) The warrants shall not have any entitlement to the funds lying in the escrow account upon liquidation or redemption.

IFSCA (Issuance and Listing of Securities) Regulations, 2021 is India’s first attempt to allow and regulate SPACs, and it is expected that SEBI will soon come up with its own regulations to facilitate listing of SPACs on Indian stock exchanges.

Legal and Regulatory Barriers regarding SPACs in India

Under the Indian Company law whenever a company is formed it should have a Memorandum of Association (MoA) which contains various important clauses like the objects clause of the company. For a SPAC, it would be almost impossible to specify the objects because at the time of its constitution, SPAC has not identified a target to accomplish a business combination. This can prove to be a barrier for transactions involving SPAC in India.

Furthermore, when it comes to fundraising, the existing regulatory framework prescribed by the SEBI, i.e., Issue of Capital and Disclosure Requirement Regulations 2018 (ICDR) has detailed provisions regarding the eligibility criteria that the issuer must satisfy. A SPAC might find it very difficult to comply with these conditions. According to ICDR, a company undertaking an IPO shall have during the last three years an average operating profit of at least Rs. 15 crores, net tangible assets of at least Rs. 3 crores, and a net worth of at least Rs. 1 crore. Furthermore, if the company has changed its name within the last one year, at least 50% of the revenue, should be earned by the company from the activity indicated by its new name. If the abovesaid conditions are not satisfied then the only option available to the company is to undertake an IPO through the book-building process, where it allots at least 75% of the net offer to qualified institutional buyers and to refund the full subscription money if it fails to do so. All these conditions can pose serious challenges to SPACs in India as they will not be able to satisfy most of the conditions mentioned under the ICDR 2018.

Conclusion

SPAC is a specialized operating and investment entity that brings together various stakeholders like sponsors, private operating companies, and public market investors. While there are numerous challenges to the success of SPACs in India, the US experience demonstrates that SPACs can offer a viable alternative to traditional IPOs for publicly listing their shares. By framing IFSCA (Issuance and Listing of Securities) Regulations, 2021, the International Financial Services Centres Authority has laid the foundation for regulating SPACs, and in the process, it has encouraged a wider group of investors to utilize the IFSC platform to explore the burgeoning investment opportunities within and outside India. It is anticipated that domestic regulators like the SEBI will soon come up with regulations covering SPACs to open up new vistas for such companies and domestic investors.

Additional Readings

International Financial Services Centres Authority. 2021. International Financial Services Centres Authority (Issuance and Listing of Securities) Regulations, 2021. https://ifsca.gov.in/Viewer/Index/202

Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2018. https://www.sebi.gov.in/legal/regulations/sep-2018/securities-and-exchange-board-of-india-issue-of-capital-and-disclosure-requirements-regulations-2018-_40328.html

Company Law Committee 2022. Report of the Company Law Committee. Government of India. March 2022.https://www.mca.gov.in/bin/dms/getdocument?mds=bwsK%2FBEAFTVdpdKuv5IR5w%3D%3D&type=open

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