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Special Purpose Acquisition Companies and the Investment Company Act of 1940

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Last week, a stockholder in three special purpose acquisition companies ("SPACs"—Pershing Square Tontine Holdings, Ltd. ("PSTH"), GO Acquisition Corp. and E.Merge Technology Acquisition Corp) brought novel claims against each SPAC, its sponsor and directors.[1] The suits claim that each SPAC is an unregistered investment company and that the compensation paid by the SPAC to its sponsor and its directors (notably the founder shares and warrants, or comparable interests in the case of PSTH) was illegal and void under the Investment Company Act of 1940 (the "Act").[2] The suits have received a fair amount of press, in part because PSTH and its attempted investment in Universal Media Group ("UMG") are high profile, and in part because two of the lawyers representing the plaintiff in the suit are Robert J. Jackson, Jr., an NYU law professor and former Securities and Exchange Commission ("SEC") commissioner (who served in that role roughly two years from January 2018 to February 2020), and John Morley, a Yale Law professor.

SPACs raise money in an IPO with a stated purpose of identifying and acquiring a business or assets (referred to as a business combination). During the pendency of the search for a business combination, the IPO proceeds are kept in a trust account, which is either held in cash or invested in short term U.S. Government securities (or mutual funds that invest solely in U.S. Government securities). In connection with consummating the business combination, the U.S. Government securities or mutual funds are sold, and holders of SPAC stock sold in the SPAC's IPO are entitled to redeem their stock for their pro rata portion of cash from the trust account. If the SPAC does not consummate a business combination within a set period of time from its IPO, it is obligated to redeem all the public holders' stock for their pro rata portion of the trust account.

The main allegations in the suits relating to investment company status of the SPACs are:

- Nearly all of the assets of the SPACs are invested in U.S. Government securities or mutual funds.

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[1] The suit against PSTH additionally named certain Pershing Square funds and fund management entities.
[2] Two of the complaints also alleged violations of the Investment Advisers Act of 1940.

- Investing in securities is basically the only thing the SPAC has ever done and, in the case of PSTH, it spent nearly all of its time negotiating a transaction in which it would have invested in still more securities.
- The abstract intention to identify an operating business to acquire at some point in the future is insufficient to allow an entity that qualifies as an investment company to avoid regulation under the Act.

There are two main alternative prongs to the definition of an investment company under the Act:

- "an issuer which is or holds itself out as being engaged *primarily*, or proposes to engage *primarily*, in the business of investing, reinvesting, or trading in *securities*." This type of company is often referred to as an "orthodox investment company," i.e. as a company holding itself out as being engaged in an investment company business; or
- "an issuer which is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading 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 [U.S.] Government securities and cash items) on an unconsolidated basis". This type of company is often referred to as an "inadvertent investment company".[3]

The second prong of the definition of an investment company mentioned above—the inadvertent investment company prong—is not at issue in the suits, and is not an issue for SPACs because 100% of a SPAC's tangible assets are invested in cash or short-term U.S. Government securities (or mutual funds that invest solely in U.S. Government securities), meaning the 40% threshold is never exceeded.

The first prong of the definition—the orthodox investment company prong—is what the plaintiff alleges causes the three SPACs to be investment companies. At base, the factual allegations are that all three SPACs have invested in securities (the U.S. Government securities, or mutual funds investing in same, in their trust accounts) since inception, and in the case of PSTH that it intended to invest in securities in the UMG transaction.[4]

Under the orthodox investment company prong, the key question is what the primary business of the SPAC is (or what it proposes to be). In 1947, the SEC developed a five-factor test for determining whether an issuer is primarily engaged in an investment company business, in a response to a request for an order that a company was primarily engaged in a non-investment company business.[5] The five factors are:

1. The company's history
2. The way the company represents itself to the investing public today
3. The activities of its officers and directors
4. The nature of its assets; and

[3] Act sections 3(a)(1)(A) and 3(a)(1)(

[4] The other two SPACs have not yet announced business combination targets.

[5] See *In the Matter of Tonopah Mining Co. of Nevada* (Investment Company Act Release No. 1084, 26 SEC 426 at 427, July 22, 1947) ("*Tonopah*").

5. The sources of its income.

Historically, courts and the SEC have emphasized the last two of the factors (the nature of an issuer's assets and the sources of its income). However, in a 2007 case (*SEC v. National Presto Industries, Inc.* ("*Presto*")), the United States Court of Appeals for the Seventh Circuit held that "what principally matters is the beliefs the company is likely to induce in investors. Will its portfolio and activities lead investors to treat a firm as an investment vehicle or as an operating enterprise?"[6] *Presto* involved a company that had historically operated as a manufacturer of consumer goods and munitions but subsequently invested a substantial portion of its assets into securities. In determining National Presto Industries, Inc. was not an investment company, the court concluded "Reasonable investors would treat Presto as an operating company rather than a competitor with a closed-end mutual fund."[7] This is consistent with *Tonopah*, which stated that "More important… the nature of the assets and income of the company … **<u>was such as to lead investors to believe</u>** that the principal activity of the company was trading and investing in securities."[8] In *Tonopah*, the SEC concluded that a company was engaged in an investment company business not only where "the company's only source of net income consists of interest, dividends and profits on the sale of securities," but also where the SEC could find "**<u>nothing to indicate that this situation will be changed substantially in the foreseeable future</u>**."[9]

With regard to the first *Tonopah* factor (the company's history), SPACs are dissimilar from the company at issue in *Presto* and other companies that initially were operating companies and subsequently invested a substantial portion of their assets into securities. While SPACs do not have a historical operating company business to indicate to investors that the purpose of the SPACs is to conduct an operating company business, they also have no history to suggest that their primary business is to invest in securities. The SEC has determined that many companies without historical operating company businesses are not primarily engaged in an investment company business including, for example, bona fide research and development companies (for which the SEC adopted a special exemption from the Act, after adopting an order that deviated from the *Tonopah* factors for such companies) and "blank check companies" as defined in Rule 419 under the Securities Act (which are structured very similarly to SPACs).

With regard to the way SPACs represent themselves to the investing public (the second *Tonopah* factor) and the operations of SPACs' officers and directors (the third *Tonopah* factor), the court's decision in *Presto* supports a conclusion that SPACs are not engaged in an investment company business. In *Presto*, the court noted that "Presto presents itself to the public (and to investors) as an operating company. That's how its web site, its annual reports, and its publicity all depict it."[10] Similarly, SPACs represent themselves as hunting for a business combination, not investing in securities for the purpose of income or appreciation on the securities.[11] Moreover, unlike certain "model inadvertent investment companies" where directors and senior managers spend most of their time managing investment portfolios, *Presto* dealt with a company where "95% of its managers' time [was] devoted to running [Presto's] consumer-

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[6] *SEC v. National Presto Industries, Inc.*, 486 F.3d 305, 315 (7th Cir. 2007).
[7] *Id.*
[8] *Tonopah* at 431 (emphasis added).
[9] *Id* at 432 (emphasis added).
[10] *Presto* at 313.
[11] If a SPAC were to determine to hold 100% of its tangible assets in cash, the SPAC's representations would not even arguably be that the SPAC intended to be in the business of investing in securities. The authors doubt this would meaningfully change investors' perception of the principal activity of the SPAC.

products and military-ordnance businesses."[12] Similarly, SPAC officers and directors are focused on facilitating the SPAC's business combination, and not on the meager investment returns offered by short-term U.S. Government securities. Reasonable investors invest in SPACs not because of the SPACs' investments in U.S. Government securities, but for the option to participate in the business combination or to redeem their stock for cash. Similar to the company at issue in *Presto*, SPACs' stock prices move in response to changes in the expectation that the SPACs will identify and consummate attractive business combinations, rather than "slight annual changes in … investment income."[13]

With regard to the nature of SPACs' assets (the fourth *Tonopah* factor) and the sources of SPACs' income (the fifth *Tonopah* factor), even though there may be a period of time where a SPAC's only assets are securities and cash and only source of income consists of interest earned on assets held in the trust account, there is plenty to indicate that such a situation "will be changed substantially in the future"[14]—i.e., the SPAC will either complete a business combination, at which point its net income will be dependent upon the operations of the post-business combination company, or it will dissolve and liquidate. Again, this is not dissimilar from research and development companies and Rule 419 blank check companies.

Based on the above, we believe that there is no legal basis to conclude that a SPAC is an investment company under the Act, provided that (i) the SPAC proposes[15] to be engaged in an operating business, once it identifies and completes a business combination, and (ii) the SPAC holds short-term U.S. Government securities and qualifying money market funds in its trust account pending completion of its business combination.

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[12] *Presto* at 313.

[13] *Id.*

[14] *Tonopah* at 432.

[15] *Presto* dealt with the question of whether or not a company was "engaged in" an investment company business. However, an issuer that merely "proposes to engage in" an investment company business would also be an "investment company" under the Act. "Proposing" or "Proposes" is not defined in the Act. However, with respect to whether a company "proposes to engage" in an investment company business, the SEC has stated that "an issuer 'proposes' to engage primarily in the investment company business when such engagement has been set before the mind or brought forward[.]" (See *In the Matter of Townsend Corporation of America and Townsend Management Company* (Investment Company Act Release No. 4045, 42 SEC 282 at 322, September 2, 1964).) To the extent a SPAC proposed to be in an investment company business as its business combination, that might change the outcome of the five factor test described above.