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Recent SEC Guidance Classifies Some SPAC Warrants as Liabilities

Recent SEC accounting guidance reclassifying SPAC warrants as liabilities instead of equities[1] has drawn new attention to SPACs and, according to public sources, significantly slowed SPAC issuance. In light of these developments, we take a moment to discuss SPACs and SPAC warrants for the newly interested.

SPACs

To understand SPAC warrants, we must first understand SPACs. SPAC stands for *special purpose acquisition company*.[2] These companies are a type of blank check company (essentially shell companies) defined as having "no specific business plan or purpose or has indicated its business plan is to engage in a merger or acquisition with an unidentified company or companies, other entity, or person."[3] A SPAC is generally created to transition a privately held company to a public traded company. Therefore, the goal of the SPAC is to acquire a company that is looking to go public, sometimes called a target company. Essentially, the SPAC serves as an alternative to a traditional IPO, one that involves an additional step, i.e., the formation and IPO of the SPAC.

SPACs can be cheaper than traditional IPOs, have shorter timelines, and are allowed to project revenues and profitability (via an S-4) where traditional IPOs can only share historical financials (via an S-1).

Formation of a SPAC

The SPAC is formed by "founders or sponsors" who rely on their business acumen to promote the SPAC and identify target companies. They provide the initial capital for the company in

[1] Coates, John and Paul Munter. "Staff Statement on Accounting and Reporting Considerations for Warrants Issued by Special Purpose Acquisition Companies ('SPACs')." *U.S. Securities and Exchange Commission* (Apr. 12, 2021) <https://www.sec.gov/news/public-statement/accounting-reporting-warrants-issued-spacs> (accessed Apr. 23, 2021).

[2] "What You Need to Know About SPACs – Investor Bulletin." *U.S. Securities and Exchange Commission* (Dec. 10, 2020) <https://www.sec.gov/oiea/investor-alerts-and-bulletins/what-you-need-know-about-spacs-investor-bulletin> (accessed Apr. 23, 2021).

[3] 17 CFR § 230.419 - Offerings by blank check companies.

exchange for “founder shares” entitling them to a significant ownership stake upon successful acquisition of a target company. Founders typically engage an investment bank to handle the SPAC IPO. This involves the sale of shares and warrants (together, a “unit”) to the public. The proceeds raised from the sale of SPAC units is placed in a trust account and invested in safe securities such as U.S. treasuries.

Lifespan

When a SPAC successfully goes public, the clock starts ticking to acquire or merge with a target company. If no suitable deal is identified, the trust fund gets redistributed to shareholders. If and when a target company is identified, the SPAC sponsors will publicly announce the details. At this juncture, SPAC investors can vote on whether or not to complete the deal.

SPAC Warrants

When investors buy into a SPAC, they typically buy a “unit.” The unit is comprised of SPAC shares and warrants. Warrants are essentially call options to buy a set amount of stock at a set price at a set future date. Usually, the unit only contains a fraction of a warrant but can include as much as a full warrant per unit. If the SPAC is successful in identifying and merging with a target company (and the strike price is met), investors can redeem their warrants for additional shares. Once the SPAC has been taken public, the SPAC shares and warrants can trade separately after an initial period.

Though warrants have similarities to call options, they contain additional terms that can differ dramatically. For example, they may have redemption clauses entitling redemption of the warrants if the common stock closes above a certain price for a specified number of days.

SPAC Warrant Valuation

The terms of warrants can differ significantly, and valuation needs to carefully consider these specific terms. A modified Black Scholes may be used to value warrants because of their similarity to options. However, there are also many critical differences between options and warrants. For example, a warrant execution may increase the outstanding shares, information on volatility is limited, and there may be a number of unique provisions or characteristics such as execution timeframe or redemption clauses.

The basic considerations in valuing warrants include:

1. Number of shares associated with the warrant
2. Type of stock (common or preferred)
3. Strike (or exercise) price
4. Term/expiration date

SEC Guidance Implications

SPACs have generally classified warrants as equities. However, the new SEC guidance classifying some warrants as liabilities would require SPACs to regularly account for changes in warrant fair value. The major implication of this reclassification is that SPACs would need to update their financial statements if changes in warrant value were material.[4] Besides the additional scrutiny being applied, regular valuation is likely to be expensive and erode some of the advantages of SPACs.

For any additional inquiries, please contact info@vegaeconomics.com.

[4] Coates, John and Paul Munter. "Staff Statement on Accounting and Reporting Considerations for Warrants Issued by Special Purpose Acquisition Companies ('SPACs')." *U.S. Securities and Exchange Commission* (Apr. 12, 2021) <https://www.sec.gov/news/public-statement/accounting-reporting-warrants-issued-spacs> (accessed Apr. 23, 2021) ("If, after considering this statement, a registrant and its independent auditors conclude that there is an error in previously-filed financial statements, the registrant would then need to evaluate the materiality of the error.").