

A Primer on Special Purpose Acquisition Companies

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Recent Market for SPACs

- **While overall IPO market has lagged, SPAC IPOs have remained resilient**
 - 70 SPACs have completed IPOs since 2004, raising \$4.6 billion, with 27 SPACs completing IPOs in 2006 alone, raising \$2.2 billion
 - SPACs represented approximately 12% of total IPO market in 2005, and approximately 22% of total IPO market in first quarter of 2006

- **SPACs have had success finding acquisitions**
 - Of 12 SPACs that completed IPOs in 2004, 7 have successfully completed acquisitions, and 4 have acquisitions in process
 - Only one SPAC (China Mineral Acquisition) has been forced into liquidation

Increase in Size of SPAC Offerings

Trend towards larger IPO sizes

- 2004: SPACs raised \$450 million
 - Average size: \$35 million
- 2005: SPACs raised \$2 billion
 - Average size: \$69 million
- First half of 2006: SPACs raised \$1.6 billion
 - Average size: \$76 million
- Marathon Acquisition Corp. raised \$300 million in August 2006
- Reflects influx of larger underwriters (e.g., Citigroup, Merrill Lynch, Deutsche Bank, etc.)

What is a SPAC?

- Business entity organized to acquire one or more operating companies through a business combination
- Specified deadline for completion of business combination
- Primary objective of raising funds through a public offering of its securities
- Exempt from “Blank-Check Company” Rule 419

How are SPACs Structured?

- Founders (i.e., the SPAC management team) invest initial capital to form SPAC
 - Founders' shares typically sold for nominal value
 - Designed to ensure founders retain 20% of equity after IPO
- IPO consists of units, composed of shares and warrants
- SPACs are subject to restrictions on operations
 - Deadline for business combination (e.g., 12-18 months)
 - Size requirement for business combination (e.g., 80% of net assets)
 - No compensation to founders
- SPACs often have Audit Committee and corporate governance structures similar to other operating companies
- Underwriters play a large role in pre-IPO structuring of SPAC
- Significant percentage of IPO proceeds (95%+) are placed in a trust account until business combination or liquidation

Founders and Management Team

- Well known private equity and hedge fund operators
- Current and former mutual fund managers
- Assorted politicians and corporate executives
- Notable officers include:
 - Former counterterrorism official Richard Clarke
 - Former Apple executives Steve Wozniak, Gilbert Amelio, and Ellen Hancock
 - Former Congressman Thomas McMillen
 - Former undersecretary for federal Department of Homeland Security Asa Hutchinson
 - Former CEO of Apollo Investment Corp. Michael Gross

Securities Offered

- Units offered in IPO consist of:
 - One share of common stock
 - One to two warrants exercisable for one share of common stock
- IPO price set between \$6.00 and \$8.00 per unit
 - Trend towards \$8.00 IPO price
- Units separate on a voluntary basis into components between 5 business days and 20 calendar days after expiration or exercise in full of underwriters' over-allotment option
- Warrants not exercisable until consummation of a business combination or liquidation
 - Exercise price varies based upon IPO price (\$5.00 to \$6.00)
 - Redeemable for nominal value if SPAC shares trade above set market price

Trust Account

- Trend towards greater percentage of IPO proceeds (up to 100%) held in trust account
 - Fund additional amounts through warrant purchases by insiders concurrent with IPO
 - Use of deferred underwriting discounts
 - Provides greater protection for investors, coupled with greater risk for insiders/underwriters
- Trend towards allowing use of money-market funds
 - Some still have restrictions (i.e., treasury and tax-free bond money-market funds only)
 - Alternative to illiquid investments in U.S. Treasuries
- Trend towards permitting disbursements of all or a portion of interest for use as working capital
 - Counters high percentage of IPO proceeds held in trust account
 - Proceeds used for tax payments and general working capital

Optional Structural Elements

- Additional features either to satisfy market expectations or as a result of agreements involving the Founders and underwriters:
 - Lock-up agreements
 - Pre-IPO warrant purchase commitment agreements
 - Purchase of warrants occurs concurrent with IPO closing
 - Aftermarket warrant purchase commitment agreements
 - Moving away from these agreements
 - Underwriters' purchase option (exercisable at a premium after the business combination)
 - Registration rights agreements

Underwriters

- Began primarily with smaller securities firms
 - EarlyBirdCapital is a frequent underwriter with 23 IPOs raising \$1.2 billion
- Recently larger firms have become involved:
 - Deutsche Bank
 - Cold Spring Capital Inc. (\$120 million)
 - Grubb & Ellis Realty Advisors (\$145 million)
 - Citigroup
 - Marathon Acquisition Corp. (\$300 million)
 - Merrill Lynch & Co.
 - Catalytic Capital Investment Corp. (\$120 million)

Founder Warrant Purchase Commitments

- Historically, management obligated to buy warrants in the aftermarket after IPO
 - Served to align management and investor interests
 - Arguably provided increased liquidity for warrants
- Recent trend is for founders to acquire warrants directly from SPAC
 - Purchase occurs concurrently with the closing of IPO
 - Proceeds are generally placed in trust account

Selection of Prospective Target Operating Companies

- Some SPACs have limited their scope of prospective operating companies to focused market segments
- However, SPACs do not have to limit their scope but can choose to target a company in any field
 - E.g., Marathon Acquisition Corp.; Harbor Acquisition Corporation
- Completed deals occurred in the following market segments:
 - Shipping
 - Energy
 - Dry-bulk cargo
 - Medical products
 - Entertainment/Media

Business Combination Restrictions

- Fair market value of target business must exceed 80% of a SPAC's net assets
 - Some have moved towards “80% of trust account assets” test in lieu of calculating net assets
- Strict deadline for business combination
 - Must consummate a business combination within 12-18 months of IPO
 - Recently, most SPACs have used 18-24 month deadline
 - Need more time to complete a deal due to increased competition
 - Extensions (e.g., Great Wall Acquisition and China Mineral Acquisition)

What are the primary regulatory steps in the IPO process?

- Prepare and file Form S-1 registration statement with SEC
- Selection of, and filing of listing application with, a trading market
- Making filing with NASD regarding underwriting compensation and arrangements

What is the SEC's role in the IPO process?

- Review and comment on Form S-1
 - Focus on disclosure
 - Not merit-based evaluation of offering
- Form S-1 assigned to the Disclosure Operations section of the SEC's Division of Corporation Finance
- Disclosure Operation is divided into 11 groups, 10 of which are organized by industry type.

What is the SEC's role in the IPO process? (cont.)

- 11th group – the **Office of Emerging Growth Companies** – reviews substantially all of the IPO registration statements for small businesses and SPACs
- After a small business has completed IPO, the responsibility for reviewing its filings is transferred to the group appropriate to its industry
 - Sole exception is for SPACs, which continued to be reviewed by the **Office of Emerging Growth Companies** until they complete a business combination

How long is the SEC review process?

- Long-standing Division of Corporation practice to provide comments within 30 days of filing of Form S-1 and within 5 days of filing subsequent pre-effective amendments
- Based on our experience, **Office of Emerging Growth Companies** comments often take 35 days or more and comments on subsequent filings can take more than 30 days.

How long is the SEC review process? (cont.)

- Main reason cited for extended review process is substantial backlog of filings, particularly SPAC filings (both IPOs and merger proxy statement/registration statements)
- Recently two other groups within the Disclosure Operations section have received SPAC training and it is hoped that we will move closer to the 30 day and 5 day review time periods

What can a SPAC promoter do to facilitate a smoother SEC review process?

- Avoid taking any steps to search for or locate a target business before and during IPO
- Avoid any contacts, preliminary or otherwise, with potential target businesses before and during IPO
- To the extent possible, limit conflict of interest-related relationships and transactions, and provide detailed disclosure to extent there are any conflicts

What are the main factors to consider in selecting an exchange or trading market?

- Nasdaq and NYSE rules and practices generally prohibit SPACs from listing with them
- Until recently, most SPACs had their securities quoted on the OTC-Bulletin Board
 - Securities quoted on OTC-BB are not “covered securities” under federal securities laws and therefore subject to blue sky regulation
 - Limits investor pool largely to institutional investors because of state blue sky exemptions for offerings to such investors
 - Costs associated with “blue-sky” compliance
- More recently, SPACs have listed their securities on the American Stock Exchange

What are the main factors to consider in selecting an exchange or trading market? (cont.)

- Securities listed on AMEX are “covered securities” and are not subject to blue sky regulation
- No limitation of investor pool
- Must meet one of four sets of listing standards
 - Minimum market capitalization of \$50 million
 - Minimum of 400 public stockholders and 1,000,000 publicly-held shares sold in IPO
- Emphasis placed on qualitative factors (e.g., quality of management team, nature of underwriter and corporate governance structure)
- Extensive review of underwriters involved in IPO

What is the NASD's role in the IPO process?

- The NASD, a self-governing body of which the underwriters are member firms, will review the proposed offering arrangements to determine whether the underwriters' compensation for the offering is "fair and equitable" to the SPAC
- Prior to commencing IPO, the underwriters must receive a "no-objection letter" from the NASD

What is the NASD's role in the IPO process? (cont.)

- Underwriting compensation is broadly defined and may include
 - “Purchase options” issued to underwriters
 - Fees received both for IPO and for subsequent advisory work (e.g., for aftermarket warrant solicitations and evaluation of potential acquisition candidates)
- Recently, a number of underwriting firms involved in SPAC offerings have received inquiries from NASD

What are the main regulatory obligations of SPACs after their IPOs?

- SPACs must file Form 10-Ks, Form 10-Qs, Form 8-Ks and proxy statements with the SEC
 - Their executive officers and directors must file Section 16 reports with the SEC
- SPACs must comply with Sarbanes-Oxley Act of 2002, including Section 302 and 906 certifications
- Corporate governance listing standards of the AMEX, including regarding director independence

What are the main operating concerns of SPACs after their IPOs?

- Investing proceeds held in the trust account so as to avoid being deemed to be an “investment company” under the 1940 Act
- Finding a suitable acquisition candidate
- Ensuring that the proceeds held outside of trust account or interest generated thereon (depending on how the IPO was structured) are sufficient to pay operating expenses, including those expenses necessary to consummate a business combination

Important steps in consummating a business combination transaction

- Conducting due diligence
- Negotiations/break-up fees
- Proxy/registration statement
 - Subject to full review by the SEC's Office of Emerging Growth Companies
 - Timing concerns

What is next for SPACs?

- Will the pace of SPACs coming to market continue?
- Who will be the investor base for SPACs going forward?
- Will the current SPACs be able to successfully complete business combinations?