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Alert | Special Purpose Acquisition Companies (SPACs)

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The SEC Proposes New Rules for Special Purpose Acquisition Companies

This GT Alert covers the following:

- The SEC has proposed lengthy rules that would require new disclosures and procedures for special purpose acquisition companies (SPACs).
- The proposed rules would remove SPACs from the safe harbor for forward-looking statements under the Private Securities Litigation Reform Act.
- The proposed rules would provide SPACs with a safe harbor from the Investment Company Act of 1940 if they satisfy certain criteria, including deadlines to complete a de-SPAC transaction.
- Although the proposal affects liability for underwriters, it is unlikely to substantially alter current practices for underwriters who already perform adequate due diligence.

On March 30, 2022, the U.S. Securities and Exchange Commission (SEC) approved, by a 3-to-1 vote, a 372-page proposal of numerous rules regarding disclosures and procedural requirements for special purpose acquisition companies (SPACs). SEC Chair Gary Gensler stated that their purpose was to impose many of the regulations applicable to traditional initial public offerings (IPOs) on SPACs, stating that SPAC investors "deserve the protections they receive from traditional IPOs, with respect to information asymmetries, fraud, and conflicts, and when it comes to disclosure, marketing practices, gatekeepers, and issuers."[1]

If these sweeping regulations are implemented as proposed, they may significantly affect capital markets practices for both issuers and underwriters, and open up new avenues for regulatory enforcement and additional private securities litigation. Even before these proposed regulations, SPACs were already being sued almost twice as much as traditional IPOs, with 32 SPAC securities class actions filed in 2021, a more than sixfold increase compared to 2020.[2] In addition, the SEC had previously brought various enforcement actions against participants in SPAC transactions. The proposed rules are open for public comment through at least May 31, 2022, and entities and underwriters operating in the SPAC space may wish to consider whether and how to respond to the SEC's proposal.

Background

SPACs are shell companies that raise funds through an underwritten IPO with the goal of acquiring a yet-to-be-identified operating company. Once the SPAC identifies the target company, it completes a business combination (the "de-SPAC" transaction) resulting in a combined public company.

Although SPACs have existed for decades, they only became increasingly popular over the last several years, as evidenced by the amount of capital raised by SPACs doubling from $80 billion in 2020 to more than $160 billion in 2021. Proponents of SPACs have cited their capital formation flexibility and nimbleness in bringing new companies to market, as referenced in SEC Commissioner Hester M. Peirce's statement opposing the proposed rules: "SPACs brought many new companies into our public markets—a welcome trend after decades of decline in the number of public companies."[3] On the other hand, critics of SPACs have argued they disproportionately benefit insiders and lack adequate disclosures,[4] and the SEC has been signaling some kind of new forthcoming rules. Roughly a year ago, the acting director of the Division of Corporation Finance issued a statement saying SEC staff was "continuing to look carefully" at filings by SPACs and their targets, and that "[a]ny simple claim about reduced liability exposure for SPAC participants is overstated at best, and potentially seriously misleading at worst."[5] The proposed rules are the culmination of that effort.

While some of the proposed rules mirror current best practices, others may present a "square peg/round hole" aspect, as they appear to mix and match different concepts of potential liability under the 1933 Securities Act ('33 Act) and the 1934 Securities Exchange Act ('34 Act). This asymmetry arises most clearly in connection with projections of future performance. Whereas in a traditional IPO governed by the '33 Act, companies typically do not offer projections of future performance, in the merger context governed by the '34 Act, a SPAC board's analysis of projections of the combined company is essential both to satisfying the board's fiduciary duties and to ensuring an informed shareholder vote.

The Proposed Rules

The SEC's proposed rules would affect SPAC IPOs and de-SPAC transactions in the following ways:

- No PSLRA (Private Securities Litigation Reform Act) Safe Harbor for Forward-Looking Statements: As acknowledged in the SEC's release, practitioners in this field typically treat financial projections, which

[1] "Statement on Proposal on Special Purpose Acquisition Companies (SPACs), Shell Companies, and Projections" (Mar. 30, 2022).
[2] "Securities Class Action Filings: 2021 Year in Review," Cornerstone Research (Feb. 2, 2022).
[3] "Damning and Deeming: Dissenting Statement on Shell Companies, Projections, and SPACs Proposal" (March 30, 2022).
[4] *See, e.g.*, "A Sober Look at SPACs," Harvard Law School Forum on Corporate Governance (Nov. 19, 2020).
[5] "SPACs, IPOs, and Liability Risk Under the Securities Laws" (April 8, 2021).

are an inherent part of the de-SPAC transaction, as protected by the PSLRA's statutory safe harbor for forward-looking statements. The proposed rules would change that by defining a SPAC as a "blank check company," which would not entitle SPACs to the benefits of the statutory safe harbor. The rules would extend liability for forward-looking statements to other merger participants, including underwriters.

The proposed rules would impose more rigorous criteria on financial projections provided to investors in connection with de-SPAC transactions. For example, projected measures not based on historical financial results or operational history would need to be clearly distinguished from those that are. Registrants would be required to disclose the purpose of the projections, who prepared them, the material bases and assumptions beneath the projections, whether the projections reflect the view of the SPAC's board of directors or management as of the date of filing, and whether projections regarding the target company reflect the view of that company's board of directors or management.

In some ways, including when it comes to underwriters, this criteria may not substantially deviate from current practices, as SPACs typically review financial projections the target company prepared as part of their due diligence and valuation of the target company, and disclose those projections to public shareholders in de-SPAC transaction materials. Underwriters review these materials as part of their due diligence. It is unlikely that SPACs will exclude financial projections from de-SPAC materials altogether because of their importance in understanding the target company's perceived value, and the decision by the SPAC's board of directors to do the merger. SPACs will need to scrutinize assumptions underlying financial projections and express them in a manner that can be understood by investors in de-SPAC materials.

- De-SPAC Fairness Determination: For de-SPAC transactions, the rules would require the SPAC to conduct a fairness determination, which would be similar to the fairness determinations required in going-private transactions subject to Rule 13e-3. The fairness determination would state, among other items, whether the SPAC reasonably believes the de-SPAC transaction is fair to unaffiliated shareholders and identify the basis for this finding with reasonable detail, including the consideration of any target projections and the valuation of the target company. The rules would require disclosures regarding all outside reports, opinions, or appraisals received by either the SPAC or its sponsors relating to: (i) the consideration or the fairness of the consideration to be offered to shareholders; or (ii) the fairness of the de-SPAC transaction or any related financing transaction to the SPAC, its sponsors, or unaffiliated shareholders. Required disclosures would include a background summary of the de-SPAC transaction, any underlying contracts and negotiations, the reasons for the de-SPAC transaction, investor redemption rights, material financing transactions, sponsor compensation, shareholder dilution, and potential and actual conflicts of interest.

  While these disclosures are typically made by SPACs, the proposed rule would likely have the effect of causing SPACs to obtain a fairness opinion from an independent investment firm, and thus require additional fees relating to the transaction.

- Underwriter Liability: The rules would establish that underwriter liability under Section 11 of the '33 Act applies to de-SPAC transactions if the underwriter takes steps to facilitate the de-SPAC transaction, or any related financing transaction, or if the underwriter otherwise participates directly or indirectly in the de-SPAC transaction. The SEC identified several examples of conduct that could constitute underwriter participation in a de-SPAC transaction, including providing financial advice to the SPAC, identifying potential merger targets, negotiating merger terms, and negotiating or soliciting PIPE (private investment in public equity) financing. As SEC Commissioner Peirce stated in her dissent, this expansion of underwriter liability may be designed to promote due diligence during the de-SPAC transaction, but it may instead result in SPAC underwriters "do[ing] everything possible to avoid being captured by the rule[.]" Accordingly, underwriters participating in a de-SPAC transaction may wish to conduct themselves in the same manner as they do in a traditional IPO.

It is common for the underwriters of SPAC IPOs to receive a portion of their underwriting fee upon the closing of the IPO, and defer the remainder to completion of the de-SPAC transaction (which results in forfeiture of the remainder if a de-SPAC is not completed). This makes the SPAC IPO attractive for sponsors bearing the initial costs of launching the SPAC, but the new proposed rules theoretically could subject underwriters to additional liability for de-SPAC transactions with which they were relatively uninvolved. As a result, underwriters may seek to restructure these fees to assure they are not subject to additional liability in the de-SPAC.

The proposed removal of the PSLRA's safe harbor for financial projections used in de-SPAC transactions would affect underwriter liability, although much less so for underwriters that have already adopted best practices. The SEC's proposal confirmed that due diligence defenses would continue to be available to underwriters and explained that the rules were designed to impose new costs on underwriters only "to the extent to which [underwriters] do not already perform due diligence that would be sufficient to perfect such a defense in connection with a de-SPAC transaction or a related financing transaction."[6] The Supreme Court's decision in *Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund*, 575 U.S. 175, 186 -87 (2015), which held that no Section 11 liability attaches to "a sincere statement of pure opinion" as long as no omission of fact renders the statement "misleading to an ordinary investor," will also circumscribe underwriter liability for financial projections used in de-SPAC transactions.

- SPAC Target Co-Registration and Target Liability: The proposed rules would deem the de-SPAC an offering of shares to the SPAC's current shareholders regardless of the transaction structure, effectively requiring that any de-SPAC transaction include the filing of a registration statement on Form S-4 or Form F-4 under the '33 Act. In addition, the rules would require that, in de-SPAC transactions, the target private company must be identified and treated as a co-registrant. The proposal acknowledges that this new co-registration requirement would cause an "increase in potential liability from the current baseline for targets and their signing officers and directors" and would pose an "increased litigation risk and the potential need for new insurance coverage or higher premiums for existing coverage." On the other hand, the effect of this requirement may be minimal because the combined company already takes on the SPAC's liabilities after the closing of the de-SPAC business combination.
- Safe Harbor From 1940 Act: The proposed rules provide a safe harbor for SPACs from the definition of an "investment company" under the Investment Company Act of 1940 (1940 Act). This appears to be the SEC's response to relatively recent 1940 Act challenges raised by certain third parties against various SPACs. Over the last year, three SPACs have been sued by law professors contending that the 1940 Act should apply to these entities because they hold government securities in trust, such as short-term treasuries and qualifying market money funds. In August 2021, a number of leading law firms (including Greenberg Traurig, LLP) authored a letter explaining that SPACs should not be considered investment companies under the 1940 Act because they are engaged primarily in identifying and consummating business combinations within a specified time period and only temporarily hold government securities. Thus, by proposing new rules establishing a safe harbor to the 1940 Act, the SEC's proposal confirms that at least some SPACs do not resemble investment companies subject to liability under the 1940 Act. SPACs that are already involved in pending litigation may cite this

[6] Securities and Exchange Commission's Proposed Rules for Special Purpose Acquisition Companies, Shell Companies, and Projections (Mar. 30, 2022), p. 250.

proposal as support for the proposition that they should not be viewed as an investment company subject to the 1940 Act.

To fall within the safe harbor, SPACs must find a merger target and initiate the de-SPAC transaction within 18 months of the SPAC's IPO, and must complete the de-SPAC transaction within 24 months of the IPO. If a SPAC fails to meet either deadline, it would then need to distribute its assets in cash as soon as reasonably practicable, or no longer be able to rely on the safe harbor.

- Other Proposed Disclosures: SPACs would be required to identify their sponsors, affiliates, and promoters, as well as the specific experience, material roles, and responsibilities of these participants. SPAC IPO disclosures would also need to identify all compensation to be awarded or paid to underwriters in connection with services rendered to the SPAC or after completion of the de-SPAC transaction, as well as any dilutive effect of that compensation. The disclosures would further include the terms of any lock-up agreements with sponsors, affiliates, and promoters. The rules would require a SPAC to disclose any actual or potential material conflict of interest. The new rules would require addressing potential shareholder dilution arising from numerous sources during SPAC formation, including outstanding warrants, convertible securities, and PIPE financing, as well as the impact that various levels of redemptions in connection with a de-SPAC transaction will have on non-redeeming shareholders.

The proposed rules would revise the requirements for target company financial statements in de-SPAC transactions to put them in the same position as a traditional IPO. In general, this would benefit target companies that qualify as smaller reporting companies or emerging growth companies.

The SEC's proposal, open for public comment through at least May 31, 2022, represents a substantial effort by the agency to impose significant controls on the SPAC market.

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