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Sweeping SEC Proposals Raise Significant Concerns for SPAC Market

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On March 30, the SEC released comprehensive proposals for rule changes that would materially expand the liability regime for SPAC transactions, including by limiting the availability of a commonly used safe harbor for forward-looking statements and broadening the scope of who may be deemed a statutory underwriter in connection with a de-SPAC transaction, which, alongside many of the other notable changes being proposed by the SEC, may have significant chilling effects on the SPAC market. If adopted, the proposals would represent the most expansive increase in the regulation of SPACs since the investment vehicles emerged in the early 1990s.

With special purpose acquisition companies (SPACs) continuing to take the US equity markets by storm,[i] the Securities and Exchange Commission (SEC, Commission or Staff) has released long-telegraphed proposals for sweeping new regulations governing SPACs and their related business combinations (de-SPACs), whose broad scope, new disclosure requirements and material liability implications for a wide array of SPAC market participants have, if adopted, the potential to fundamentally alter the regulatory landscape for SPAC and de-SPAC transactions going forward. The summary fact sheet and full proposing release (Proposing Release), which was issued by the SEC on March 30 and supported by a 3-1 margin of the SEC's Commissioners, cites "greater transparency and more robust investor protections … [which] could assist investors in evaluating and making investment, voting, and redemption decisions with respect to [SPAC transactions]" as the (purported) rationale for the comprehensive wave of amendments (Proposed Rules).

The Proposed Rules touch on virtually all aspects of the SPAC process and raise concerns for all SPAC market participants, from sponsors, management teams and private company acquisition targets, to underwriting banks, supplementary capital providers such as PIPE investors, and even financial advisory firms that are not providing any direct financial support for a transaction. As discussed in past editions of the SPAC Report, Chairman Gensler has long advocated the view that de-SPAC transactions are functionally equivalent to a traditional initial public offering (IPO) by that private operating company, and should be regulated as such. The Proposed Rules follow the contours of the Chairman's prior statements and, if adopted, would result in a greatly expanded liability profile for de-SPAC transactions, one more akin to a traditional IPO, including such novel expansions as deeming underwriters in SPAC IPOs to be underwriters in the subsequent de-SPAC transaction if they take any steps to facilitate the de-SPAC transaction. Commissioner Hester M. Peirce cited this expansive approach to SPAC transactional liability in particular in her blistering dissent, and found that the sum of the elements of the Proposed Rules, "rather than simply mandating sensible disclosures around SPACs and de-SPACs, something I would have supported — seem [instead to be] designed to stop SPACs in their tracks."

The SEC is seeking public comments on the Proposed Rules through May 31, 2022, or 30 days after publication in the Federal Register, and given the volume and dynamic nature of the proposals, a vigorous and active comment period is expected. Key highlights of the Proposed Rules include:

- Amending the definition of "blank check company" such that the liability safe harbor provided by the Private Securities Litigation Reform Act of 1995 (PSLRA) for forward-looking statements, such as financial projections, would be unavailable for de-SPAC registration statements;
- A new rule that deems underwriters in SPAC IPOs to be underwriters in subsequent de-SPAC transactions if they take steps to facilitate the de-SPAC transaction or any related financing transaction, or otherwise participate in the de-SPAC transaction, and potentially deeming other de-SPAC participants as statutory underwriters as well, including financial advisors and PIPE investors, such that the range of actors facing potential liability exposure in connection with participation in a SPAC or de-SPAC transaction would be greatly expanded; and
- Requiring additional disclosures in SPAC and de-SPAC registration statements, including with respect to conflicts of interest, dilution and the "fairness" of de-SPAC transactions from the perspective of retail holders (which, if adopted, may result in a fairness opinion becoming a de facto requirement for consummating a de-SPAC transaction).

Below we detail some of the main elements of the Proposed Rules, with analysis and brief discussion of the potential implications for the SPAC market if the Proposed Rules are adopted.

Projections, Guidance and PSLRA Safe Harbor

PSLRA Safe Harbor. The PSLRA provides a safe harbor for forward-looking statements under federal securities laws, pursuant to which a company is protected from liability in any private right of action for forward-looking statements included in disclosure documents filed with the Commission when the forward-looking statements are identified as such and are accompanied by meaningful cautionary statements.[ii] The PSLRA is not available in traditional IPOs or offerings involving "blank check companies." Most SPAC and de-SPAC transactions however, are specifically structured such that the SPAC would not be considered a "blank check company,"[iii] suggesting the PSLRA safe harbor should be available to them. Market commentators have cited the availability of the PSLRA safe harbor as granting a "perceived freedom to use projections in connection with de-SPAC transactions, [as a result of the perception of]… reduced liability exposure." Certain critics have even gone so far as to claim that the availability of the PSLRA safe harbor has been critical to the recent SPAC boom, creating a "regulatory arbitrage" whereby sponsor teams capitalized on a loophole in the regulatory system that would have otherwise prevented many SPAC targets from reaching the public markets,[iv] particularly given many of the acquisition targets brought public over the last two years via de-SPAC have been pre-revenue, and therefore relied primarily on forward guidance and projections of future financial results to solicit investor interest, which would likely have been considered off-limits in a traditional IPO. The Proposed Rules amend the definition of "blank check company" (for purposes of the PSLRA) to explicitly exclude SPACs from the safe harbor.

Even if SPACs are formally excluded from use of the safe harbor, note that in certain instances, a SPAC or target company may feel compelled to disclose projections in disclosure documents, despite the increased liability risk, for example: (i) in order to comply with state law requirements regarding disclosure of all information reviewed by a board of directors when considering an acquisition; (ii) to avoid claims that not disclosing such information was a material omission under federal securities law anti-fraud provisions; or (iii) if the projections were otherwise required to be disclosed pursuant to Regulation M-A. When combined with the proposed expansion of underwriting liability for SPAC IPO underwriters in connection with subsequent de-SPACs (as further discussed below), the unavailability of the safe harbor may lead underwriters to demand structural and/or compensation changes in order to limit (or be compensated for) the increased liability profile.

Increased Disclosures of Factors Underlying Projections. If projections or guidance are included in a de-SPAC registration statement, the Proposed Rules would require disclosure regarding: (i) the purpose for which the projections were prepared and the party that prepared them, (ii) the basis and all material assumptions underlying the projections, and any factors that may materially impact such assumptions (for example clearly outlining material growth rates or discount multiples used in preparing projections, and the reasons for selecting such growth rates or discount multiples), and a discussion of any factors that may cause such assumptions to no longer be reasonable and (iii) whether the disclosed projections remain accurate from the perspective of the board or management of the SPAC or target company, as applicable, as of the date of the relevant filing with the Commission (Proposed Item 1609). As most de-SPAC transactions already include fulsome disclosure regarding the assumptions underlying projections, we would not expect such increased disclosure requirements to be overly troubling to the SPAC market.

Underwriter Status and Liability in a de-SPAC Transaction

SPAC IPO Underwriters and Other de-SPAC Participants. Proposed Rule 140a would deem SPAC IPO underwriters who take any steps to facilitate a de-SPAC transaction (or any related financing transaction in the context of such de-SPAC, such as a concurrent PIPE financing, or who otherwise directly or indirectly participates in such de-SPAC transaction), a statutory underwriter with respect to such de-SPAC transaction, conferring previously unforeseen underwriter liability risk.

- Proposed Rule 140a appears to be the SEC's attempt to impose a "gatekeeper liability" regime on the SPAC market, an approach long-supported by Chairman Gensler, which would subject market participants that the SEC has deemed to be the SPAC market's "gatekeepers" — including notably the investment banks involved in the de-SPAC process — to underwriter liability risk, the theory being that the approach encourages such "gatekeepers" to increase their own scrutiny of SPAC disclosure documentation, and otherwise conduct a more extensive due diligence exercise, in an effort to mitigate their own expanded risk profile.

- Note the Proposing Release makes clear proposed Rule 140a is not intended to limit or be an exhaustive assessment of what constitutes an "underwriter" for purposes of Section 2(a)(11) of the Securities Act, with the SEC noting that "financial advisors, PIPE investors, or other advisors, depending on the circumstances, may be deemed statutory underwriters in connection with a de-SPAC transaction if they are purchasing from an issuer "with a view to" distribution, are selling "for an issuer," and/or are "participating" in a distribution." Further note that affirming statements released by Commissioners Crenshaw and Lee both cite deferred underwriting compensation payable to SPAC IPO underwriters upon the consummation of a de-SPAC as problematic, raising concerns that the SEC would view merely the receipt of a deferred underwriting fee as leading to exposure for SPAC IPO underwriters to liability in connection with a de-SPAC, even if they are not actively participating in such de-SPAC transaction, for example by assisting with arranging a related PIPE financing. Deferred underwriting compensation is a standard feature of virtually all SPAC IPOs, allowing SPAC teams to reach the public markets without excessive up-front expense, while incentivizing underwriting banks to only work with and market SPACs with skilled management teams who are likely to get a deal done. If adopted, Proposed Rule 140a may result in IPO underwriters demanding full compensation up-front (i.e., at the time of the initial SPAC IPO) in order to reduce such liability risk, which may be a prohibitive cost for many SPAC sponsor teams.

- Significantly, note that Proposed Rule 140a is characterized by the SEC as a "clarification" rather than a rule change — suggesting that banks may already be subject to underwriter liability for past de-SPAC transactions, and keeping the door open to retroactive claims. It is notable that in response to the Proposed Rules, numerous underwriters have temporarily paused work on new SPAC IPOs, and certain larger financial institutions may have permanently left the space.

Co-Registration by Target. The Proposed Rules would amend Form S-4 and Form F-4, such that acquisition targets would be required to be listed as co-registrants in the registration statement filed in connection with a de-SPAC transaction, therefore subjecting the acquisition target, as well as its officers and directors, to potential liability under Section 11 and Section 12 of the Securities Act for material misstatements or omissions in the registration statement disclosure. Note that many de-SPAC transactions are already structured such that the target company is the registrant, with the target's board and management signing the registration statement.

De-SPAC Transactions are Also an Offer of Securities to Existing SPAC Investors. Proposed Rule 145a would deem any business combination involving (x) a reporting shell company (i.e., a SPAC) and (y) an operating company as involving a sale of securities to such reporting shell company's shareholders (in addition to the target company's shareholders), requiring that the registration statement filed in connection with the de-SPAC transaction register not just the offering of shares to the target company's shareholders, but also an offering to the existing shareholders of the SPAC, who would be deemed to be electing to receive new shares of the combined entity (if they do not avail themselves of their redemption right). Proposed Rule 145a reflects the SEC's view that the de-SPAC transaction is the "SPAC target IPO" and, although the SPAC's existing shareholders may not be receiving new shares at the time of the de-SPAC (as the target company merges into the SPAC shell vehicle and the existing SPAC shareholders typically, if they do not redeem, simply hold on to their pre-de-SPAC equity), that they should be treated as being distributed new securities at the time of the de-SPAC so that they would be afforded the same disclosure and liability protections with respect to material misstatements or omissions in de-SPAC disclosure documents as traditional IPO investors.

Dilution Disclosure

Increased Disclosure Regarding Dilution Events. The Proposed Rules include additional and more explicit disclosure requirements regarding dilutive events that will or may occur in the future in connection with both the SPAC IPO and de-SPAC transaction, including requiring: (i) for SPAC IPOs, simplified tabular dilution disclosure on the prospectus cover page (Proposed Item 1602(a)(4)) and a further description of material potential sources of dilution following the IPO, including tabular disclosure of the amount of potential future dilution from the public offering price that will be absorbed by non-redeeming SPAC shareholders upon consummation of the de-SPAC, to the extent quantifiable (in addition to the disclosure already required under Item 506 of Regulation S-K) (Proposed Item 1602(c)); (ii) in connection with a de-SPAC, requiring disclosure of each material potential source of additional dilution that non-redeeming shareholders may experience by electing not to redeem their shares, for example from sponsor compensation, underwriting fees, outstanding warrants and convertible securities, and any additional financing such as related PIPE financings (Proposed Item 1604(c)); and (iii) in connection with a de-SPAC, requiring a sensitivity analysis be presented in tabular format that shows the amount of potential dilution under a range of reasonably likely redemption levels, and quantifies the increasing impact of dilution on non-redeeming shareholders, as redemptions increase (Proposed Item 1604(c)(1)).

Other Enhanced Disclosure Requirements, 'Fairness' Opinions, Conflicts of Interest, Director Independence

"Fairness" Representations and (Potentially) Opinions. The Proposed Rules would require (i) a statement from the SPAC as to whether it reasonably[v] believes that the de-SPAC transaction and any related financing transactions are "fair" to retail holders of the SPAC (Proposed Item 1606(a)), and (ii) identification of material factors upon which such reasonable belief is based and, to the extent practicable, the weight assigned to each factor, with factors potentially including (x) the valuation of the private operating company, (y) the consideration of any financial projections and (z) any report, opinion or appraisal obtained from a third party (Proposed Item 1606(b)).

Note that the proposed disclosure requirements with respect to the fairness of the transaction, while not specifically requiring a fairness opinion, may, if adopted, result in a fairness opinion becoming a condition to consummating a de-SPAC transaction.

Director Independence and Disinterested Shareholder Approval Disclosure. The Proposed Rules would: (i) require disclosure regarding whether any director voted against, or abstained from voting on, approval of the de-SPAC transaction or any related financing transaction, and if so, identification of the director and, if known after making a reasonable inquiry, the reasons for the vote against the transaction or abstention (Proposed Item 1606(a)); (ii) require disclosure regarding whether the de-SPAC transaction or any related financing transaction is structured so that approval of at least a majority of unaffiliated security holders is required (Proposed Item 1606(c)); (iii) require disclosure regarding whether the SPAC's independent directors have retained an unaffiliated representative to act solely on their behalf for purposes of negotiating the terms of the de-SPAC transaction or any related financing transaction and/or evaluating the fairness of the de-SPAC transaction or any related financing transaction (Proposed Item 1606(d)); and (iv) require disclosure regarding whether the de-SPAC transaction or any related financing transaction was approved by a majority of the SPAC's independent directors (Proposed Item 1606(e)). The Proposing Release notes these additional disclosures are intended to allow investors to better evaluate potential conflicts of interest and misaligned incentives in connection with the decision to proceed with a de-SPAC transaction.

Compensation Arrangements and Conflicts of Interest. Proposed Item 1603(b) would require disclosure regarding: (i) any conflicts of interest with respect to determining whether to proceed with a de-SPAC transaction with a specific proposed target and (ii) the compensation arrangements among the SPAC, the sponsor, and their executive officers and directors. Although most SPACs already provide fulsome disclosure regarding the presence of actual or potential conflicts of interest as material risk factors, their inclusion in the Proposed Rules indicate SPAC market participants may wish to renew scrutiny of such conflicts and related disclosure.

Background of the Management Team and Affiliate and Related Party Transactions. Proposed Item 1603(a) would require additional disclosure about the sponsor, its affiliates and any promoters of the SPAC in registration statements and schedules filed in connection with SPAC IPOs and de-SPAC transactions, including disclosure regarding: (i) the experience, material roles, and responsibilities of such parties, as well as any agreement, arrangement or understanding (x) between the sponsor and the SPAC, its executive officers, directors or affiliates, in determining whether to proceed with a de-SPAC transaction and (y) regarding the redemption of outstanding securities; (ii) the controlling persons of the sponsor and any persons who have direct and indirect material interests in the sponsor, as well as an organizational chart that shows the relationship between the SPAC, the sponsor and the sponsor's affiliates; (iii) in tabular form, the material terms of any lock-up agreements with the sponsor and its affiliates; and (iv) the nature and amounts of all compensation that has or will be awarded to, earned by, or paid to the sponsor, its affiliates and any promoters for all services rendered in all capacities to the SPAC and its affiliates, as well as the nature and amounts of any reimbursements to be paid to the sponsor, its affiliates and any promoters upon the completion of a de-SPAC transaction.

Fiduciary Duties. Proposed Item 1603(c) would require disclosure regarding: (i) the fiduciary duties each officer and director of a SPAC may owe to other companies, including whether and to what extent the SPAC's officers or directors may have to navigate conflicts of interest and their obligations under the laws of the jurisdiction of incorporation or organization of the SPAC and a target company; (ii) that SPAC directors and officers may be compelled to act in the interest of another company or companies that compete with the SPAC for business combination opportunities; and (iii) that SPAC directors and officers may have their attention divided such that it may affect their decision-making with respect to the SPAC. Similar to Proposed Item 1603(a), the Proposing Release notes that it does not expect any incremental disclosures required by Proposed Item 1603(c) to be overly burdensome as, given the significance of such fiduciary relationships, it is unlikely that a director or officer — and by extension, the SPAC — would not already know what relationships would require disclosure.

Investment Company Act

Investment Compact Act Safe Harbor. The Proposed Rules include a safe harbor for SPACs that would deem a SPAC to not be an investment company[vi] under the so-called "subjective" test[vii] for status under the Investment Company Act of 1940 (1940 Act), if certain conditions are met, including that: (i) the SPAC's assets consist solely of government securities, government money market funds and cash; (ii) the SPAC's activities are limited to seeking to complete a single de-SPAC transaction (which may involve the combination of multiple targets) as a result of which the surviving public entity will be primarily engaged in the business of the target company or companies[viii] and will have a class of securities registered on a national securities exchange; (iii) the activities of a SPAC's officers, directors and employees are primarily focused on activities related to seeking a target company, and the board of directors of the SPAC adopts an appropriate resolution regarding this business purpose; and (iv) the SPAC announces a business combination within 18 months of its IPO, and completes a business combination within 24 months of its IPO.

Going Forward

After peaking in the mid-1990s, the number of public company listings in the United States has declined by more than 25 percent over the last 20 years. Today, roughly 70 percent of capital is raised in private markets, cutting off many retail investors from the opportunity to invest in early-stage companies. Promoting access to the public markets for smaller investors remains an elusive but constant mantra of the SEC, agnostic to changing political tides. The resurgence of SPACs over the last several years represents a promising opportunity that even Commissioners who voted in support of the Proposed Rules have cited as having the potential to help address certain of the challenges private operating companies have noted as behind their hesitation to entering the public markets. Unfortunately, it is likely the Proposed Rules, at least in their current form, and in particular the proposed expansion of the liability regime that limits the availability of the forward-looking statements safe harbor and broadens the scope of who may be deemed a statutory underwriter in connection with a de-SPAC transaction, will be subject to legitimate and substantial criticism from market participants, both as overly harsh and burdensome, and as likely to induce significant chilling effects on SPAC market activity generally. In particular the proposed expansion of the liability regime, by limiting the availability of the forward-looking statements safe harbor and broadening the scope of who may be deemed a statutory underwriter in connection with a de-SPAC transaction, have the potential to induce significant chilling effects on the SPAC market.

To read the full newsletter, please click here.

[i] 2020 *had* been dubbed the "Year of the SPAC" — as a result of the record number of SPAC issuances and cash raised by sponsor teams — that is until 2021 again shattered the record books, with 613 SPACs debuting on the public markets and over $162B in aggregate proceeds raised during

the course of the year. In 2021, SPACs comprised over 63 percent of all IPOs, and represented nearly half of all proceeds raised. Although the number of SPAC issuances slowed somewhat during Q1 2022, after nearly doubling year over year from 2020 to 2021, the market remains robust, with 59 IPOs in 2022 as of the date of this publication. Source: Spacanalytics.com and Spacinsider.com.

[ii] See Section 27A of the Securities Act of 1933, as amended (Securities Act) and Section 21E of the Securities Exchange Act of 1934. Note that the PSLRA does not impact the Commission's ability to bring enforcement actions relating to forward-looking statements.

[iii] To take advantage of the PSLRA safe harbor, SPACs rely on the fact that under Rule 419 of the Securities Act, if they raise more than $5 million in a firm commitment underwritten initial public offering listed on a national securities exchange, they are excluded from the definition of "blank check company" because they are not selling "penny stock," and would therefore be eligible for the safe harbor. See CFR § 230.419 and CFR § 240.3a51-1.

[iv] Amanda M. Rose, "SPAC Mergers, IPOs, and the PSLRA's Safe Harbor: Unpacking Claims of Regulatory Arbitrage."

[v] The Proposing Release does not defined what constitutes a "reasonable" belief, but instead notes merely that as a result of this standard: "SPACs may incur additional costs associated with proposed Item 1606(a) to the extent that, in response to this proposed item, SPACs newly seek to obtain fairness opinions."

[vi] In September 2021, Katten joined more than 60 law firms in a joint statement (available here) responding to private litigation that asserted that SPACs are unregistered investment companies as without factual or legal basis.

[vii] The Proposing Release notes: "The safe harbor we are proposing only addresses investment company status under Section 3(a)(1)(A) of the Investment Company Act, commonly known as the "subjective test." Section 3(a)(1)(C) of the Investment Company Act provides an alternate "objective test" that defines an "investment company" as any issuer that is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and that owns or proposes to acquire investment securities, having a value exceeding 40 percent of the value of the company's total assets (exclusive of Government securities and cash items) on an unconsolidated basis. If a SPAC owns or proposes to acquire 40 percent or more of investment securities, it would likely need to register and be regulated as an investment company under the Investment Company Act."

[viii] Note this requirement is intended to prevent transactions typical of private equity funds, where a company is purchased for the purpose of disposition within a few years: "Thus, to rely on the rule, the SPAC must have a business purpose aimed at providing its shareholders with the opportunity to own interests in a public entity that, in contrast to an investment company, will either be an operating company, or will, through a primarily controlled company, operate such operating company."

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