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Client Alert

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United States: SEC proposes rules for further disclosure and enhanced investor protections regarding SPACs

Sweeping reforms to the regulation of SPACs announced by the SEC

In brief

On 30 March 2022, the Securities and Exchange Commission ("SEC") approved proposed rules relating to special purpose acquisition companies ("SPACs") and released an accompanying fact sheet. Work on the final rules will begin following the public comment period, which ends on the later of 31 May 2022 and 30 days following the publication of the proposing release in the Federal Register.

Over the last year, the SEC has signaled that the SPAC market should expect regulatory changes in response to the unprecedented growth in use of SPAC vehicles. Prior to this proposal, guidance from the SEC on the topic has largely focused on disclosure requirements. The proposed rules are notable in that they reach beyond enhanced disclosure and address the following topics:

- enhanced disclosure requirements, including those related to SPAC sponsors and projections;
- liability of participants in de-SPAC transactions, including revised registration requirements for de-SPAC transactions, rules expanding when underwriters of SPAC initial public offerings will be deemed underwriters of de-SPAC transactions and the availability of the safe harbor for projections under the Private Securities Litigation Reform Act of 1995; and
- the status of SPACs under the Investment Company Act of 1940 ("**Investment Company Act**").

The proposed rules are the SEC's latest salvo in its fight to align the regulation of de-SPAC transactions more closely with those for traditional initial public offerings. It is yet to be seen in what format the rules ultimately will take and how the market will respond.

On one hand, with many SPACs nearing the end of their stated life cycle, it is possible that the anticipated regulatory changes will create greater pressure to complete transactions prior to implementation of final regulations. According to Pitchbook, there are approximately 339 SPACs that have yet to execute a deal and have less than a year to complete one. The trend of SPACs withdrawing their initial public offerings may increase in the face of these regulatory headwinds.

On the other hand, much of what the SEC has proposed was signaled previously and has already been incorporated into market practices. As a result, market participants may to some extent have already digested significant portions of the proposal.

What is certain is that the new regulations will significantly affect how SPACs acquire target companies and meaningfully increase the cost for SPAC initial public offerings and de-SPAC transactions.

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Enhanced disclosure requirements

Codification of evolving SPAC disclosure practices

Set forth below is a list of amendments to Regulation S-K proposed by the SEC that specifically address disclosure requirements for SPAC initial public offerings as well as de-SPAC transactions. These proposed disclosure requirements largely

codify practices that were put in place during the recent SPAC boom and could, through the emphasis on disclosure of a fairness assessment, push more SPACs to seek fairness opinions. The proposal would require:

1. SPAC Sponsor and Conflicts of Interest:
   a. disclosure about the experience, material roles and responsibilities of SPAC sponsors and their affiliates and promoters, as well as any agreement, arrangement or understanding (i) between the sponsor and the SPAC, its executive officers, directors or affiliates, in determining whether to proceed with a de-SPAC transaction; and (ii) regarding the redemption of outstanding securities; and
   b. disclosure of any conflict of interest between (i) the SPAC sponsor or its affiliates or the SPAC's officers, directors, or promoters; and (ii) unaffiliated security holders, including any conflict (x) in determining whether to proceed with a de-SPAC transaction and (y) arising out of the way a SPAC compensates the sponsor or the SPAC's executive officers and directors, or the manner in which the sponsor compensates its own executive officers and directors;
2. Dilution: narrative and tabular disclosure about potential sources of dilution in a SPAC's structure, including disclosure regarding dilution resulting from SPAC sponsor compensation, warrants and PIPE financings and the impact of shareholder redemptions;
3. Fairness of the De-SPAC Transaction: additional disclosures in de-SPAC transactions addressing fairness, including whether (a) the SPAC reasonably believes that the de-SPAC transaction and any related financing transaction are fair to investors; (b) the SPAC has received any outside report, opinion, or appraisal relating to the fairness of the de-SPAC transaction; and (c) any cleansing vote requirements are being utilized, such as a requirement for approval by a majority of unaffiliated shareholders or disinterested directors;
4. Projections:
   a. a proposed amendment to Item 10(b) of Regulation S-K, applicable to all issuers (i.e., not only SPACs), would require (i) that any projected measures not based on financial results or operational history be clearly distinguished from those that are based on financial results or operating history; and (ii) operational history and projections based on historical measures and operating results be presented with equal or greater prominence to other projections;
   b. with respect to projections disclosed in an SEC filing, the purpose for which the projections were prepared would be required as well as the material bases and assumptions underlying the projections and any factors that may impact the assumptions, including a discussion of any material growth rates or discount multiples used in preparing the projections, and the reasons for selecting such growth rates or discount multiples; and
   c. where projections included in a filing relate to a target company in a de-SPAC transaction, the disclosure must state whether the target has affirmed to the SPAC that the projections reflect the view of the target's management or board about its future performance as of the date of the filing.

Dissemination of de-SPAC disclosure

The SEC is proposing that disclosure documents in de-SPAC transactions be disseminated to investors at least (a) 20 calendar days in advance of a shareholder meeting or the earliest date of action by consent, or (b) the maximum period for disseminating such disclosure documents permitted under the laws of the jurisdiction of organization of the SPAC if such period is less than 20 calendar days. Depending on the de-SPAC transaction structure, this period can be as short as 10 calendar days under current rules.

Smaller reporting company status

In addition, the SEC has proposed that there be a re-determination of smaller reporting company ("SRC") status (i.e., measuring public float) within four business days following the consummation of a de-SPAC transaction. SRC status allows target companies to avail themselves of reduced disclosure obligations.

Generally, this redetermination requirement will result in SPACs that initially qualified as SRCs to provide more comprehensive disclosures earlier following a de-SPAC transaction than under existing rules. Currently, SRC status is determined at the time of filing of the SPAC's initial registration statement on Form S-1 or F-1 and is re-determined on an annual basis with the post-business combination company permitted, when a SPAC is the legal acquirer in the de-SPAC transaction, to retain SRC status until the next annual determination date.

One potential issue with this proposal is that target companies may face uncertainty as to what disclosure may be required going forward as SRC status will depend on post-closing trading.

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Required financial statements

In order to better align the required financial statements of private operating company targets in de-SPAC transactions with those required in a traditional initial public offering, the SEC is proposing, among other things, the disclosure of three years of statements of comprehensive income, changes in shareholder's equity and cash flows.

There is, however, an exception to this requirement under proposed Rule 15-01(b) of Regulation S-X, which would permit a shell company registrant to include two years of financial statements for the target company of a de-SPAC transaction in all transactions involving a SPAC and target company that would qualify as an emerging growth company. This exception is in contrast with existing guidance under the SEC Financial Reporting Manual which makes emerging growth company status unavailable where the SPAC has filed or was already required to file its annual report. Thus, this proposed new exception is expected to be welcomed by the market.

Liability of participants in de-SPAC transactions

Safe harbor for projections under the Private Securities Litigation Reform Act of 1995 ("PSLRA")

The SEC has proposed to amend the definition of "blank check company" to include SPACs. Under existing Rule 419, SPACs are generally not "blank check companies" because they are not selling "penny stock," as defined in Rule 3a51-1 under the Securities Exchange Act of 1934 ("**Exchange Act**").

The change proposed by the SEC would make clear that the liability safe harbor in the PSLRA for forward-looking statements, such as projections, is unavailable for filings by SPACs.

This approach is directionally aligned with comments made by John Coates, Acting SEC Director, Division of Corporation Finance, in August of 2021. In his comments, Mr. Coates questioned whether the safe harbor was applicable to de-SPAC transactions given that they could be considered to be "initial public offerings" (another category for which the safe harbor under the PSLRA does not apply).

Accordingly, the alleged availability of the PSLRA safe harbor for projections in de-SPAC transactions has not been considered settled law since at least Mr. Coates' statement. The market may have already digested this proposed rule change prior to the SEC's formal announcement. However, to the extent that issuers have refrained from including projections in their filings in recent months as a result of Mr. Coate's statements, the proposed requirement of a "fairness" determination (and disclosure of the bases of such determination), may force a reversal of course by putting pressure on filers of de-SPAC registration statements to include some form of projections. Such pressure could have a further chilling effect on the market given new rules that would deem the underwriters of a SPAC's initial public offering to be underwriters of such SPAC's de-SPAC transaction, as further discussed below.

Persons deemed to be statutory underwriters of a de-SPAC

Underwriters of a SPAC's initial public offering typically defer a portion of the underwriters' discount (usually 3.5% of the gross proceeds from the initial public offering). Payment of these deferred fees is contingent on consummation of a de-SPAC transaction. The SEC has noted that such deferred fees create a financial incentive for the underwriters of a SPAC's initial public offering to ensure the consummation of a de-SPAC transaction, and that, in fact, such underwriters often take roles in connection with a de-SPAC transaction (e.g., as financial advisor and PIPE placement agent).

Citing this dynamic, the SEC is proposing a new Rule 140a under the Securities Act of 1933 ("**Securities Act**") that would deem underwriters in a SPAC initial public offering to be underwriters in any subsequent de-SPAC transaction where such underwriters also take steps to facilitate a de-SPAC transaction, or any related financing transaction, or otherwise participate in a de-SPAC. As a result, underwriters of SPAC initial public offerings would be exposed, subject to a due diligence defense, to liability for material misstatements and omissions in a registration statement for the de-SPAC transaction under Section 11 and Section 12(a)(2) of the Securities Act.

In addition, the SEC warned that even though proposed Rule 140a only addresses the underwriter status with respect to a de-SPAC transaction of the underwriters of a SPAC's initial public offering, other participants in de-SPAC transactions could fall within the definition of underwriter for purposes of Section 2(a)(11) of the Securities Act:

> "Federal courts and the Commission may find that other parties involved in securities distributions, including other parties that perform activities necessary to the successful completion of de-SPAC transactions, are 'statutory underwriters' within the definition of underwriter in Section 2(a)(11). For example, 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."

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Historically, projections, a frequent feature in SEC filings for de-SPAC transactions (and long considered a competitive advantage vis-à-vis traditional initial public offerings), have not been included in registration statements for traditional initial public offerings, in part, because of the liability exposure of investment banks that serve as underwriters. The proposed Rule 140a and SEC comments could further chill SPAC initial public offerings and make some financial advisors reticent to participate in de-SPAC transactions.

Revised registration requirements for de-SPAC transactions

The SEC has proposed a requirement that the private operating company target of a de-SPAC transaction be a co-registrant when a SPAC files a registration statement on Form S-4 or Form F-4 for a de-SPAC transaction.

This requirement would expand liability under the Exchange Act for material misstatements and omissions in the Form S-4 or F-4 to the target and its directors who sign the registration statement. While this is an expansion of liability as a technical matter, it is arguably not a material substantive expansion as:

1. In de-SPAC transactions the target company, as a practical matter, assumes the liabilities of the SPAC, including those under the Exchange Act, as it is the target company's shareholders that typically control the post-closing listed entity;
2. De-SPAC transactions are structured in a variety of different ways as a result of tax considerations as well as legal requirements in various jurisdictions. In many de-SPAC transactions, the target company or its affiliate files a registration statement; and
3. Directors and officers of target companies already face liability exposure through their participation in the SPAC's proxy solicitation.

De-SPAC as a sale of securities

The SEC's proposed Rule 145a would deem a de-SPAC transaction to be a sale of securities to a SPAC’s shareholders for purposes of the Securities Act. The proposed change is based on the theory that a SPAC’s shareholders are effectively exchanging securities representing interests in the SPAC for a new security representing interests in the combined operating company.

Depending on how a de-SPAC transaction is structured, a SPAC's shareholders may not actually receive new securities in a de-SPAC transaction. If the SPAC is the surviving company in the de-SPAC transaction, shareholders that do not elect to redeem their shares continue to hold securities of the SPAC. But, if the target company or a new holding company is the surviving registrant, then the SPAC's shareholders will receive new securities in exchange for their SPAC shares.

Although the SEC states that a valid exemption could remain available in lieu of registration, its position is that Section 3(a)(9) of the Securities Act, which exempts securities exchanged by an issuer with its existing security holders where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange, would generally not be available for de-SPAC transactions. In the SEC's eyes, (a) the deemed exchange by the SPAC’s existing shareholders for the combined company’s securities should be viewed as part of the same offering as the exchange of the operating company’s securities for their interests in the combined company and (b) the use of a proxy solicitor by the SPAC would also make the Section 3(a)(9) exemption unavailable.

The impact of the proposed rule would be to (a) require that all de-SPAC transactions be registered with the SEC under the Securities Act, (b) expose those persons deemed to be statutory underwriters of the initial public offering of the SPAC to a potentially broader set of plaintiffs (i.e., both target company shareholders receiving shares in a de-SPAC transaction and SPAC shareholders) and (c) end the ability to effectuate a business combination through a proxy statement without filing a registration statement.

Status of SPACs under the Investment Company Act

The SEC is proposing a new Rule 3a-10 under the Investment Company Act that would establish a safe harbor from investment company status for SPACs.

The conditions of the safe harbor include that the SPAC:

1. maintain assets comprised only of cash items, government securities, and certain money market funds;
2. seek to complete a single de-SPAC transaction after which the surviving entity will be primarily engaged in the business of the target company;
3. enter into an agreement with a target company to engage in a de-SPAC transaction within 18 months after its initial public offering and complete its de-SPAC transaction within 24 months of such offering; and

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4. distribute in cash to investors as soon as reasonably practicable any assets of the SPAC (a) that are not used in connection with the de-SPAC transaction or (b) in the event of a failure of the SPAC to satisfy either the 18 month deadline or the 24 month deadline discussed above.

A SPAC that does not satisfy the conditions set forth above would not necessarily fall within the definition of "investment company" under the Investment Company Act. However, SPACs that do fit within the proposed safe harbor would have greater certainty that they will not be found to be investment companies. A safe harbor clarifying that SPACs are not investment companies would be valuable in the wake of recent shareholder litigation on this topic.

Approximately 40% of SPACs had not announced a transaction within 18 months following their initial public offering and 35% had not completed a de-SPAC transaction within 24 months following their initial public offerings. This illustrates that many SPACs will find it challenging to meet the third requirement described above. Notably, some SPACs have longer life cycles than that proposed by the SEC, including through extensions of such life cycle that may be sought. The proposal could lead to the shortening of the investment horizon, and limiting the ability of SPACs to seek extensions of their outside dates, which is particularly problematic in situations where the SPAC is actively under discussions or otherwise engaged in the deal process with a particular target.

SPACs must now balance speed of execution with the heightened due diligence and procedural aspects imposed by the new rules.

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For further information and to discuss what this development might mean for you, please get in touch with your usual Baker McKenzie contact.

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