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# SEC ADOPTS TOUGH NEW RULES FOR SPACS

NEW GUIDANCE FOR ALL COMPANIES ON PROJECTIONS

Jan 31, 2024

## WHAT HAPPENED

On January 24, 2024, the SEC approved by a 3-2 vote new rules to substantially change the disclosure and liability regime governing SPACs, including de-SPAC transactions, or "SPAC target IPOs" as referred to by Chairman Gensler .

Among other things, the new rules provide for:

- Disclosure of key features and risks, sponsor identity, conflicts of interest and compensation of the parties and their affiliates, and dilution.
- Disclosure of the transaction background, including discussions by the parties, and enhanced disclosure of third party reports or opinions.
- Loss of PLSRA safe harbor protection for projections, along with new related disclosures.
- Aligning financial statement requirements for target companies with those for a typical IPO.
- Treatment of target companies as co-registrants.
- Redetermination of the combined company as a smaller reporting company after the de-SPAC closing.

The SEC did not adopt two of the proposals, electing instead to provide guidance on:

- Underwriter status in de-SPAC transactions, instead of proposed Rule 140a.
- The status of SPACs under the Investment Company Act of 1940 (1940 Act), instead of proposed Rule 3a-10 – potentially raising risks for SPACs with durations of more than 12-18 months, and possibly other public companies as well.

The SEC also adopted new rules:

- Governing projections by public companies generally, not just SPACs.
- Treating any business combination involving a reporting shell company – not just SPACs – as a sale of securities to shareholders of the shell.

## TAKEAWAYS

The new rules and guidance could, among other things:

- Increase costs of SPAC IPOs and de-SPAC transactions to comply with the new disclosure requirements.
- Reduce the use of projections in de-SPAC transactions by denying them safe harbor protection and increase costs by subjecting them to more rigorous scrutiny and disclosure.
- Increase costs of, and potentially discourage involvement of, third parties who provide advice to SPAC participants due to increased disclosure requirements.
- Increase potential liabilities for participants in de-SPAC transactions where their involvement could create potential risk of characterization as underwriters.
- Reduce flexibility in structuring SPACs with durations of more than 12-18 months depending on perceptions of heightened risk from the new 1940 Act guidance.

As summarized in the Addendum at the end of this alert, Commissioners Peirce and Uyeda dissented and warned that the new rules may significantly reduce the appeal of SPACs and de-SPAC transactions and, thus, the number of public companies in U.S. markets.

## EFFECTIVE DATES

The final rules will become effective 125 days after publication in the Federal Register. Compliance with the structured data requirements (which require tagging of information disclosed pursuant to new subpart 1600 of Regulation S-K in Inline XBRL) will be required 490 days after publication of the final rules in the Federal Register.

## DEEPER DIVE

**New SPAC disclosure requirements**

The new rules (new Subpart 1600 of Regulation S-K) require additional disclosures about:

- *SPAC Sponsor* – detailed information, including how the rights and interests of the SPAC sponsor, its affiliates, and any promoters may differ from, or may conflict with, those of public shareholders, along with enhanced disclosure regarding the compensation of the SPAC

sponsor, its affiliates or promoters and agreements, arrangements, or understandings with the SPAC or its affiliates, including lock-ups, and share transfers by a SPAC sponsor, its affiliates, and promoters;

- *Potential or actual conflicts of interest* – including (1) in determining whether to proceed with a de-SPAC transaction or (2) arising from the manner in which a SPAC compensates the sponsor or its management or the SPAC sponsor compensates its officers and directors or fiduciary duties owed to other companies. The conflicts include those between (x) the SPAC sponsor and its affiliates, the SPAC's officers, directors or promoters, or the target's officers or directors and (y) unaffiliated shareholders of the SPAC.
- *Dilution* – including as a result of shareholder redemptions, sponsor compensation, underwriting fees, outstanding warrants and convertible securities, and PIPE financings (including a simplified table on the prospectus cover page in S-1s or F-1s, excluding de-SPAC transactions); and
- *Certain key features and potential risks* – in plain English – on the prospectus cover page and in the prospectus summary of registration statements filed in connection with SPAC IPOs and de-SPAC transactions.

**Enhanced disclosure and fairness-related procedural requirements in de-SPAC transactions**

New Subpart 1605 will require enhanced disclosures about de-SPAC transactions – to align more closely with those in traditional IPOs – as well as the board determination:

- *Background and reasons* – additional disclosures on de-SPAC transactions and any related financing transaction, including – with respect to both the SPAC and the target – background, material terms and effects, reasons for the transactions, structure and timing, material differences in shareholder rights, tax and accounting matters.
  - Benefits and detriments to non-redeeming shareholders, quantified to the extent practicable, including prospective returns the sponsor and its affiliates stand to gain or lose that are dependent on the completion of the transaction.
  - Any material interests of the SPAC's sponsor, officers or directors in the de-SPAC transaction or any related financing transaction, including any fiduciary or contractual obligations to other entities and any interest in, or affiliation with, the target company.
  - Any material interests held by target officers or directors that consist of any interest in, or affiliation with, the SPAC or its sponsor.

- *Board determination* – the SPAC's board will need to state (1) in cases where applicable law requires a determination as to advisability and in the best interests of shareholders, such as in Delaware, the determination reached by the board, and (2) the basis for such belief, including the material factors supporting such belief, to the extent considered, as well as (3) whether any cleansing vote requirements are being utilized, such as a requirement for approval by a majority of unaffiliated shareholders or disinterested directors.

- *Reports, opinions and appraisals* – whether the SPAC or its sponsor has received any outside report, opinion (other than an opinion of counsel) or appraisal materially related to the board determination referred to above, the approval of the de-SPAC transaction, the consideration or fairness of the consideration to shareholders of the target or the SPAC and provide a detailed description of the advisor, any material relationships with the advisor, the role of the advisor in determining the consideration or valuation and a summary of the report, which would also need to be filed as an exhibit.

**Increased requirements for de-SPAC transactions to align them with IPOs**

The new rules will increase disclosure, procedural and liability requirements for de-SPAC transactions:

- *Loss of PSLRA safe harbor for forward-looking statements* – provide that the safe harbor for forward-looking statements under the Private Securities Litigation Reform Act of 1995 (PSLRA) will not be available to SPACs, including for projections of targets seeking to access the public markets through a de-SPAC transaction. As the safe harbor is not available in a traditional IPO, the SEC believes de-SPAC transactions (and other blank check offerings) should be treated the same.
  - In light of questions as its authority to directly modify the PLSRA through rulemaking, the SEC effected the change by expanding the definition of "blank check company" – which is excluded from use of the PLSRA – to include companies whose business plan is to engage in a merger or acquisition with an unidentified company.

- *Align non-financial disclosures with those for IPOs* – amend the SEC forms and schedules filed in connection with de-SPAC transactions (including S-1, S-4, 14A and TO) to require additional disclosures about the target company, equivalent to those in the "Super 8-K" currently required following closing of an IPO.

- *Minimum dissemination period* – require that disclosure documents in de-SPAC transactions be disseminated to investors at least 20 calendar days before a shareholder meeting or the earliest date of action by consent, or the maximum period allowed under governing law if less than 20 calendar days.

- *Target company as co-registrant* – deem the target company in a de-SPAC transaction to be a co-registrant of the registration statement on Form S-4 or Form F-4 filed for a de-SPAC transaction, such that the target and its signing persons would be subject to liability under Section 11 of the Securities Act as signatories – equivalent to liability in an IPO by an issuer.

    - The SEC notes that this means target companies will be required to file periodic reports after effectiveness of the de-SPAC registration statement and until they terminate or suspend their reporting obligations.

- *Re-determination of SRC status* – amend the definition of smaller reporting company (SRC) to require a re-determination of SRC status following completion of a de-SPAC transaction – such that the former SPAC would be unable to utilize reduced disclosure and other accommodations in the first 10-K, 10-Q or 8-K if it no longer qualifies.

**Other requirements**

- *Tender offers.* New Item 1608 codifies a staff position that (1) tender offer statements filed in connection with a de-SPAC transaction must contain substantially the same information about a target that is required under the proxy rules and (2) a SPAC must comply with the procedural requirements of the tender offer rules when conducting the transaction for which the Schedule TO is filed, such as a redemption of the SPAC securities.
- *XBRL.* Tagging will be required of quantitative disclosures (detailed) and narrative disclosures (block text), after a one-year phased-in compliance date.

**Guidance as to underwriter status and liability in de-SPAC transactions**

Instead of approving controversial Rule 140a addressing when a specific party is an underwriter for de-SPAC transactions, the SEC decided to follow its practice of applying the terms “distribution” and “underwriter” broadly and flexibly, based on facts and circumstances. While not implementing the proposed rule, the SEC provided guidance regarding underwriter status in de-SPAC transactions, explaining:

- A “distribution” is not limited to traditional capital raising. Although different in form, a de-SPAC transaction has the same purpose and effect as an IPO by providing the target company with capital and access to the public market.
- Although the target company does not formally “sell” shares in every case, the statutory concepts of offer and sale are broad and can encompass situations where no actual exchange of shares takes place. Moreover, new Rule 145a establishes that a “sale” occurs from the

combined company to the SPAC's existing shareholders even if the target is not "selling" or "distributing" its own shares.

- An "underwriter" is not limited to purchasing securities from an issuer with a view to distribution. It also includes anyone who is:
  - offering or selling for an issuer in connection with a distribution,
  - participating in, or having a direct or indirect participation in any such undertaking, or
  - participating in, or having a participation in, the direct or indirect underwriting of such an undertaking.

- Although not every de-SPAC transaction may have an underwriter, an underwriter would be present where someone is selling for the issuer or participating in the distribution of securities in the combined company to the SPAC's investors and the broader public. Depending on the facts and circumstances, such an entity could be deemed a "statutory underwriter" even though it may not be named as an underwriter in any given offering or may not be engaged in activities typical of a named underwriter in traditional capital raising.

The SEC noted proposed Rule 140a was not intended to address any business combination transaction not involving a de-SPAC transaction and that the new guidance is not intended to influence current practice in traditional M&A.

**Increased requirements for disclosure of projections**

In light of recent concerns about the use of projections in de-SPAC and other transactions that may have lacked a reasonable basis, the SEC adopted amendments to increase requirements for projections:

- ***For all companies*** (Item 10(b) of Regulation S-K):
  - Any projected measures that are not based on historical financial results or operational history should be clearly distinguished from projected measures that are based on historical financial results or operational history.
  - Projections that are based on historical financial results or operational history should generally not be presented without also presenting such historical measure or operational history with equal or greater prominence.
  - The presentation of projections that include a non-GAAP financial measure should include a clear definition or explanation of the measure, a description of the GAAP financial measure to which it is most directly comparable, and an explanation why the non-GAAP financial

measure was used instead of a GAAP measure. (The need to provide a GAAP reconciliation would continue to be governed by Regulation G and Item 10(e) of Regulation S-K.)

The SEC confirmed that the new rules do not affect staff guidance in CDIs relating to non-GAAP financial measures used in forecasts for business combinations.

The guidelines also apply to projections of future economic performance of persons other than the registrant, such as the target company in a business combination transaction, that are included in the registrant's SEC filings.

- ***For de-SPAC transactions*** (new Item 1609 of Regulation S-K), the disclosure should include:
    - The purpose for which the projections were prepared and the party that prepared them.
    - All material bases of the disclosed projections and all material assumptions underlying the projections, and any material factors that may affect such assumptions (including material growth or reduction rates or discount rates used in preparing the projections, and the reasons for selecting such growth or reduction rates or discount rates).
    - Whether the disclosed projections still reflect view of the board or management of the SPAC or target company, as applicable, as of the most recent practicable date before the filing; if not, then discussion of the purpose of disclosing the projections and the reasons for any continued reliance by the management or board on the projections.

The disclosures in the first two bullets will also be required in any 8-K report or exhibit relating to a de-SPAC transaction that includes projections related to the SPAC or the target.

**Business combinations involving shell companies – new Rule 145a**

To address incidents where shell companies are used to distribute securities in business combinations without a registration statement, new Rule 145a will deem any business combination of an SEC reporting shell company – not just SPACs – with an operating company to involve a sale of securities to the existing shareholders of a reporting shell company – regardless of the form or structure and regardless of whether a shareholder vote or consent is solicited. Although shareholders of a shell company may not make a traditional investment decision or vote, the SEC believes they are effectively exchanging their interests in the shell company for interests in a non-shell company and therefore will have surrendered "value" for the purposes of Section 2(a)(3) of the Securities Act. The new rule is intended to address potential disparities in disclosure and liability based solely on the form or structure of the transaction.

The new rule will not apply to "business combination related shell companies," so it will not affect traditional triangular mergers involving shell companies created by an operating business or other

non-shell entity.   It will also not apply to a business combination of one shell company with another shell company.

Although the SEC acknowledges that the use of a valid exemption would remain available in lieu of registration, it believes that Section 3(a)(9) – which exempts any securities exchange by an issuer with its existing security holders exclusively where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange – will not be available for the sales covered by Rule 145a.

**Financial statement requirements in business combination transactions involving shell companies**

The SEC believes the manner in which a company goes public should not result in substantially different financial statement disclosures.  New Article 15 of Regulation S-X, as well as related amendments, will more closely align the financial statement requirements in business combinations involving a shell company and a private operating company with those in traditional IPOs – and is based in part on staff guidance for transactions involving shell companies.

The new requirements address, among other things: (1) the number of years of financial statements; (2) audit requirements for the target operating company; (3) the age of financial statements for the target operating company; (4) requirements in cases where the target will not be the predecessor; and (5) requirements for the shell company after combining with a predecessor target.

**Guidance under the Investment Company Act of 1940**

The SEC withdrew its controversial proposal for a restrictive safe harbor for SPACs from the definition of "investment company" under the Investment Company Act of 1940 (the 1940 Act). After reviewing comments, it recognized that the determination is highly fact-based and individualized, and that a specific duration limitation, as proposed, may not be appropriate because a SPAC could become an investment company at any stage of its operation.

Instead, it decided to provide guidance on factors relevant to whether a SPAC would constitute an investment company. Although duration is only one of a number of factors, the SEC noted that "a SPAC's activities may become more difficult to distinguish from an investment company the longer the SPAC takes to achieve its business purpose."  The SEC highlighted the following:

- *The nature of SPAC assets (whether held in escrow or directly) and income*. In particular, a SPAC that owns or proposes to acquire 40% or more of its total assets in investment securities would likely need to register under the 1940 Act unless an exclusion from the definition applies.  Such activities would also weigh in favor of a SPAC being considered to be primarily engaged in the business of investing, reinvesting, and trading in securities.

- *Management activities.* Concerns would arise if a SPAC held its investors' money in securities, but the SPAC management did not actively seek a de-SPAC transaction or spent a considerable amount of their time actively managing the SPAC's portfolio for the primary purpose of achieving investment returns.

- While the duration of a SPAC is not the sole factor, a SPAC's activities may become more difficult to distinguish from those of an investment company the longer the SPAC takes to achieve its stated business purpose. The SEC cautioned that SPACs should consider the one-year safe harbor for "transient investment companies" under Rule 3a-2 and the 18-month cut-off for blank-check companies for escrowed funds in an offering of penny stock under Rule 419. According to the SEC:

  "A SPAC that operates beyond these timelines raises concerns that the SPAC may be an investment company, and these concerns increase as the departure from these timelines lengthens. Thus, a SPAC needs to be cognizant that, depending on the facts and circumstances, it could be viewed as a fund-like investment if it operates beyond the duration limits contemplated in other similar contexts."

- *Holding out.* A SPAC that holds itself out in a manner that suggests that investors should invest in its securities primarily to gain exposure to its portfolio of securities prior to the de-SPAC transaction would likely be an investment company.

- *Merging with an investment company.* A SPAC that seeks to engage in a de-SPAC transaction with an investment company would, at some point prior to the de-SPAC transaction, be proposing to engage in the business of being an investment company.

## ADDENDUM

**Key Concerns of Dissenting Commissioners**

Commissioner Uyeda's dissenting statement criticized, among other things, the "de facto merit" regulation, i.e., the stricter treatment of SPACs and de-SPAC transactions as compared to comparable companies or transactions:

- **Unjustifiedly Stricter Disclosure for SPACS vs other M&ATransactions**
  - *Projections.* If the SPAC or the target company makes projections, including in a third-party fairness opinion, disclosure is required on whether they reflect the views of the board or management team as of the most recent practicable date.
  - *Identification of dissenting/abstaining directors.* SPAC directors who vote against, or abstained from voting on, the de-SPAC transaction must be identified and, if known, the reasons for the vote or abstention must also be disclosed.

  - *No immateriality exception for discussions.* The SPAC must disclose all "contacts," which means discussions, with the target company concerning the de-SPAC transaction. In contrast, the buyer in a typical M&A transaction needs to disclose only "material contacts."

- **Disclosure Applicable to More "Officers."** Disclosure regarding conflicts of interest and fiduciary duties in SPAC IPOs and de-SPAC transactions will apply to "officers" – not just executive officers as with other companies.

- **XBRL Tagging.** Registration statements for traditional IPOs do not require any XBRL tagging.

- **1940 Act guidance.** The guidance amounts to *de facto* merit regulation by raising concerns about SPACs that operate beyond arbitrary 12-18 month timeframes adopted for different regulatory purposes before completing a business combination. Further, the guidance could have implications for any an operating company that temporarily derives income from investment securities – not just SPACs. In addition, the guidance erroneously applies existing rules for its support.

Commissioner Peirce's dissenting statement highlighted some of the obstacles for SPACs created by the new rules and guidance:

- **1940 Act.** The 1940 Act guidance will increase costs and harm investor protection by potentially rushing the completion of de-SPAC transactions.

- **Co-registrant status.** Requiring target companies to co-register on the SPAC's registration statement will increase costs without commensurate benefit.

- **Loss of PLSRA protection.** Eliminating eligibility for safe harbor protection for forward-looking statements for projections will make them more costly and no more accurate (and maybe even less).

- **Dilution.** New required dilution disclosures may be unduly speculative and compromise accuracy for the sake of false comparability.

- **Third party advice.** Requiring disclosure of third-party assessments of the de-SPAC transaction could potentially discouraging prudent advice.

- Requiring disclosure of board director votes on approval of the de-SPAC transaction could result in affect voting behavior and thereby increase risk.

She also questioned some of the SEC's actions:

- Excluding SPACs from the PSLRA safe harbor 30 years later by rewriting the statutory definition of "blank check company.w"

- Effectively creating a "backdoor" 1940 Act rule through new guidance, even though the staff had reviewed "more than 1,000 SPAC IPOs" over the past 20 years without deeming a SPAC to be an investment company.
- Providing underwriting guidance without providing "directly relevant legal precedent" and questioning the statutory basis for new Rule 145a and the view that a de-SPAC transaction involves a distribution when the target company does not sell or distribute its securities into the market.

She expressed dismay about the SEC "removing a potential avenue for bringing small companies into the public market," and "fail[ing] to acknowledge, let alone grapple with, real issues around the public markets' accessibility for small companies."

## RELATED PRACTICE AREAS

- Securities & Corporate Governance

## MEET THE TEAM

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