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IS THE PARTY OVER? SEC PROPOSES SUBSTANTIAL NEW REQUIREMENTS FOR SPACS AND DE-SPAC TRANSACTIONS

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On March 30, 2022, the SEC approved by a 3-1 vote a proposal to effect significant changes to disclosure and liability rules governing SPACs, including de-SPAC transactions, or “SPAC target IPOs” as referred to by Chairman Gensler. As Commission Peirce identified in her dissenting statement, the proposal would, among other things:

- Require a SPAC to state whether it “reasonably believes that the de-SPAC transaction and any related financing transaction are fair or unfair to unaffiliated security holders of the [SPAC]";
- Deem target companies to be co-registrants at the de-SPAC stage;
- Eliminate the availability of the safe harbor for forward-looking statements in de-SPAC transactions;
- Impose underwriter liability on SPAC IPO underwriters by deeming many of them to be underwriters at the de-SPAC stage; and
- Establish a non-exclusive safe harbor for SPACs under the Investment Company Act of 1940.

The proposal also includes new rules and amendments relating to shell companies and to the use of projections in SEC filings.

If adopted as proposed, the new rules may significantly impact the appeal of SPACs and de-SPAC transactions – including by existing SPACs -- by, among other things:

- Changing underwriting compensation arrangements, such as by moving back-end fees to the IPO if underwriters seek to reduce potential liability in the de-SPAC transaction;
- Reducing the use of projections in de-SPAC transactions and/or subjecting them to more rigorous scrutiny and disclosure;

- Increasing potential liabilities for targets and underwriters or financial advisors, resulting in increased diligence and underwriting or adviser costs; and
- Reducing flexibility in structuring SPACs in order to utilize the investment company safe harbor.

The public comment period will remain open until the later of May 31, 2022 or 30 days following publication of the proposing release in the Federal Register.

New SPAC disclosure requirements

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

- *SPAC Sponsor* – including its experience, material roles and arrangements relating to proceeding with a de-SPAC transaction and the redemption of securities; controlling persons and others with material interests in the sponsor; material terms of lock-up agreements; and the nature and amounts of all forms of compensation arrangements;
- *Potential or actual conflicts of interest* – including in determining whether to proceed with a de-SPAC transaction or arising from the manner in which a SPAC compensates the sponsor or the SPAC's or the sponsor's executive officers and directors or fiduciary duties owed to other companies;
- *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

Proposed Subpart 1605 would require enhanced disclosures for de-SPAC transactions – to align more closely with those in traditional IPOs – as well as a fairness determination requirement:

- *Background and reasons* – additional disclosures on de-SPAC transactions and any related financing transaction, including background, material terms and effects, reasons for the transactions, structure and timing, material differences in shareholder rights, tax and accounting matters.

    - This would include a reasonably detailed discussion of 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.

    - Material interests of the SPAC's sponsors, officers and 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 private operating company that is the target of the de-SPAC transaction.

- *Fairness determination* – the SPAC would need to state (1) whether it reasonably believes that the de-SPAC transaction and any related financing transaction are fair or unfair to investors, and (2) the basis for such belief, including the material factors supporting such belief and the weight assigned to each, 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* – the SPAC would need to disclose whether it or its sponsor has received any outside report, opinion, or appraisal relating to the fairness of the transaction 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 proposals would 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) would 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.

- *Align non-financial disclosures with those for IPOs* – amend the registration statement forms and schedules filed in connection with de-SPAC transactions to require additional disclosures about the private operating 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 private operating company (target) 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 to the registration statement – equivalent to liability in an IPO by an issuer.

- *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 or 10-Q if it no longer qualifies.

Underwriter status and liability in de-SPAC transactions

The SEC is proposing a new rule, Securities Act Rule 140a, that would deem anyone who has acted as an underwriter of the securities of a SPAC and takes steps to facilitate a de-SPAC transaction, or any related financing transaction or otherwise participates (directly or indirectly) in the de-SPAC transaction to be engaged in a distribution and to be an underwriter in the de-SPAC transaction. The SEC believes that by extending underwriter status to de-SPAC transactions, the proposed rule should better motivate SPAC underwriters to perform a "gatekeeper" function to ensure the accuracy of the disclosure in these transactions by affirming that they are subject to Section 11 liability for that information.

The proposing release contains a detailed discussion of underwriter status and liability, potentially implying that SPAC IPO underwriters may *already* have exposure for de-SPAC transactions. For example, the SEC describes the rule as "clarify[ing]" the status of anyone who acts as an underwriter in a SPAC IPO and participates in taking steps to facilitate a de-SPAC transaction, or any related financing transaction, with a detailed discussion of the broad application of terms such as "statutory underwriters" and "in connection with" a "distribution." In addition, the SEC noted that a significant portion of compensation of SPAC IPO underwriters is typically deferred until, and conditioned upon, completion of the de-SPAC transaction, and that underwriter liability can exist even without a pecuniary benefit or if the party does not sell securities directly to the public or does not have privity of contract with the issuer.

Increased requirements for disclosure of projections

The SEC noted that projections are not expressly required by federal securities laws, but that companies may disclose them: (1) to comply with applicable corporate law regarding a board decision to approve a business combination or the basis underlying a fairness opinion or (2) to avoid claims that the omission violates Rule 10b-5 or Regulation M-A, such as in cases where projections were used to negotiate the price or terms or to allocate risks.

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 is proposing 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; and
  - 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 closely related, and an explanation why the non-GAAP financial measure was used instead of a GAAP measure.

- For de-SPAC transactions (new Item 1609 of Regulation S-K), the disclosure should include:
  - With respect to any projections disclosed by the registrant, the purpose for which the projections were prepared and the party that prepared the projections;
  - All material bases of the disclosed projections and all material assumptions underlying the projections, and any factors that may materially impact such assumptions (including a discussion of any factors that may cause the assumptions to be no longer reasonable, material growth rates or discount multiples used in preparing the projections, and the reasons for selecting such growth rates or discount multiples); and
  - Whether the disclosed projections still reflect view of the board or management of the SPAC or target company, as applicable, as of the date of 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.

As part of its justification, the SEC explained that, in its view, de-SPAC transactions present heightened incentives for aggressive projections because (1) the sponsor's compensation may be dependent in large part on completion of the transaction; (2) the projections may be used to value the target and influence how investors evaluate the transaction; and (3) such projections may be used to help meet stock exchange listing requirements. The proposed disclosure would inform investors about why projections were prepared and by whom, which the SEC believes would clarify the motivations underlying such projections and help investors assess the reliability of the projections.

Business combinations involving shell companies

To address incidents where shell companies are used to distribute securities in business combinations without a registration statement, new Rule 145a would 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 reporting shell company's shareholders – regardless of the form or structure and regardless of whether a shareholder vote or consent is solicited. Although no securities may actually change hands, the SEC believes shareholders in a reporting shell company merger 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). The proposed rule is intended to address potential disparities in the disclosure and liability protections available to reporting shell company shareholders that have historically existed based solely on the form or structure of the transaction in a reporting shell company business combination.

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 – generally would not be available for the sales covered by proposed Rule 145a. This is because, in the view of the SEC, the deemed exchange by the reporting shell company'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. Similarly, the use of a proxy solicitor by the reporting shell company would also make the exemption unavailable.

The proposed rule would not apply to "business combination related shell companies" or to a business combination of one shell company into another shell company.

Financial statement requirements in business combination transactions involving shell companies

The SEC believes the manner in which a company goes public should not generally result in substantially different financial statement disclosures. Proposed Article 15 of Regulation S-X, as well as related amendments, would 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 proposed requirements would address, among other things: (i) the number of years of financial statements; (ii) audit requirements for the target operating company; (iii) the age of financial statements for the target operating company; (iv) requirements in cases where the target will not be the predecessor; and (v) requirements for the shell company after combining with a predecessor target.

Proposed safe harbor under the Investment Company Act of 1940

The SEC believes that the asset composition and sources of income for most SPACs may raise questions about their status as investment companies under Section 3(a)(1)(A) of the Investment Company Act of 1940 (the 1940 Act). Proposed Rule 3a-10 would provide a safe harbor from the definition of "investment company" under Section 3(a)(1)(A) of the 1940 Act for SPACs that satisfy certain conditions that limit a SPAC's duration, asset composition, business purpose and activities.

The conditions are:

- *Nature and management of SPAC assets* – A SPAC's assets must consist solely of Government securities, Government money market funds and cash items prior to the completion of the de-SPAC transaction. Although acquiring other types of assets and then transferring such assets to another entity or to SPAC shareholders would suggest that the SPAC's primary business is that of investing in securities, the provision would not prevent the SPAC from using its assets to pay operating expenses. Further, the assets may not be traded for the primary purpose of recognizing gains or decreasing losses from market value changes.

- *Single de-SPAC transaction* – The safe harbor would only be available to SPACs that seek to complete a single de-SPAC transaction. 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. Further, the SPAC would need to seek to complete a de-SPAC transaction as a result of which the surviving company would have at least one class of securities listed for trading on a national securities exchange. This requirement would not prevent the SPAC from acquiring more than one target, provided all targets are acquired in a single transaction.

- *Evidence of primary engagement* – The safe habor would require a SPAC to be primarily engaged in the business of seeking to complete a de-SPAC transaction in the manner and within the timeframe set forth in the rule – as evidenced by the activities of its officers, directors and employees, its public representations of policies, and its historical development. Further, the board of directors would need to adopt a resolution evidencing that the company is primarily engaged in the business of seeking to complete a single de-SPAC transaction. In addition, under the proposed rule, a SPAC may not hold itself out as being primarily engaged in the business of investing, reinvesting or trading in securities; for example, it could not market itself as a means for gaining exposure to U.S. Treasury securities akin to a money market fund.

- *Duration limitations* – A SPAC would need to file a Form 8-K announcing that it has entered into an agreement with the target(s) to engage in a de-SPAC transaction no later than 18 months after the effective date of the IPO registration statement and then complete the de-SPAC transaction no later than 24 months after the effective date of the registration statement for the IPO. Any assets that are not used in connection with the de-SPAC transaction would need to be distributed in cash to investors as soon as reasonably practicable thereafter. If the 18-month or 24-month deadline is not met, the SPAC would be required to distribute its assets in cash to investors as soon as reasonably practicable – the one-year safe harbor under Rule 3a-2 for transitory investment companies would not then be available.

The SEC acknowledges that a SPAC would not be required to rely on the safe harbor, but believes that the proposed rule would provide more certainty as well as a clear framework for SPACs to determine their status under the 1940 Act.

The proposed safe harbor would only address status under Section 3(a)(1)(A) (the subjective test) of the 1940 Act. SPACs would still need to avoid investment company status under Section 3(a)(1)(C) (the objective test), which encompasses 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% of the value of the company's total assets (exclusive of Government securities and cash items) on an unconsolidated basis.

RELATED CAPABILITIES

- Securities & Corporate Governance

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