SEC's SPAC Crackdown Begins

On March 30, 2022, the SEC proposed rules covering special purpose acquisition companies (SPACs) for initial public offerings (IPOs) and business combinations with private operating companies (de-SPAC transactions). The rules would better align the procedural and disclosure requirements for de-SPAC transactions more closely with those for IPOs. The proposal also covers shell companies and projections disclosure. Highlights include:

- New disclosures
  - SPAC sponsors, conflicts of interest, and dilution
  - Fairness statement for de-SPAC transactions
- Investor protections
  - A requirement that the private operating company would be a co-registrant when a SPAC files a registration statement on Form S-4 or Form F-4 for a de-SPAC transaction
  - A re-determination of smaller reporting company (SRC) status within four days of a de-SPAC transaction
  - An updated "blank check company" definition to make the liability safe harbor in the Private Securities Litigation Reform Act of 1995 (PSLRA) for forward-looking statements, such as projections, unavailable in SPAC filings and certain other blank check companies
  - A rule that deems underwriters in a SPAC IPO to be underwriters in a subsequent de-SPAC transaction when certain conditions are met
- Level the disclosure requirements between business combinations involving a reporting shell company and amend the financial statement requirements for shell company transactions
- Additional guidance on the use of projections in SEC filings
- Clarify when SPACs may be subject to regulation under the Investment Company Act of 1940

The SEC's regulatory agenda indicates a final rule is planned before April 2024.

Background

A SPAC is a company with no commercial operations that is formed strictly to raise capital through an IPO for the purpose of acquiring an existing company. The IPO proceeds are placed in an escrow account for the future acquisition of one or more companies. A SPAC generally sets a two-year period to identify and complete a business transaction. If the SPAC fails to do so within the specified period, it must return the funds to its shareholders and then dissolve. This structure is similar to blank check companies, which were popular in the 1980s and became a source of securities fraud schemes. Blank check companies eventually fell out of favor

with increased regulation by the SEC, most notably Rule 419 issued in 1992. Although SPACs are not subject to Rule 419 requirements, they are typically structured to operate under similar—though usually less stringent—conditions to attract investors and comply with exchange listing requirements.

In the past two years, U.S. securities markets have experienced an unprecedented surge in the number of SPAC IPOs, with SPACs raising more than $83 billion in 2020 and more than $160 billion in 2021. In 2020 and 2021, more than half of all IPOs were conducted by SPACs. SPAC transactions slowed in 2022 following the issuance of an SEC staff statement on April 12, 2021, which highlighted potential accounting implications related to warrants that are commonly included in SPAC transactions.

See article "What You Need to Know About SPACs" for additional details on the history of SPACs, how a SPAC is established and operates, existing regulations, and accounting considerations for private companies using SPACs to enter capital markets.

Enhanced Disclosures

The proposal would add a new Subpart 1600 to Regulation S-K prescribing disclosures about the SPAC's sponsor, potential conflicts of interest, and dilution, as well as new disclosures for de-SPAC transactions.

Sponsor Disclosure – Item 1603(a)

Item 1603(a) would require the following disclosures about the sponsor:

- The sponsor's controlling persons 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
- The experience, material roles, and responsibilities of the sponsor, its executive officers, directors, or affiliates, as well as details on any agreement, arrangement, or understanding between these parties in determining whether to proceed with a de-SPAC transaction and the redemption of outstanding securities
- Tabular disclosure of the material terms of any lock-up agreements with the sponsor and its affiliates
- 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

Conflicts of Interest – Item 1603(b)

Disclosure will be required of any actual or potential material conflict of interest between the sponsor or its affiliates or the SPAC's officers, directors, or promoters, and unaffiliated security holders. This includes any conflict of interest in determining whether to proceed with a de-SPAC transaction and any conflicts related to the SPAC's compensation to the sponsor, the SPAC's executive officers and directors, or how the sponsor compensates its own executive officers and directors.

Dilution – Items 1602(c)

The proposal cites a study that found the median dilutive impact of sponsor compensation, underwriting fees, warrants, and rights equaled 50.4 percent of the cash raised in a SPAC IPO. The complex structures make it difficult for investors to understand the dilutive impact of sponsor compensation on the SPAC's non-redeeming shareholders.

New disclosures would be required about the potential for dilution in registration statements filed by SPACs, both for the IPO and de-SPAC transactions. This includes a description of material potential sources of future dilution following a SPAC's IPO, as well as tabular disclosure of the amount of potential future dilution from the public offering price that will be absorbed by non-redeeming SPAC shareholders, to the extent quantifiable. Disclosure would be required of each material potential source of additional dilution that non-redeeming shareholders may experience at different phases of the SPAC lifecycle by electing not to redeem their shares in connection with the de-SPAC transaction. A tabular sensitivity analysis also is required 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. A description of the model, methods, assumptions, estimates, and parameters necessary to understand the sensitivity analysis also is mandated.

The tabular disclosure would incorporate a range of potential redemption levels on the prospectus cover page of SPAC registration statements on Forms S-1 and F-1.

Remaining Pro Forma Net Tangible Book Value per Share				
Offering Price of _____	25% of Maximum Redemption	50% of Maximum Redemption	75% of Maximum Redemption	Maximum Redemption

These disclosures would be in addition to the disclosure already required under Item 506 of Regulation S-K.

Fairness Statement – Item 1606(a)

Proposed Item 1606(a) of Regulation S-K would require a statement in any Forms S-4 and F-4 or Schedules 14A, 14C, and TO filed in connection with a de-SPAC transaction as to whether the SPAC reasonably believes that the de-SPAC transaction and any related financing transaction are fair or unfair to the SPAC's unaffiliated security holders, as well as a description of the basis for this statement.

Prospectus Cover & Summary

In addition to the current requirement in Item 501 of Regulation S-K, the proposal includes a new requirement for plain English disclosures for SPAC and de-SPAC transactions on the prospectus cover page. SPAC transaction required details include the time frame for the SPAC to consummate a de-SPAC transaction, redemptions, sponsor compensation, dilution (including simplified tabular disclosure), and conflicts of interest. For de-SPAC transactions, details should include the fairness of the de-SPAC transaction, material financing transactions, sponsor compensation and dilution, and conflicts of interest.

SPACs should include the following information in the prospectus summary in plain English:

- The process by which a potential business combination candidate will be identified and evaluated
- Whether shareholder approval is required for the de-SPAC transaction
- The material terms of the trust or escrow account, including the amount of gross offering proceeds that will be placed in the trust
- The material terms of the securities being offered, including redemption rights
- Whether the securities being offered are the same class as those held by the sponsor and its affiliates

- The length of the time period during which the SPAC intends to consummate a de-SPAC transaction, and its plans if it does not do so, including whether and how the time period may be extended, the consequences to the sponsor of not completing an extension of this time period, and whether shareholders will have voting or redemption rights with respect to an extension of time to consummate a de-SPAC transaction
- Any plans to seek additional financing and how such additional financing might impact shareholders
- Tabular disclosure of sponsor compensation and the extent to which material dilution may result from such compensation
- Material conflicts of interest

Details for de-SPAC transactions in the prospectus summary include:

- The background and material terms of the de-SPAC transaction
- The fairness of the de-SPAC transaction
- Material conflicts of interest
- Tabular disclosure on sponsor compensation and dilution
- Financing transactions in connection with de-SPAC transactions
- Redemption rights

Investor Protections

The proposal creates new rules and amendments to better align the treatment of private operating companies entering the public markets through de-SPAC transactions more closely with those conducting IPOs. The changes are intended to provide investors with disclosures and liability protections comparable to those that would be present if the private operating company were to conduct an IPO.

- **Target as Co-Registrant to Form S-4 and Form F-4.** Currently, only the SPAC and its principal executive officer, principal financial officer, controller, and at least a majority of its board of directors are required to sign the registration statement for a de-SPAC transaction. The private operating company and its officers and directors are not required to sign the registration statement and may avoid liability for false or misleading statements. The proposal would require a private operating company to be treated as a co-registrant when a SPAC files a registration statement. This would make both the SPAC and the target company and both sets of principal executive officers, principal financial officers, controllers, and boards of directors liable for any material misstatements or omissions in the registration statement.
- **Underwriter Liability in De-SPAC Transactions.** The civil liability provisions of the Securities Act provide strong incentives for underwriters to take steps to help ensure the accuracy of disclosure in a registration statement. Section 11 of the Securities Act imposes civil liability on underwriters for any part of the registration statement, at effectiveness, which contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, to any person acquiring such security. Proposed Rule 140a would clarify that a person who has acted as an underwriter in a SPAC IPO and participates in the distribution by taking steps to facilitate the de-SPAC transaction—or any related financing transaction—or otherwise participates (directly or indirectly) in the de-SPAC transaction will be deemed to be engaged in the distribution of the securities of the surviving public entity in a de-SPAC transaction. This rule would have the effect of subjecting those SPAC IPO underwriters (subject to a due diligence defense) to liability for material misstatements or omissions in the de-SPAC transaction registration statement.
- **Elimination of PSLRA Safe Harbor.** The proposal would amend the definition of blank check company to eliminate the PSLRA safe harbor for forward-looking statements, such as projections, for filings by SPACs and certain other blank check companies. Under existing Rule 419, SPACs are generally not blank check companies because they are not selling penny stock.

- **Minimum Dissemination Period.** Disclosure documents in de-SPAC transactions would be required to 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 for disseminating such disclosure documents permitted under the laws of the jurisdiction of incorporation or organization if such period is fewer than 20 calendar days.
- **SRC Re-Determination.** SRCs are a category of registrants that are eligible for scaled disclosure requirements in Regulation S-K and Regulation S-X. Currently, most SPACs qualify as SRCs and a post-business combination company after a de-SPAC transaction is permitted to retain this status until the next annual determination date when a SPAC is the legal acquirer of the private operating company in a de-SPAC transaction. The proposal would require a re-determination of a post-business combination company's SRC status before its first SEC filing after the filing of its Super Form 8-K, with its public float measured as of a date within four business days following the de-SPAC completion. This would generally require SPACs that initially qualified as SRCs to provide more comprehensive disclosures (such as three years of financial statements and quantitative and qualitative information about market risk) earlier following a de-SPAC transaction than under existing rules. The update would reduce regulatory arbitrage by requiring a target company going public through a de-SPAC transaction to provide similar information to investors as a comparable company conducting a traditional IPO.

Shell Companies

Currently, business combinations between shell companies and non-shell companies may result in investors in the reporting shell company not always receiving the disclosures and other protections under securities regulations if the transaction is deemed an exchange and not a sale. The proposal covers all business combinations involving shell companies, including SPACs, and would:

- Rule that a business combination involving a reporting shell company and a non-shell company constitutes a sale of securities to the reporting shell company's shareholders for purposes of the Securities Act. This means the disclosure requirements and liability provisions of the Securities Act would apply.
- Better align the required financial statements of private operating companies in transactions involving shell companies with those required in IPO registration statements. The requirements include the disclosure of three years of statements of comprehensive income, changes in stockholders' equity, and cash flows. A shell company registrant would be permitted to include two years of statements of comprehensive income, changes in stockholders' equity, and cash flows for the private operating company for all transactions involving an emerging growth company (EGC) shell company and a private operating company that would qualify as an EGC.

Projections

Existing guidance in Item 10(b) of Regulation S-K lists important factors to be considered in formulating and disclosing projections in SEC filings. A registrant has the option to present its good faith assessment of future performance but must have a reasonable basis for that assessment. A registrant should disclose the assumptions underlying the projections, the limitations of such projections, and the format of the projections. The proposal expands and updates this guidance. New Item 1609 addresses financial projections used in de-SPAC transactions and includes additional disclosure requirements relating to financial projections.

Item 10(b) Updates – All Issuers

The SEC is concerned when companies present projections more prominently than actual historical results or use non-generally accepted accounting principles (GAAP) financial measures in projections without a clear explanation or definition. The amendments to Item 10(b) would generally apply to all issuers and will clarify:

- Any projected measures that are not based on either historical financial results or operational history should be clearly distinguished from projected measures that are based on historical financial results or operational history.

- It generally would be misleading to present projections that are based on historical financial results or operational history without 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 closely related, and an explanation of why the non-GAAP financial measure was used instead of a GAAP measure.
- The guidance also applies to any projections of future economic performance of persons other than the registrant, such as the target company in a business combination, that are included in the registrant's SEC filings.

Consistent with existing guidance, the reference to the nearest GAAP measure would not require a reconciliation to that GAAP measure; providing a GAAP reconciliation continues to be governed by Regulation G and Item 10(e) of Regulation S-K.

New Item 1609 – De-SPAC Transactions Only

A sponsor's compensation largely depends on the completion of the de-SPAC transaction, and the SPAC and its sponsor may have an incentive to use the private operating company's financial projections in seeking support for the de-SPAC transaction. Controlling shareholders and management of the private operating company may have an incentive to be overly aggressive in their development of projections as a means of justifying a higher price for their company. As a result, the SEC is proposing new de-SPAC transactions disclosures that include:

- For any registrant projections, the purpose of the projections and who prepared the projections
- All material assumptions underlying the projections, and any factors that may materially impact the assumptions (including 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)
- If the disclosed projections still reflect the view of the board or management of the SPAC or target company as of the filing date; if not, then disclose what is the purpose of the projections and the reasons for any continued reliance on the projections by the management or board

SPACs & the Investment Company Act

The proposal addresses the registration status of SPACs under the Investment Company Act. An investment company is currently defined in Section 3(a)(1)(A) as any issuer that is, or holds itself out, as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities. Depending on the facts and circumstances, a SPAC could meet this definition. The proposal would create a non-exclusive safe harbor under the ICA's **subjective test**[1] so that SPACs that meet the following conditions would not need to register as an investment company. To qualify, a SPAC must:

- Maintain assets comprising only cash items, government securities, and government money market funds prior to the de-SPAC transaction. These assets may not at any time be acquired or disposed of to recognize gains or losses from

[1] *The safe harbor does not apply to the **objective test** in §3(a)(1)(C) 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.*

movements in market value. **Acquiring other asset types and then transferring those assets to another entity or to SPAC shareholders would suggest that the SPAC's primary business is security investing**

- Seek to complete a single de-SPAC transaction after which the surviving entity will be primarily engaged in the target's business, which is not that of an investment company
- The SPAC must identify a target company and sign an acquisition agreement within 18 months of the IPO and the de-SPAC transaction must be completed within 24 months. Any assets that are not used for the de-SPAC transaction must be distributed in cash to SPAC shareholders as soon as reasonably practicable after completing the de-SPAC transaction. A SPAC seeking to rely on the safe harbor also would be required to distribute the SPAC's assets in cash to investors if the SPAC fails to meet either the 18-month or the 24-month deadline
- The SPAC is primarily engaged in the business of seeking to complete a de-SPAC transaction, as contemporaneously evidenced by an appropriate resolution of the SPAC's board of directors, as well as by the activities of the SPAC's officers, directors, and employees; its public policy representations; and its historical development
- The SPAC must file a Form 8-K—no later than 18 months after the effective date of its initial registration statement—disclosing an agreement to engage in the de-SPAC transaction with at least one target company
- The SPAC does not hold itself out as being primarily engaged in the business of investing, reinvesting, or trading in securities

A SPAC would not be required to rely on the proposed rule.

Conclusion

We will continue to follow this developing situation. If you have questions about these changes, contact your advisor today.

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