SEC Proposes Significant Changes to Rules Affecting SPACs and De-SPACs

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On March 30, 2022, the Securities and Exchange Commission (SEC or Commission) proposed new rules that would impose additional disclosure requirements on initial public offerings (IPOs) by special purpose acquisition companies (SPACs) and in business combination transactions involving SPACs (de-SPACs).

The proposed rules would significantly impact SPACs in a number of ways, including by:

- Mandating new disclosure requirements in SPAC IPOs and de-SPAC business combinations regarding the sponsor of the SPAC, potential conflicts of interest and dilution of shareholder interests.
- Imposing specialized disclosure and procedural requirements in de-SPAC transactions, including:
  - mandating a fairness determination from the SPAC as to the de-SPAC transaction and any related financing transactions, and
  - requiring disclosure regarding any outside report, opinion or appraisal received by the SPAC or its sponsor.
- Aligning de-SPAC transactions with traditional IPOs for purposes of non-financial statement disclosures and liability protections, including:
  - deeming the private operating company a co-registrant when a SPAC files a Securities Act registration statement for a de-SPAC transaction,
  - rendering unavailable to SPACs the liability safe harbor in the Private Securities Litigation Reform Act of 1995 (PSLRA) for forward-looking statements, and
  - deeming any underwriter in a SPAC IPO to be an underwriter in a subsequent de-SPAC transaction if such person takes steps to facilitate the de-SPAC transaction, or any related financing transaction, or otherwise participates (directly or indirectly) in the de-SPAC transaction.
- Requiring that disclosure documents in de-SPAC transactions generally be disseminated to investors at least 20 calendar days in advance of a shareholder meeting or the earliest date of action by consent.
- Deeming a business combination involving a SPAC and another entity that is not a shell company to constitute a sale of securities to the SPAC shareholders for purposes of the Securities Act.
- Aligning more closely the financial statement requirements in a business combination transaction involving a SPAC and a private operating company with those in a traditional IPO.
- Updating and expanding guidance regarding the general use of projections in SEC filings, as well as when projections are disclosed in connection with a de-SPAC transaction.
- Creating a safe harbor that would be available to qualifying SPACs under the Investment Company Act of 1940 (Investment Company Act).

Comments should be received by May 31, 2022, or within 30 days after publication in the Federal Register, whichever is later.

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Background

Though SPACs have existed as an alternative to blank check companies since the early 1990s, they recently have become the predominant choice for issuers to go public, due to certain perceived advantages over a traditional IPO, including pricing certainty and streamlined disclosure requirements. SPACs raised more than $83 billion in 2020 and $160 billion in 2021, and in both of those years, SPACs constituted more than half of all IPOs. As SPACs have gained in prominence, certain commentators have expressed concern that there are insufficient shareholder protections as compared to traditional IPOs.

To address these concerns, the SEC has proposed a series of new rules and rule amendments, which can be divided into five different categories, each of which is summarized below.

Proposed New Subpart 1600 of Regulation S-K

Proposed Subpart 1600 to Regulation S-K sets forth specialized disclosure requirements applicable to SPACs regarding the sponsor, potential conflicts of interest and dilution, and requires certain disclosures on the prospectus cover page and in the prospectus summary. It also would require enhanced disclosure for de-SPAC transactions, including a fairness determination requirement.

SPAC Sponsor

Proposed Item 1603 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 registered offerings and de-SPAC transactions. The disclosures would address:

- The experience, material roles and responsibilities of these parties, as well as any agreement, arrangement or understanding (1) between the sponsor and the SPAC, its executive officers, directors or affiliates, in determining whether to proceed with a de-SPAC transaction and (2) regarding the redemption of outstanding securities;
- 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;
- Tabular disclosure of the material terms of any lock-up agreements with the sponsor and its affiliates; and
- 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

Proposed Item 1603 also would require that a SPAC disclose any actual or potential material conflict of interest between (1) the sponsor or its affiliates or the SPAC's officers, directors or promoters, and (2) unaffiliated security holders.

Actual or potential conflicts would include the contingent nature of sponsor compensation that may induce the sponsor and affiliates to pursue a business combination transaction that would not necessarily benefit the shareholders, the time pressure the sponsor is under to enter into a business combination, whether the sponsor is involved in multiple SPACs, and when a sponsor and/or its affiliates hold financial interests or have contractual obligations to other entities, including entities with which the SPAC is exploring entering into a business combination. These potential conflicts of interest may be especially relevant to shareholders at the time the SPAC and sponsor are considering entering into a business combination, especially as the SPAC nears the end of the period to complete such a transaction.

Dilution

Proposed Items 1602 and 1604 would require additional disclosure about the potential for dilution in (1) registration statements filed by SPACs, including those for IPOs, and (2) de-SPAC transactions. Sources of dilution may include sponsor compensation, underwriting fees, shareholder dilution, outstanding warrants, convertible securities and PIPE financings.

A simplified tabular dilution disclosure would be required on the prospectus cover page in SPAC IPOs on Form S-1 or F-1. The SPAC also should disclose that dilution may be disproportionately born by shareholders of a SPAC that do not redeem their shares prior to consummation of the business transaction.

For a de-SPAC transaction, SPACs would use a sensitivity analysis to disclose the amount of potential dilution under a range of reasonably likely redemption levels and quantify the increasing impact of dilution on non-redeeming shareholders as redemptions increase.

Prospectus Cover Page

Proposed Item 1602 would require that certain fundamental disclosures be made in plain English on the SPAC's IPO prospectus cover page, including the time a SPAC has to consummate a de-SPAC transaction, redemptions, sponsor compensation, dilution (including the simplified tabular disclosure described above) and conflicts of interest.

On the de-SPAC cover page, the SPAC would be required to include information on the fairness of the de-SPAC transaction, material financing transactions, sponsor compensation, dilution and conflicts of interest.

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Prospectus Summary Disclosures

Proposed Item 1602 also would require certain key disclosures to be included in a prospectus summary. For SPAC IPOs, a range of information related to the prospective business combination would be required, including how a target will be identified, whether the business combination requires shareholder approval, the length of time to consummate the transaction (including any possible extensions), plans and consequences of seeking additional financing for the business combination and any material conflicts of interest. The prospectus summary also would include information on the securities offered, including the terms, redemption rights and whether they are of the same or a different class than those held by the sponsor and its affiliates.

For de-SPAC transactions, information more specifically related to the business combination must be included, including the background and material terms of the transaction, whether the transaction is fair to investors, investor redemption rights, material conflicts of interest, financing transactions in connection with the de-SPAC and a tabular disclosure of sponsor compensation and dilution.

Background of and Reasons for the De-SPAC Transaction; Terms and Effects

Proposed Item 1605 would require disclosure of the background, material terms and effects of the de-SPAC transaction to better assist investors in understanding the merits of the transaction. The disclosures are modeled on certain line-item requirements found in Regulation M-A but tailored to address issues more specific to de-SPAC transactions. The disclosures include:

- A summary of the background of the de-SPAC transaction, including, but not limited to, a description of any contacts, negotiations or transactions that have occurred concerning the de-SPAC transaction;
- A brief description of any related financing transaction, including any payments from the sponsor to investors in connection with the financing transaction;
- The reasons for engaging in the particular de-SPAC transaction and for the structure and timing of the de-SPAC transaction and any related financing transaction;
- An explanation of any material differences in the rights of security holders of the post-business-combination company as a result of the de-SPAC transaction; and
- Disclosure regarding the accounting treatment and the federal income tax consequences of the de-SPAC transaction, if material.

De-SPAC Fairness Opinion

To address concerns regarding perceived potential conflicts of interest and misaligned incentives, proposed Item 1606(a) would require the SPAC to disclose whether it reasonably believes the proposed business combination and any related financing transactions are fair or unfair to unaffiliated security holders, as well as including a discussion of the basis for this statement. The SPAC would be required to discuss in reasonable detail the material factors upon which a reasonable belief regarding the fairness of a de-SPAC transaction and any related financing transaction is based and, to the extent practicable, the weight assigned to each factor.

To provide additional context for evaluating the SPAC's decision to proceed with a de-SPAC transaction, proposed Item 1606 separately would require disclosure on whether:

- The business combination or any related financing transaction is structured so that approval of at least a majority of unaffiliated security holders is required;
- A majority of directors who are not employees of the SPAC has retained an unaffiliated representative to act solely on behalf of unaffiliated security holders for purposes of negotiating the terms of the de-SPAC transaction or any related financing transaction and/or preparing a report concerning the fairness of the de-SPAC transaction or any related financing transaction; and
- The de-SPAC transaction or any related financing transaction was approved by a majority of the directors of the SPAC who are not employees of the SPAC.

Reports, Opinions and Appraisals

Proposed Item 1607 would require disclosure about whether or not the SPAC or its sponsor has received any report, opinion or appraisal obtained from an outside party relating to the consideration or the fairness of the consideration to be offered to security holders or the fairness of the de-SPAC transaction or any related financing transaction to the SPAC, the sponsor or security holders who are not affiliates. To assist investors in evaluating such report, opinion or appraisal, the proposed item further would require disclosure of:

- The identity, qualifications and method of selection of the outside party and/or unaffiliated representative;
- Any material relationship between (1) the outside party, its affiliates, and/or unaffiliated representative, and (2) the SPAC, its sponsor and/or their affiliates, that existed during the past two years or is mutually understood to be contemplated and any compensation received or to be received as a result of the relationship;

- Whether the SPAC or the sponsor determined the amount of consideration to be paid to the private operating company or its security holders, or the valuation of the private operating company, or whether the outside party recommended the amount of consideration to be paid or the valuation of the private operating company; and
- A summary concerning the negotiation, report, opinion or appraisal, which would be required to include a description of the procedures followed; the findings and recommendations; the bases for and methods of arriving at such findings and recommendations; instructions received from the SPAC or its sponsor; and any limitation imposed by the SPAC or its sponsor on the scope of the investigation

Any report, opinion or appraisal would need to be filed as an exhibit to the Form S-4, Form F-4 and Schedule TO for the de-SPAC transaction or included in the Schedule 14A or 14C for the transaction, as applicable.

Aligning De-SPAC Transactions With IPOs

Co-Registrant Status of Private Operating Company

Arguing the de-SPAC transaction effectively is an IPO of the target private operating company and that a private operating company's method of becoming a public company should not negatively impact investor protection, the proposed rules would amend Form S-4 and Form F-4 to require that the SPAC and the target company be treated as co-registrants when these registration statements are filed by the SPAC in connection with a de-SPAC transaction.

This requirement would make the additional signatories to the form, including the principal executive officer, principal financial officer, controller/principal accounting officer and a majority of the board of directors or persons performing similar functions of the target company, potentially liable under Section 11 of the Securities Act of 1933 (Securities Act) (subject to a due diligence defense for all parties other than the SPAC and the target company), for any material misstatements or omissions in the Form S-4 or Form F-4 at the time of effectiveness, thereby incentivizing these persons to more carefully review and diligence the target company disclosures in the registration statement.

Private Securities Litigation Reform Act Safe Harbor

The PSLRA provides a safe harbor for forward-looking statements under the Securities Act and the Exchange Act of 1934 (the Exchange Act), whereby a company is protected from liability for forward-looking statements in any private right of action under the Securities Act or Exchange Act when, among other things, the forward-looking statement is identified as such and is accompanied by meaningful cautionary statements.

The safe harbor is not available, however, when a forward-looking statement is made in connection with an IPO or an offering by a blank check company. The proposal seeks to amend the definition of "blank check company" to include SPACs for purposes of the PSLRA. By amending the definition of "blank check company" to include SPACs, the proposal would cause "the statutory safe harbor [to not be] available for forward-looking statements, such as projections, made in connection with de-SPAC transactions involving an offering of securities by a SPAC." The unavailability would extend to statements regarding the projections of target private operating companies in these transactions.

Underwriter Status and Liability

The release observes that although the timing of a SPAC IPO and a de-SPAC transaction can be separated by a considerable length of time, "the result of a de-SPAC transaction, however structured, is consistent with that of a traditional initial public offering." That is, the de-SPAC transaction is the mechanism "by which the target company's securities, as securities of the combined company, are distributed into the hands of public investors." As with a traditional IPO, the SEC believes investors would benefit from the rigor and diligence exercised by SPAC underwriters in connection with the de-SPAC transaction.

Proposed Rule 140a would clarify that a person who has acted as an underwriter in a SPAC initial public offering (SPAC IPO Underwriter) 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 engaged in the distribution of the securities of the surviving public entity in a de-SPAC transaction, *i.e.*, that person will be an underwriter within the meaning of Section 2(a)(11) of the Securities Act. The release argues that attaching underwriter status to SPAC IPO Underwriters in connection with de-SPAC transactions should incentivize them to help ensure under Section 11 of the Securities Act the accuracy of the disclosures in de-SPAC transactions, given the attendant liability for registered de-SPAC transactions.

While not an exhaustive list, the Commission observed that acting as a financial advisor to the SPAC, assisting in identifying potential target companies, negotiating merger terms, finding and negotiating PIPE or other financing, or receiving compensation in connection with a de-SPAC could all constitute underwriter participation in the transaction.

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Minimum Dissemination Period

In order to give investors and the market adequate time to assess a proposed de-SPAC transaction, the proposed amendments would require that the prospectuses and proxy and information statements filed in connection with de-SPAC transactions be distributed to shareholders at least 20 calendar days in advance of a shareholder meeting or the earliest date of action by consent, or the maximum period for disseminating such disclosure documents permitted under the applicable laws of the SPAC's jurisdiction of incorporation or organization if such period is less than 20 calendar days.

Business Combinations Involving Shell Companies

Shell Company Business Combinations as Sales to Shell Company Investors

The proposing release posits that when a reporting shell company conducts a business combination with a company that is not a shell company the substantive reality of the transaction is that reporting shell company investors effectively have exchanged their security representing an interest in the reporting shell company for a new security representing an interest in the combined operating company.

With a view to providing disclosure and liability protections to investors in reporting shell companies under these circumstances, proposed Rule 145a would deem any business combination of a reporting shell company involving another entity that is not a shell company to involve a sale of securities to the reporting shell company's securityholders. Nothing in proposed Rule 145a would prevent the use of a valid exemption, if available, to cover the sale transaction.[1]

The release emphasizes that proposed Rule 145a is narrowly drawn and business combinations between two bona fide non-shell entities would not be impacted. Further, recognizing the special role of so-called business combination related shell companies in merger and acquisitions activity, proposed Rule 145a would not apply to reporting shell companies that are definitional business combination related shell companies.

De-SPAC Financial Statement Requirements

Currently, the manner by which a private operating company chooses to become a public company may impact its financial statement disclosures due to differing requirements found in applicable SEC forms. The proposal seeks to end this transactional asymmetry by amending relevant forms, schedules and rules to more closely align the financial statement reporting requirements in business combinations involving a shell company and a private operating company with those in traditional initial public offerings.

This harmonization would extend to the number of years of financial statements that are required, the audit requirements of a predecessor target business, and the age of the financial statements of a predecessor target business, among others. The release also addresses whether and when the historical financial statements of a shell company are required in filings made after the consummation of a business combination.

One prominent change would expand the circumstances in which a target company may report only two years of historical financial statements: The proposed amendments would permit a shell company registrant to include in its Form S-4/F-4/proxy or information statement 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 without regard to whether the shell company has filed or was already required to file its annual report.

Outside of this welcome change, the proposed amendments generally codify existing practices, so issuers would not see any significant changes to their obligations.

Enhanced Projections Disclosure

Financial Projections Generally

The release acknowledges that financial projections may be helpful for investors making an investment decision but expresses concern with the potential for abuse, including financial projections that (1) do not have a reasonable basis, (2) use non-GAAP financial metrics without sufficient explanation or justification, or (3) are displayed with excessive prominence in comparison to historical financial information.

To address these concerns, the SEC proposes to update its views on the projected financial information. The proposed amendments would continue to require that all financial projections have a reasonable basis but it would go further and state that:

- 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;
- presenting projections that are based on historical financial results or operational history without presenting such historical measure or operational history with equal or greater prominence generally would be misleading;

[1] The release, however, notes that exemption under Section 3(a)(9) of the Securities Act generally would not be available.

- projections that include a non-GAAP financial measure should also clearly define or explain the measure, describe the GAAP financial measure to which it is most closely related, and explain why the non-GAAP financial measure was used instead of a GAAP measure; and
- the guidance also applies to projections of future economic performance of persons other than the registrant that are included in the registrant's SEC filings.

SPAC Financial Projections

The SEC believes that financial projections used in de-SPAC transactions present increased risks due to the nature of such transactions and the SPAC structure. For example, the compensation of the sponsor of a SPAC may depend largely on whether a de-SPAC transaction is completed, and the financial projections of a private target company may influence how investors evaluate a proposed de-SPAC transaction. The SEC has proposed additional disclosure requirements for financial projections used in a de-SPAC transaction, including requiring a registrant to disclose:

- the purpose of the projections and the party that prepared them;
- all material bases and assumptions underlying the projections, and any factors that may materially impact such assumptions;
- any material growth rates or discount multiples used in preparing the projections, and the reasons for selecting such growth rates or discount multiples;
- whether the disclosed projections reflect the view of the SPAC's board or management as of the date of the filing, and if not, the purpose of disclosing the projections and the reasons for the board's or management's continued reliance on the projections; and
- where the projections relate to the target company, whether the target company has affirmed that its projections reflect the view of its management or board as of the date of the filing, and if not, the purpose of disclosing the projections and the reasons for the continued reliance on the projections by the SPAC's management or board.

Investment Company Act Safe Harbor

Proposed Rule 3a-10 would provide a safe harbor from the definition of "investment company" under Section 3(a)(1)(A) of the Investment Company Act for SPACs that meet the following conditions, among others:

- **Asset Composition.** The 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. In addition, these assets may not be acquired or disposed of for the primary purpose of recognizing gains or decreasing losses resulting from market value changes.
- **Activities.** The SPAC must seek to complete a single de-SPAC transaction after which the surviving company will be primarily engaged in the business of the target company, and the surviving company must have at least one class of securities listed for trading on a national securities exchange. A SPAC relying on the safe harbor is limited to only one de-SPAC transaction, which can involve the combination of multiple target companies as long as they are treated as part of a single de-SPAC transaction.
- **Business Purpose.** The activities of the SPAC's officers, directors and employees, its public representations of policies and its historical development must be primarily focused on activities related to seeking a target company. The board would need to adopt an appropriate resolution as evidence of this business purpose. In addition, the SPAC could not hold itself out, or otherwise suggest, that it is primarily engaged in the business of investing, reinvesting or trading securities.
- **Duration.** The SPAC must file a report on Form 8-K announcing that it has entered into an agreement with a target company (or companies) to engage in a de-SPAC within 18 months after its IPO and complete its de-SPAC transaction within 24 months of such offering. Any assets that are not used in connection with the de-SPAC transaction must be distributed in cash to investors as soon as reasonably practicable thereafter. If a SPAC fails to meet either the 18-month or the 24-month deadline, it also would be required to distribute the SPAC's assets in cash as soon as reasonably practicable.

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