Professional Perspective

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SEC's Proposed SPAC Rules & Market Reaction

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On March 30, 2022, the Securities and Exchange Commission (SEC) proposed rules governing special purpose acquisition companies (SPACs). The proposed rules, issued with 3-1 support from the commission, are intended to enhance investor protections by requiring additional disclosures in SPAC initial public offering (IPO) and de-SPAC transaction filings and by expanding the scope of potential liability under federal securities laws in connection with these transactions.

If adopted, the proposed rules would significantly increase the regulatory burden on all participants in the SPAC process. Indeed, since the release of the proposed rules—which are not likely to be finalized until the end of this year—several financial institutions that have previously acted as both underwriters of SPAC IPOs and the financial advisors in the subsequent de-SPAC transactions have reduced their involvement in the SPAC market.

This article summarizes the key provisions of the proposed rules and the early response of certain market participants, followed by a list of key considerations for those engaging in SPAC transactions while the publication of the final rules remains pending.

SEC Reimagines SPAC Regulation

That the SEC has proposed these rules is unsurprising in light of Chair Gary Gensler's continued statements that he would prioritize the regulation of the once-booming SPAC market. The proposed rules reflect the apparent belief by the SEC that de-SPAC transactions are more akin to an IPO than to a traditional merger or acquisition and should thus be subject to the same level of regulatory scrutiny. In announcing the release of the proposed rules, Gensler stated that, "[f]or traditional IPOs, Congress gave the SEC certain tools, which I generally see as falling into three buckets: disclosure; standards for marketing practices; and gatekeeper and issuer obligations. Today's proposal would help ensure that these tools are applied to SPACs."

Commissioner Hester Peirce, the lone dissenting vote, expressed concern that the proposed rules will squelch participation in the SPAC market, noting that "rather than simply mandating sensible disclosures around SPACs and de-SPACs . . . [the proposal] seems designed to stop SPACs in their tracks." Peirce may have been right in this assessment: In the handful of months since the release of the proposed rules, although due in part to market forces, the market has seen a dramatic reduction in the number of SPAC IPOs and even the cancellation of several planned de-SPAC transactions.

Key Provisions of Proposed Rules

Increased Disclosure Obligations

The proposed rules would require increased disclosures in both SPAC IPO and de-SPAC transaction filings. Highlights from the proposed rules include the following:

Fairness of De-SPAC Transaction. One of the most significant aspects of the proposed rules is the requirement that a de-SPAC registration or proxy statement disclose whether the SPAC "reasonably believes that the de-SPAC transaction and any related financing transaction are fair or unfair" to the SPAC investors.

This rule would also require the SPAC to lay out "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." Moreover, to the extent the SPAC or its sponsors received a third-party fairness opinion, the SPAC must disclose specified information about that report or opinion and attach it as an exhibit to the registration statement or include it in the proxy statement.

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Sponsors. Given the critical role that a SPAC sponsor plays in the de-SPAC process, the proposed rules require robust disclosures about the sponsor, such as:

- The experience, material roles, and responsibilities of the SPAC sponsor.
- Any agreement between the sponsor and the SPAC regarding whether to proceed with a de-SPAC transaction or the redemption of outstanding securities.
- Tabular disclosure of the material terms of any lock-up agreements with the sponsor.
- The nature and amounts of any compensation that has been or will be awarded to the sponsor, including any reimbursements to be paid upon the completion of the de-SPAC transaction.

Conflicts of Interest. The proposed rules require fulsome and transparent disclosures concerning potential conflicts of interest, reflecting the SEC's view that de-SPAC transactions are inherently conflicted due to the misaligned incentives of the SPAC insiders vis-à-vis the public stockholders.

In particular, the SEC has focused on the conflict stemming from "the contingent nature of the sponsor's compensation, whereby the sponsor and its affiliates have significant financial incentives to pursue a business combination transaction even though the transaction could result in lower returns for public stockholders than liquidation of the SPAC or an alternative transaction."

Specifically, among other things, the proposed rules would require disclosure of:

- Any material conflict of interest between the sponsor or the SPAC's insiders, and public stockholders, including any conflict in determining whether to proceed with a de-SPAC transaction and any conflict arising from the manner in which a SPAC compensates the sponsor or the SPAC's officers and directors, or the sponsor compensates its own executive officers and directors.
- The fiduciary duties owed by any officer or director of a SPAC to any other company.

Expansion of Potential Section 11 Liability

The proposed rules would significantly expand the scope of potential liability under the Securities Act of 1933, as amended, particularly to the extent the rules could create liability for additional participants in the process who, under the prior regime, would not have faced such exposure.

Underwriter Liability. Under the proposed rules, the underwriter of a SPAC IPO that then "takes steps to facilitate a de-SPAC transaction, or any related financing transaction or otherwise participates (directly or indirectly) in the de-SPAC transaction" will be deemed to be an underwriter in the de-SPAC transaction, thus subjecting it to potential liability under the Securities Act. This is significant because the underwriter of a SPAC IPO frequently continues to provide financial advisory services to the SPAC in connection with the de-SPAC transaction, often deferring a portion of its underwriting fees until completion of the de-SPAC transaction.

The SEC provides that the following activities may be sufficient to establish underwriter status in connection with the de-SPAC transaction:

- Acting as a financial advisor to the SPAC in connection with the de-SPAC transaction.
- Assisting in identifying potential target companies.
- Negotiating merger terms for the de-SPAC transaction.
- Finding investors for and negotiating private investments in public equity—commonly known as PIPE investments.
- Receiving compensation in connection with the de-SPAC transaction, including deferred compensation earned in connection with the SPAC IPO.

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Target Company Liability. The proposed rules would require the target company in a de-SPAC transaction to be a co-registrant on the SPAC's registration statement for the reverse merger, thus subjecting the target company, its principal executives, financial and accounting officers, and board of directors to potential liability for any material misstatements or omissions in the document.

PSLRA Safe Harbor. Under the current rules, the safe harbor of the Private Securities Litigation Reform Act (PSLRA) protects parties from liability in any private right of action related to forward-looking statements made under the Securities Act and the Securities Exchange Act of 1934, as amended, so long as the forward-looking statement is identified and accompanied by meaningful cautionary statements. The PSLRA protection from liability does not apply in the IPO context, however.

Financial projections have commonly been used in de-SPAC transactions given that target companies often have a short operating history and may be operating in emerging industries. The operating assumption of market participants has generally been that parties to de-SPAC transactions are subject to the protections afforded by the PSLRA safe harbor since, unlike IPOs, they are not specifically excluded. However, in light of the SEC's general position that de-SPAC transactions bear a closer resemblance to IPOs than to traditional M&A transactions, the proposed rules would make clear that the PSLRA safe harbor protection does not apply to projections used in the de-SPAC context, and parties to those transactions could thus face increased liability for material misstatements or omissions in such projections.

Comments to Proposed Rules

The public comment period for the proposed rules closed on June 13, 2022. While the more than 70 comment letters submitted to the SEC varied in terms of their support of or opposition to the proposed rules, a number of comment letters described how certain of the proposed rules exceed the SEC's statutory authority, foreshadowing a possible legal battle if the rules are adopted as proposed. Specifically, these comment letters argue that proposed Rule 140a, the rule that would expand underwriter status and, thus, Section 11 liability, is unlawful.

The Securities Industry and Financial Markets Association (SIFMA) submitted a lengthy comment letter describing its "significant concerns" with proposed Rule 140a. SIFMA argues that a de-SPAC transaction does not involve underwriting activity because in such a transaction, the issuer itself directly distributes securities to the public—similar to a public merger transaction—and those securities are separate and distinct from the securities issued in the SPAC IPO. SIFMA argues that the US Court of Appeals for the Second Circuit, among other federal courts, has expressly rejected the extension of Section 11 liability to anyone that "takes steps to facilitate" a securities transaction on the basis that Section 11 liability is limited to certain parties specified in the statute.

Multiple law firms reaffirmed SIFMA's arguments in their comment letters as well. Many of these letters explain that the proposed rules erroneously conflate the distribution of securities in connection with the SPAC IPO with the distribution of different securities for a substantively different company, registered on a different registration statement and sold to different investors, in connection with the de-SPAC transaction.

Numerous other commenters from a variety of organizations also take issue with the underwriter liability provisions of the proposed rules, arguing that holding underwriters liable for material omissions or misstatements made during the de-SPAC transaction will dissuade otherwise neutral advisors from participating in SPAC transactions to the detriment of retail investors. This worry appears to be a valid one given that a number of prominent financial institutions have since announced their withdrawal from the SPAC market.

Key Takeaways

As adoption of the rules remains pending, several considerations are pertinent for those engaging in SPAC transactions:

Focus on Robust Disclosure

SPACs and SPAC targets must ensure robust and thorough disclosures. The SEC has already begun undertaking a stringent review of disclosures and issuing comments in line with the proposed rules, even before the rules become final. We expect this trend to continue.

In addition, plaintiffs' lawyers are using the fulsome and thorough disclosure requirements of the proposed rules as ammunition in class action allegations. SPACs and SPAC targets should focus, in particular, on disclosing in clear, plain

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English any potential conflicts of interest of the sponsors and other participants to the SPAC IPO and de-SPAC transaction, as well as the fairness of and the reasons for the de-SPAC transaction.

Consider Fairness Opinions

Given the proposed rule regarding disclosures as to the fairness of the transaction, we expect that SPACs will increasingly seek to obtain fairness opinions in connection with de-SPAC transactions, despite their considerable cost, particularly when more significant conflicts of interest may be present. SPACs and prospective SPAC targets should consider this when negotiating their engagement letters with their financial advisors.

However, some firms that provide fairness opinions, including the major investment banks, have declined to do so because of the risk of incurring potential underwriter or other liability. In addition, a fairness opinion would require disclosure of the projections upon which the opinion is based. See below for the trouble with projections.

Expect Heightened Diligence Requirements

As we have already seen, the proposed rules could potentially dissuade investment banks from participating in the SPAC process altogether. Those that do continue acting as underwriters for SPAC IPOs are likely to end their participation in the process there and insist on receiving their full compensation up front rather than deferring a portion of it until the de-SPAC transaction is consummated. Alternatively, investment banks may decide to limit their advising of a given SPAC to its de-SPAC transaction.

If the proposed rules are adopted, we further expect that the due diligence requirements imposed, and indemnity and similar protections demanded, by the financial advisors to the transaction will increase, more in line with the process conducted in an underwritten public offering. These developments are likely to have a chilling effect on the SPAC market, as they will make the SPAC IPO process more costly and the de-SPAC transaction more difficult and time-consuming.

The End of Projections

If the final rules remove the safe harbor of the PSLRA for forward-looking statements and, in particular, projections of future financial performance, SPAC participants will be exposed to potentially significant expanded liability under the Securities Act. SPACs and prospective target companies will need to carefully consider the extent to which projections should be provided in these transactions, and whether the benefit of a fairness opinion outweighs the risk of disclosing the projections on which the fairness opinion is based.

This is particularly relevant in light of some of the underperformance of combined public companies following a de-SPAC transaction as compared to the target company's projections. Ultimately, we may see a significant curtailment in disclosure of forward-looking projections, one aspect of the SPAC process that has been touted as providing a significant advantage over a traditional IPO.

Focus on Conflicts

In light of the proposed rules, SPACs and prospective target companies need to carefully analyze potential conflicts of interest between SPAC insiders and sponsors, on the one hand, and public stockholders, on the other. Consider ways to align the financial interests of the two groups, if possible, to reduce the conflicts. In all cases, as noted above, disclose the conflicts of interest accurately and fully.

Be aware, however, that even complying with the heightened conflict of interest disclosures required under the proposed rules may not prevent a court from applying the entire fairness standard, instead of the more deferential business judgment rule, in considering whether a de-SPAC transaction is fair to stockholders—particularly if other material facts are not disclosed. *In re MultiPlan Corp. Stockholders Litigation* presented the Delaware Court of Chancery with a case involving allegations that the imminent loss of one of the SPAC target's most important customers had not been disclosed. C.A. No. 2021-0300-LWW (Del. Ch. Jan. 3, 2022).

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The court denied a motion to dismiss and found the entire fairness standard applied in connection with breach of fiduciary duty claims. The court did so, despite disclosures about conflicts, for two reasons:

- The controlling stockholder's $25,000 initial investment was worth approximately $356 million, though it would have been worthless without a completed transaction, and an entity controlled by the controlling stockholder acted as financial advisor in the transaction and received $30.5 million for its services.

- A majority of the directors were not adequately disinterested to make an independent, informed decision about moving forward with the acquisition of the SPAC target. Most of the board members were compensated with interests in the sponsor, and all but one director sat on at least five other boards of SPACs controlled by the sponsor.

Conclusion

The proposed rules would in some cases align with current market practices, but in other cases would place significant new burdens on all participants in a SPAC transaction. The SPAC market has already begun to soften, and there is no question the proposed rules, if adopted substantially as proposed, would continue to impact the SPAC market. Those considering engaging in SPAC transactions should continue to evaluate the potential impact of the proposed rules going forward, including in connection with any ongoing de-SPAC transactions.

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