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BLOG

SEC's Investor Advisory Committee Recommends Enhanced Scrutiny of SPAC Disclosure

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On September 9, 2021, the Investor Advisory Committee (IAC) of the Securities and Exchange Commission (SEC) unanimously approved in an open meeting the IAC's recommendation that the SEC regulate special purpose acquisition companies (SPACs) "more intensely by exercising enhanced focus and stricter enforcement of existing disclosure rules." The full text of the IAC's recommendations, including areas of recommended focus, was published in its report (Report).

The IAC recommendations are significant in that they call for the SEC to act in advance of formal rulemaking to enhance disclosures through enforcement. Several members of the IAC and several SEC Commissioners noted in their remarks at the open meeting that there is still much to learn about SPACs over the next 18 to 24 months as the SPACs that went public in late 2020 and early 2021 complete their initial business combinations. They also stressed that empirical data relating to these transactions will assist the IAC in making further recommendations and will guide the SEC in future rulemaking. In the meantime, SPACs can expect that the Staff will continue to use the review and comment process and existing rules at its disposal to push for greater disclosure in filings for SPAC IPOs and business combinations.

Areas of Enhanced Focus

In the Report, the IAC recommended enhanced disclosure regarding:

1. the role of the SPAC sponsor, including the sponsor's appropriateness, expertise, and capital contributions as well as any conflicts of interest on the part of the sponsor, insiders, and their affiliates;
2. economics of various participants, including the "promote" paid and its impact on dilution, in order to make a meaningful comparison of the upside potential and downside risks, including, to the extent particulars cannot be determined, disclosure around "guardrails" or ranges of acceptable terms;
3. the mechanics and timeline of the SPAC process, including the precise nature of the instrument being purchased, the events required for value appreciation of the instrument, and the details of the shareholder approval process for the de-SPAC transaction, specifically including whether shareholders are allowed to vote in favor of the transaction while also redeeming their shares;

4. boundaries of the search area for a business combination and attributes of acceptable and unacceptable targets, including ground rules for any changes to the search area;
5. competitive pressure and risks involved in finding appropriate targets and disclosure regarding the absorption of expenses by the sponsor in the event there is no successful de-SPAC, "beyond mere risk factors";
6. the acceptable range of terms under which any additional funding (e.g., PIPEs) might be sought at the time of acquisition/redemption;
7. the manner in which the sponsor will assess the capability of potential targets to have adequate governance and internal control procedures to be a "'34 Act company," and whether the sponsor will take any steps to ensure that the target can meet such standards; and
8. the minimum pre-de-SPAC diligence the sponsor will commit to regarding accounting practices used by the target.

While many of these areas overlap with those raised by the Division of Corporation Finance in CF Disclosure Guidance: Topic No. 11 of December 22, 2020, some of these areas are new and have not to date been a focus of Staff comments, notably enhanced disclosure on the sponsor's expected manner of conducting due diligence of a target's public company readiness and the extent to which it will commit to diligence regarding a target's accounting practices.

Rationale Behind IAC's Enhanced Disclosure Recommendations

The Report includes an explanation of the rationale behind the recommendations. First, the IAC cites concerns that "sponsors and targets of SPACs may effectively be conducting regulatory arbitrage by seeking a deal structure with a staggered disclosure approach which amounts to [a] less-restrictive path to the public markets." As an example, the IAC finds no reason for having a safe harbor for projections and recommends that this safe harbor be eliminated. Further, the IAC recommends that the SEC make inquiries regarding the due diligence completed by all parties. The Report recommends that the SEC continue to explore data to determine whether the lack of underwriter diligence and Section 11 liability in SPAC transactions puts retail investors at a disadvantage and whether the SEC should make any recommendations to Congress regarding necessary statutory changes.

Second, the IAC is concerned about inherent conflicts of interest between sponsors/insiders and retail investors. The IAC proposes that a method of addressing this conflict of interest is to standardize disclosure around the sponsor's total investment, including details such as the break-even post-merger price.

Lastly, the IAC expressed concerns that the risks, specifically dilution, are not well understood by the average retail investor. The IAC proposed to include a table setting forth the cash per share contingent on specified levels of redemption on the cover of the IPO prospectus so the impact of de-SPAC dilution is clearly disclosed.

Conclusions

While some of the IAC's recommendations will require future rulemaking, such as the elimination of the safe harbor for forward looking statements, many of the disclosure recommendations could likely be implemented through enforcement of existing disclosure rules. The IAC discussed several issues, although stopped short of making recommendations, including the appropriateness of extending underwriter liability to de-SPAC transactions. Such changes would likely require Congress to make statutory changes. The Report appropriately notes that more data is needed before further recommendations can be made, and several panelists noted the need for further empirical data to guide future policymaking.

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Author

David Sakowitz

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