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BLOG

SEC Proposes Sweeping New Regulations of SPAC Transactions

APRIL 4, 2022

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On March 30, 2022, the Securities and Exchange Commission (SEC) published proposed regulations regarding special purpose acquisition companies (SPACs) that, if adopted, will increase the potential liability for SPACs, SPAC underwriters and target companies participating in SPAC business combination (de-SPAC) transactions. The proposed rules would add specialized disclosure obligations for SPACs in connection with their initial public offerings (IPOs) and in de-SPAC transactions. The SEC has also proposed a safe harbor under which SPACs would not be deemed to be investment companies under the Investment Company Act of 1940 (ICA), subject to meeting certain conditions. The proposed rules are subject to a 60-day public comment period.

Alignment of IPOs and De-SPAC Transactions

De-SPAC transactions have faced criticism from the SEC and commentators on the grounds that the liability regime for companies going public through a de-SPAC transaction differs from that of a traditional IPO. In addition, the form of the de-SPAC transaction can result in different disclosure and liability rules applying to the participants in the transaction, depending on whether the transaction requires filing a registration statement (or only a proxy statement) and on whether the SPAC or the target company is the registrant.

The collective impact of the proposed rules is that de-SPAC transactions would be required to be registered on Form S-4 or Form F-4 regardless of the structure of the transaction and the target company would be deemed to be a co-registrant on that registration statement, even if it is not issuing securities as part of the transaction. In addition, underwriters participating in the SPAC's IPO that directly or indirectly facilitate the de-SPAC transaction or any related financing transactions would be deemed "statutory underwriters." As a result, SPACs, target companies, their officers and directors signing the registration statement, and SPACs' IPO underwriters that facilitate de-SPAC transactions would all have potential liability under Section 11 of the Securities Act of 1933, as amended (Securities Act) for any material misstatements or omissions in the de-SPAC registration statement.

De-SPAC Transactions Deemed an Offering of Securities to SPAC Stockholders

Proposed Rule 145a would deem that a de-SPAC transaction constitutes a sale of securities to a SPAC's stockholders for purposes of the Securities Act. The proposed rules would interpret "sale" broadly on the theory that a SPAC's stockholders are effectively exchanging their securities representing interests in the SPAC for a new security representing interests in the combined operating company.

Whether SPAC stockholders actually receive new securities in a de-SPAC transaction depends on how the de-SPAC is structured. If the SPAC is the surviving company, stockholders that do not elect to redeem their shares continue to hold securities of the SPAC. In contrast, if the target company or a new holding company is the surviving registrant, then SPAC stockholders receive new securities in the surviving registrant in exchange for their SPAC shares.

Because all "sales" must be registered or exempt from registration under the Securities Act, and no clear exemption would be available for issuances of securities to the SPAC's public stockholders, the impact of the proposed rule would be to require that all SPAC business combinations be registered with the SEC under the Securities Act. This will further the SEC's goal of providing protection under the Securities Act for all SPAC stockholders regardless of transaction structure.

Target Deemed to be Offering its Securities

The proposed rules would deem a target company in a de-SPAC transaction to be a co-registrant when a SPAC files a registration statement for a de-SPAC transaction. This change seeks to provide investors with the same protections that the Securities Act would provide to investors if the target company went public in a traditional IPO. As a result, additional signatories on the registration statement, including the target company's principal executive officer, principal financial officer, controller/principal accounting officer, and board of directors, would be liable (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.

The SEC has sought public comments on whether the sponsor of the SPAC should also be required to sign the registration statement in light of its control over the SPAC. This approach would not be consistent with the treatment of controlling stockholders of companies going public through a traditional IPO, which are not currently subject to Section 11.

Expansion of Underwriter Liability

The proposed rules would deem anyone who has acted as an underwriter of a SPAC's IPO that 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.

De-SPAC transactions currently differ significantly from traditional IPOs in that there are no underwriters of securities. Banks facilitating the de-SPAC transaction generally act as M&A financial advisors to the target or the SPAC or as placement agents in connection with related financing transactions. Although SPAC IPO underwriters defer a portion of their underwriting fees until completion of the business combination, receipt of these fees typically is not conditioned on the provision of any ongoing services. The proposing release suggests that the receipt of deferred compensation in connection with the de-SPAC transaction could constitute direct or indirect participation in the de-SPAC transaction.

An underwriter has potential liability under Section 11 of the Securities Act subject to a "due diligence" defense that protects the underwriter from liability if it can establish that, after reasonable investigation, it had reasonable ground to believe the registration statement did not contain material misstatements or omissions. To establish its "due diligence" defense, an underwriter must establish that it exercised reasonable care in verifying the statements in the registration statement. Underwriters are therefore motivated to conduct extensive due diligence. The goal of the proposed rules is to provide that same motivation to SPAC IPO underwriters with the goal of improving the accuracy of the disclosure in de-SPAC transactions.

The proposed rules unfortunately are both over and under inclusive in that they fail to take into account the role of various participants in the de-SPAC transaction. An investment bank that acted as an underwriter for a SPAC IPO but that acts only as a co-placement agent in the private placement of securities to a limited group of sophisticated investors (a "PIPE") in connection with the de-SPAC transaction would not only have potential liability to PIPE investors but also to all SPAC stockholders in connection with the registration statement for the de-SPAC. At the same time, neither a financial advisor to the target company nor an investment bank that acts as a financial advisor to the SPAC would be deemed an underwriter if it was not part of the IPO underwriting syndicate.

The proposed rules also ignore long-standing SEC interpretations providing that a "distribution" of securities ends when the securities have come to rest in the hands of investors. If the proposed rules are adopted, SPAC IPO underwriters could potentially be liable both to IPO investors as well as to investors at the time of the de-SPAC transaction to the extent they directly or indirectly facilitate the de-SPAC transaction or any financing.

The SEC leaves open the possibility that other persons performing services necessary to completing a de-SPAC transaction, including PIPE investors, could be deemed statutory underwriters. An expansive and poorly defined liability scheme could risk chilling the participation of both advisors and investors in these transactions.

PSLRA Safe Harbor for Forward-Looking Statements and Increased Disclosure Related to Projections

The proposed rules would provide that the safe harbor under the Private Securities Litigation Reform Act of 1995 (PSLRA) for forward-looking statements, such as projections, is not available in connection with de-SPAC transactions. The PSLRA provides a safe harbor under which a company is protected from liability for forward-looking statements in any private right of action under the Securities Act or the Securities Exchange Act of 1934, as amended (Exchange Act) when, among other things, the forward-looking statement is identified as such and is accompanied by meaningful cautionary statements. The PLSRA is currently not applicable to IPOs.

Prior to the adoption of the PSLRA, courts recognized similar protections under what was referred to as the "bespeaks caution" doctrine. While the PSLRA provides a safe harbor, registrants can rely on this common law doctrine as well. It is unclear whether the availability of the PSLRA safe harbor has had any meaningful impact on the willingness of SPACs to include forward-looking information or on the care taken by de-SPAC participants to ensure that such statements are reasonable.

The SEC has proposed to amend its rules relating to projections generally and to require specific disclosures applicable to de-SPAC transactions. With respect to all projections, Item 10(b) of Regulation S-K would be amended to provide that:

- Any projected measures that are not based on historical financial results or operational history 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; 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.

With respect to SPACs specifically, the proposed rules would require disclosure of:

- 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 the 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.

Proposed Safe Harbor Under the ICA

Proposed Rule 3a-10 under the ICA would provide a safe harbor from the definition of "investment company" under Section 3(a)(1)(A) of the ICA for SPACs that meet certain conditions discussed below.

The proposed rule states that, for a SPAC to rely on the proposed safe harbor prior to the completion of a de-SPAC transaction:

- The SPAC's assets must consist solely of "government securities" and "government money market funds" (each as defined under the ICA) and cash items;
- The SPAC must enter into an agreement with the target company (or companies) to engage in a de-SPAC transaction no later than 18 months after the effective date of its registration statement for its IPO and the SPAC must then complete the de-SPAC transaction no later than 24 months after the effective date of its registration statement for its IPO;
- The SPAC would be required to distribute its assets in cash to investors as soon as reasonably practicable if it does not meet either the 18-month deadline or the 24-month deadline;
- The SPAC must seek to complete a single de-SPAC transaction (which can involve more than one operating company) as a result of which the surviving public company, either directly or through a primarily controlled company, will be primarily engaged in the business of the target company or companies, which is not that of an investment company;
- 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; and
- The SPAC must evidence that it is primarily engaged in the business of seeking a de-SPAC transaction through the activities of its officers, directors and employees, public representations of its policies, its historical development, its board adopting an appropriate resolution and by not holding itself out as being primarily engaged in the business of investing in securities.

A SPAC would not be able to rely on Rule 3a-2 (which generally provides a one-year grace period for "transient" investment companies) subsequent to its reliance on proposed Rule 3a-10 in the event that it fails to meet either proposed Rule 3a-10's 18-month or 24-month time frame. The SEC has requested comments on these deadlines and on whether to specifically mandate that the SPAC dissolve following completion of a de-SPAC transaction or if the SPAC fails to identify or complete a de-SPAC transaction.

Specialized SPAC Disclosure Rules

The SEC proposes adding a new Subpart 1600 to Regulation S-K that would set forth specialized disclosure requirements for SPACs relating to, among other things, the sponsor, potential conflicts of interest and dilution.

Disclosure of Determination of the Fairness of the Transaction and Transaction Background

Registration statements and proxy statements filed in connection with a de-SPAC transaction would be required to include a statement from the SPAC as to whether it reasonably believes that the de-SPAC transaction and any related financing transaction are fair to the SPAC's unaffiliated security holders, as well as a discussion of the bases for this statement. This disclosure obligation is similar to the disclosure required in connection with "going private" transactions under Rule 13e-3 under the Exchange Act, which applies when an affiliate of the target stands on both sides of the deal such that there is a potential conflict of interest in relation to unaffiliated stockholders.

In addition, disclosure would include (i) whether the transaction required the approval of disinterested stockholders or of a majority of non-employee directors, and (ii) whether non-employee directors 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 preparing a report concerning the fairness of the de-SPAC transaction. At present, stock exchange rules already require the approval of a majority of independent directors.

The rules would also require disclosure of the effects of the de- SPAC transaction and any related financing transaction on the SPAC and its affiliates, the sponsor and its affiliates, the private operating company and its affiliates, and unaffiliated security holders of the SPAC, including a reasonably detailed discussion of both the benefits and detriments to non-redeeming stockholders of the de-SPAC transaction and any related financing transaction, with the benefits and detriments quantified to the extent practicable.

Much of the remaining disclosure required by the new rules parallels that required under current Regulation M-A and is consistent with current practice in de-SPAC transactions, which generally already includes discussion of the background of the transaction, a description of any related 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 and whether a third-party fairness opinion was obtained.

Increased Disclosure Regarding Sponsors

The proposed rules would require specified disclosure about the sponsor, its affiliates and any promoters of the SPAC and related conflicts of interest in SPAC IPOs and de-SPAC transactions, much of which is already consistent with current disclosure practice. These disclosures would include an organizational chart showing the relationship among the SPAC, the sponsor, and the sponsor's affiliates, and information regarding controlling persons of the sponsor and any persons who have direct and indirect material interests in the sponsor. The SEC has not proposed a quantitative standard as to what would constitute a "material" interest in the sponsor.

The SEC has proposed to define the term "SPAC sponsor" to include "the entity and/or person(s) primarily responsible for organizing, directing or managing the business and affairs of a SPAC, other than in their capacities as directors or officers of the SPAC as applicable". The SEC noted that the proposed definition is intended to encompass activities that are commonly associated with sponsors of SPACs and that the term is intended to be defined broadly.

Dilution

The cover page to a SPAC's IPO registration statement would require a new table setting forth dilution to public stockholders, assuming 25%, 50%, 75% and maximum redemptions, and the prospectus would be required to include a description of material potential sources of future dilution following a SPAC's IPO.

Registration statements in connection with a de-SPAC transaction would similarly require a simplified tabular disclosure of dilution. The prospectus would need to include disclosure of each material potential source of additional dilution that non-redeeming stockholders may experience, including dilution from sponsor compensation, underwriting fees, outstanding warrants and convertible securities and finance transactions such as PIPE transactions. This disclosure would include a sensitivity analysis in a tabular format showing the amount of potential dilution under a range of reasonably likely redemption levels.

Dissemination of Proxy Statements and Prospectuses

Prospectuses and proxy statements for de-SPAC transactions would be required to be delivered to stockholders a minimum of 20 calendar days in advance of a stockholder meeting.

Financial Statement Requirements

Financial Statements of Target Companies

The proposed rules seek to align the financial statements that would be required for a target company in a de-SPAC transaction with those required for a traditional IPO. Under current SEC guidance the number of years of financial statements required for a target company varies based on the form of the transaction. Current SEC interpretations, in some cases, have disadvantaged target companies combining with SPACs in comparison to target companies that are emerging growth companies (EGCs) filing a Form S-1 for an IPO.

The SEC has historically required target companies acquired by a SPAC, where the SPAC is the surviving public company, to include three years of financial statements (even if the target company would be an EGC) unless the SPAC has not yet filed a Form 10-K. This interpretation has arbitrarily tied the level of target company disclosure required to timing of the SPAC's first Form 10-K. Under a new Article 15 of Regulation S-X, the financial statements of the target company would be the same as if the target company were filing a registration statement for an IPO (two years for EGCs and smaller reporting companies (SRCs) and three years for other registrants).

SRC status for the surviving company would be determined following the business combination with public float determined as of a date within four business days after consummation of the business combination. This redetermination would be reflected in the surviving company's first periodic report.

Financial Statements of Acquired Businesses of a Target Company

In addition, the rules clarify the number of years of financial statements that would be required for businesses acquired by a target company (either prior to the business combination or pending probable acquisitions). Target companies would apply the requirements of Rule 3-05 of Regulation S-X (or Rule 8-04 for SRCs) for financial statements of acquired businesses ("Rule 3-05"), to align with the rules applicable to an IPO registration statement. Significance under Rule 1-02(w) of Regulation S-X would be measured in relation to the target company's financial statements rather than the SPAC's.

The proposed rules appear to eliminate the 75-day grace period for filing financial statements of a probable or recently acquired business. Rule 3-05 currently permits registrants to omit from a registration statement the financial statements of recently acquired or probable acquisitions if the significance is measured at 50% or less. Rule 3-05 further provides that the omitted financial statements must be filed on Form 8-K within 75 days after consummation of the acquisition. The SEC has instead proposed that the omitted financial statements would be required in an Item 2.01(f) Form 8-K filed with Form 10 information filed upon closing of the business combination. Presumably, this would be the case even if the acquisition closed less than 75 days prior to the closing of the business combination.

Financial Statements of SPACs following a Business Combination

Under the proposed rules, consistent with current practice, the financial statements of the SPAC can be omitted from filings following the filing of the first periodic report that includes post-business combination financial statements. Prior to such time, the SPAC's financial statements would be required in all filings (including registration statements and the Form 8-K with Form 10 information filed following the de-SPAC transaction).

What the Proposed Rules Do Not Include

Although the SEC purports to be overhauling its rules related to SPACs to bring de-SPAC transactions in line with traditional IPOs, the SEC has not included any proposals to remedy rules that unfairly burden companies that go public through a de-SPAC transaction. These include:

- Categorizing any company that goes public through a de-SPAC as an "ineligible issuer" that is not permitted to use free writing prospectuses for three years following a de-SPAC transaction;
- Making Rule 144 under the Securities Act unavailable for one year following a de-SPAC and conditioning the use of Rule 144 by any company that went public through a de-SPAC transaction on meeting Rule 144(i)'s ongoing current information requirements, which requirements are not applicable to other registrants;
- Making Form S-8 unavailable until 60 days following a de-SPAC transaction; and
- Failing to adjust transition periods to allow companies that go public through a de-SPAC transaction to have the full benefit of all grace periods to comply with SEC rules that are applicable to other newly public companies.

Conclusion

Given the sweeping and controversial nature of the proposed regulations, it is expected that industry participants will comment extensively on the SEC's proposal. The proposed rules will likely be viewed by many industry participants as tipping the scales in favor of traditional IPOs and against de-SPAC transactions. Ideally, this rulemaking process will encompass a re-examination of all methods of going public, including direct listings, IPOs and de-SPAC transactions, with a view to facilitating capital formation in all forms.

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