Updates
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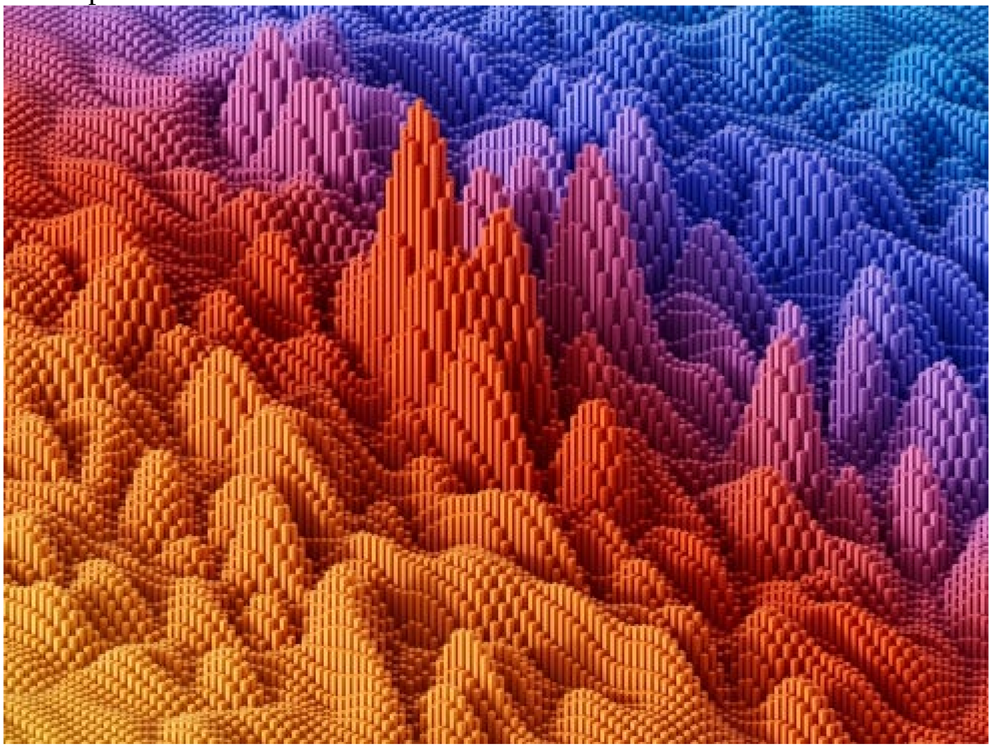
SEC Speaks Out on SPACs



When a significant volume of capital is raised from investors through nontraditional capital markets transactions, the U.S. Securities and Exchange Commission (SEC) is sure to follow with increased scrutiny. The SEC made that readily clear in recent weeks with several important statements conveying the risks of Special Purpose Acquisition Companies (SPACs). While many financial sponsors, operating companies, and investors have been drawn to SPACs on the premise that they represent a streamlined method for private targets to become public companies, the SEC is cautioning sponsors and target companies that the SEC views its role in reviewing disclosure regarding the de-SPAC transaction (the transaction in which a private operating company combines with the SPAC) much the same as for a conventional initial public offering (IPO), and will be eyeing disclosures by sponsors and targets carefully for any misleading statements or omissions, including projections and valuations. Further, the SEC is reminding sponsors and target companies that important provisions of the securities laws, such as financial reporting, internal control, and corporate governance, still apply to the resulting public company. Given the SEC's scrutiny, SPACs and private target companies should take steps to mitigate these risks in connection with a de-SPAC transaction.

An Abundance of SPACs

While many commentators called 2020 the year of SPACs, the volume of SPAC IPOs in the first quarter of 2021 continued to grow at an accelerated pace. SPAC sponsors have availed themselves of a significant amount of capital to fund their IPOs and subsequent PIPEs. Many private companies are learning that with an abundance of SPACs looking for private targets, they have the opportunity to go public through a process that may be more expedited and offer greater flexibility than a conventional IPO.

The level of SPAC activity, amount of capital invested, and inherent risks to investors have drawn the SEC's attention. On March 31, 2021, the SEC's Division of Corporation Finance (Corp Fin) staff members and Acting Chief Accountant Paul Munter issued statements addressing matters that private companies should carefully consider before undertaking a business combination with a SPAC. On April 8, 2021, Acting Director of Corp Fin, John Coates, issued a statement discussing liability risk under the securities laws in the context of SPAC transactions.

These statements from the SEC are important reminders that SPAC acquisition targets must commit substantial time and resources to prepare for life as a public company post-transaction, and that participants in SPAC transactions must be mindful of potential securities law liability arising from transaction-related disclosures. The statements appear aimed to temper the frothiness of SPAC enthusiasm by highlighting the risks and challenges for both SPAC sponsors and private companies considering going public through a de-SPAC transaction.

Statement of the Acting Director of Corp Fin

The statement from Acting Director Coates focuses on a narrow—but significant—point regarding potential liability for misstatements in the forward-looking information included in SEC-filed disclosure documents relating to a de-SPAC transaction. Coates notes that some "have claimed that an advantage of SPACs over conventional IPOs is lesser securities law liability exposure for targets and the public company itself." Coates goes on to explain that "in some ways, liability risks for those involved are higher, not lower, than in conventional IPOs, due to the potential conflicts of interest in the SPAC structure." In particular, he suggests that the Private Securities Litigation Reform Act (PSLRA) safe harbor for forward-looking statements should not be available for private companies introducing themselves to the public markets, whether that introduction is via a conventional IPO or a de-SPAC transaction.

The PSLRA safe harbor protects public companies against liability in private litigation for forward-looking statements that end up not coming to fruition when those statements are accompanied by meaningful cautionary statements. The safe harbor, on its face, does not apply to "initial public offerings." Whether or not the PSLRA safe harbor applies to de-SPAC transactions is of particular importance because one of the often-cited advantages of a SPAC over a conventional IPO is that a SPAC transaction allows for the use of financial projections in marketing the deal, which would not be used in marketing a conventional IPO. In the statement, Coates suggests that, although the IPO exemption from the PSLRA has commonly been considered to apply only to a conventional IPO, the underlying legislative history and circumstances "point toward a conclusion that the PSLRA safe harbor should not be available for any unknown private company introducing itself to the public markets" through a de-SPAC transaction. In short, Coates argues that a de-SPAC transaction is, in substance, an initial public offering and should be treated that way under the PSLRA, even if the form is different from a conventional IPO.

Notably, even with the protections of the PSLRA, many public companies opt not to provide explicit projections in their SEC filings expressly to avoid having those projections incorporated by reference into prospectuses for securities offerings. Instead, many companies provide projections, such as earnings guidance, in earnings releases, which can be furnished with the SEC on Form 8-K (rather than filed).

In disclosure documents regarding M&A transactions (including de-SPAC transactions), however, companies are typically required under state law to disclose to stockholders projections relied on by the board in approving the transaction. This means that even if the participants in a de-SPAC transaction would prefer not to disclose projections, they may be required to do so if the SPAC board relied on those projections. Coates points out that although these projection disclosures may be required, participants should recognize that, even if the safe harbor covers a de-SPAC transaction, the safe harbor only protects against liability to private litigants and does not prevent the SEC from taking appropriate action to enforce the securities laws. The safe harbor also does not protect against false or misleading statements made with actual knowledge that the statement was false or misleading.

Coates' statement suggests that the SEC may consider additional rulemaking regarding SPACs, not only to clarify the scope of the safe harbor in the PSLRA but also to provide specific guidance on how projections and related valuations are presented and used in SPAC transaction disclosures. He also suggests that the SEC may reconsider whether the concept of who is an "underwriter" should be modified in the context of a de-SPAC transaction. This last point highlights the significant incentives that underwriters have under the securities laws to play a gatekeeping role in performing due diligence in an underwritten IPO. It also poses the question of whether securities laws may be updated to further incentivize SPAC participants to undertake similar diligence.

Corp Fin Staff Statement

The Corp Fin statement highlights three focus areas for private companies considering going public through a business combination with a SPAC.

- **Shell Company Restrictions.** Since SPACs are "shell companies" under Rule 405 of the Securities Act, SPACs are subject to restrictions under the securities laws that will affect the combined public company even after the "de-SPAC" transaction has closed. These restrictions include:
    - For three years following the completion of a business combination, the combined public company will be an "ineligible issuer" under Securities Act Rule 405 of the Securities Act. While an ineligible issuer, the combined public company may not, among other things, qualify as a well-known seasoned issuer, use free writing prospectuses, or rely on the gun-jumping safe harbor under Securities Act Rule 163A for communications made more than 30 days prior to the public filing of a registration statement. Taken together, these rules add friction to capital markets transactions undertaken by a combined public company during the three years following the completion of a business combination.
    - Financial statements for the operating business in the de-SPAC transaction must be filed within four business days of completing the business combination. The combined public company is not permitted to use the 71-day extension for filing those financial statements otherwise afforded by Form 8-K.
    - For three years following the completion of a business combination, the combined public company may not incorporate Exchange Act reports by reference on Form S-1 registration statements, representing another potential point of friction for capital markets transactions following the de-SPAC transaction.
    - For 60 days following the filing of current Form 10 information by the combined public company (which is typically done through filing a "Super 8-K" within four business days following the completion of a business combination), the combined public company will not be eligible to use Form S-8 to register compensatory securities offerings.
- **Books and Records and Internal Controls Requirements.** Corp Fin's statement reminds companies that following a business combination with a SPAC, the combined company will be a public company and

subject to the resulting regulatory requirements. In particular, the staff emphasizes that combined companies must be ready to maintain internal accounting controls, and books and records, in accordance with public company standards.

- **Exchange Listing Standards.** Similar to Corp Fin's discussion of public company readiness in the context of books and records and internal controls, the statement also emphasizes that if a SPAC is listed on a national securities exchange, the combined public company will need to satisfy quantitative and qualitative listing standards upon completion of the business combination, including corporate governance requirements. Failure to maintain these standards may result in delisting.

Acting Chief Accountant Statement

Like the Corp Fin statement, the statement from Acting Chief Accountant Munter urges SPAC acquisition targets to focus on preparing to function as public companies. Many SPAC acquisition targets may be at an earlier stage in their development than companies that pursue a conventional IPO or are considering going public through a SPAC on a shorter timeline than they would use to prepare for an IPO. The rising number of SPACs looking for private companies has necessitated expanding the search to include companies that may not be ready to function as public companies. The quick timeline associated with SPAC acquisitions, driven by the 18-to-24-month period in which a SPAC must identify a target and negotiate and complete a merger, may exacerbate this issue.

The resulting public company must be ready to meet SEC filing, audit, tax, governance, and investor relations needs immediately following the completion of the merger. For many SPAC acquisition targets, preparing to meet these demands will require (1) hiring new personnel and establishing new processes to produce high-quality financial reporting and ensure adequate internal controls, (2) recruiting new board members that meet independence requirements and have relevant public company experience, and (3) close coordination with the company's auditors to ensure financial statements are audited in accordance with public company standards. Private company targets in the sights of a SPAC must have a clear and comprehensive plan to immediately function as a public company upon closing the de-SPAC transaction.

SEC Enforcement Risks

Reminders from the SEC about the importance and application of securities laws to particular activity are often followed by enforcement action. We expect that to be the case with SPAC transactions, likely addressing conduct relating to various stages of the process: (1) the initial offering, (2) the SPAC search for a private target, and (3) the de-SPAC transaction. The SEC recognizes that enforcement actions are important not only because they stop illegal conduct by those charged but also because they function as a deterrent to other market participants. Of particular relevance is the SEC's robust enforcement in the area of financial fraud and disclosure, areas where Corp Fin has now laid down clear markers for SPAC sponsors and targets. The SEC's expertise and attention to this area of the securities laws may lay the groundwork for potential enforcement activity relating to SPACs.

Key Takeaways

- The capital markets have changed, but the securities laws have not. Deal participants need to ensure that their disclosure is carefully crafted and supported by thorough due diligence and that attendant risks and cautionary considerations are appropriately described.
- SPACs may shorten the time it takes to go public, but the work required to become public-ready remains the same. Companies that are considering going public through a SPAC acquisition would be well-advised to read Acting Chief Accountant Munter's statement about the financial reporting and auditing requirements imposed by the securities laws for public companies.
- Becoming a public company on an accelerated timeline means the private company must have a comprehensive plan in place to meet its obligations, including (1) people, processes, and technology, (2) capable, experienced management and a board of directors that understands SEC rules and regulations, and (3) appropriate board oversight by a properly composed board, including independent directors and a strong audit committee.

For an overview of the basics of SPACs and the process of going public through a de-SPAC transaction versus an IPO, see our SPAC FAQs.

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