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Proposed SEC Rules Related to SPAC IPOs and SPAC Business Combinations

Expanded Liability and Disclosure Requirements, Projections, Fairness, and Investment Company Act Safe Harbor

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1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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Boom and Bust – What Brought Us to this Place?

- The market for SPAC IPOs grew exponentially in recent years, with over $83 billion and $160 billion raised in 2020 and 2021, respectively
- IPO pace in 2022 much lower - $12 billion in first six months
- DeSPAC transactions in 2020 and 2021 showed similar trends, with 267 deSPAC transactions announced and 199 closed in 2021.
- Although stock price appreciation resulted from certain of the early de-SPAC transactions, many of these companies struggled in the market following their business combination
- On and apples-to-apples basis, however, during the same time period traditional IPOs also exhibited negative returns to stockholders following their market debuts, in certain cases exceeding average deSPAC losses
- Media focus on SPACs exaggerated these trends and several highly publicized misteps in the de-SPAC market (Lordstown Motors, Nikola, Virgin Galactic) led to calls for regulators to step in

Source: SPAC Insider; LexisNexis

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The Regulators

- SEC serves as primary regulator of SPACs, with extensive authority over the IPO and deSPAC process
  - Multiple and extensive filings required at both stages of the SPAC process
  - Review and comment process can lead to effectively substantive regulation, with the threat of non-clearance being significant
  - Suggestions in 2021 that the SPAC structure may result in a “40 Act Company” only strengthened this position
- Stock exchanges have special listing rules for SPACs, mostly intended to ensure liquidity in both the post-IPO and post-deSPAC context, as well as traditional governance (independence of board members) and related issues
- US Congress involved to a lesser extent – portions of the US federal securities laws may only be modified with Congressional authority (ie has not be delegated to SEC)

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SEC Proposal – Public Meeting on March 30, 2022

- 372 pages in length and subject to a shortened public comment period – followed five separate regulatory actions by the SEC during the ’20-’21 period addressing investor education, warrant accounting and liability risks (among related topics)
- Passed with a split vote, as one of the Commissioners dissented from the majority indicating her strong disagreement with many of the proposed changes
- Followed soon after by efforts of the SEC Investor Advocate to encourage companion rule changes by the national stock exchanges (NYSE, Nasdaq and NYSE American) to require any SPAC stockholder seeking redemption to vote against the proposed deSPAC business combination
- Senator Elizabeth Warren issues “The SPAC Hack” report in June 2022, generally supporting the SEC proposal but also suggesting that legislation may be introduced extending certain aspects of the new rules

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SEC Proposed Changes

- Five principal areas of focus:
  - Disclosure-related changes
  - Liability-related changes
  - Shell company-related changes
  - Projections-related changes
  - Investment Company Act ("40 Act")-related changes

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Disclosure-Related Changes

Definitions

- Proposal to add a new Subpart 1600 to Regulation S-K.
- Proposed Item 1601 consists of certain definitions.
- “Special purpose acquisition company” would mean a company that has indicated that its business plan is to (1) register a primary offering of securities that is not subject to the requirements of Rule 419; (2) complete a de-SPAC transaction within a specified time frame; and (3) return all remaining proceeds from the registered offering and any concurrent offerings to its shareholders if the company does not complete a de-SPAC transaction within the specified time frame.
- “De-SPAC transaction” would mean a business combination such as a merger, consolidation, exchange of securities, acquisition of assets, or similar transaction involving a SPAC and one or more target companies (contemporaneously, in the case of more than one target company).
- “Target company” would be defined as an operating company, business, or assets.
- “SPAC sponsor” would be defined as 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.

Disclosure-Related Changes

Disclosure Regarding SPAC Sponsors

- Proposed Item 1603(a) 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, including disclosure on the following:
  - 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.

Disclosure-Related Changes

Conflicts of Interest Disclosure

- Proposed Item 1603(b) would require disclosure of any actual or potential material conflict of interest between:
  - (1) the SPAC sponsor or its affiliates or the SPAC's officers, directors, or promoters, and
  - (2) unaffiliated security holders.
  - This would include any conflict of interest in determining whether to proceed with a de-SPAC transaction and any conflict of interest arising from the manner in which a SPAC compensates the sponsor or the SPAC's executive officers and directors, or the manner in which the sponsor compensates its own executive officers and directors.
- Proposed Item 1603(c) would require disclosure regarding the fiduciary duties each officer and director of a SPAC owes to other companies.

Disclosure-Related Changes

Dilution Disclosure

- Proposed Items 1602(a)(4), 1602(c) and 1604(c) 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.
  - Proposed Item 1602(c) would require dilution disclosure in registration statements filed by SPACs other than for de SPAC transactions that would require a description of material potential sources of future dilution following a SPAC's IPO, as well as tabular disclosure of the amount of potential future dilution from the public offering price that will be absorbed by non-redeeming SPAC shareholders, to the extent quantifiable.
  - Proposed Item 1602(a)(4) would require simplified tabular dilution disclosure incorporating a range of potential redemption levels on the prospectus cover page of SPAC registration statements on Forms S-1 and F-1.
  - Proposed Item 1604(c) would require disclosure of each material potential source of additional dilution that non-redeeming shareholders may experience at different phases of the SPAC lifecycle by electing not to redeem their shares in connection with the de-SPAC transaction.
  - Proposed Item 1604(c)(1) would require a sensitivity analysis in a tabular format that shows the amount of potential dilution under a range of reasonably likely redemption levels and quantifies the increasing impact of dilution on non-redeeming shareholders as redemptions increase. A description of the model, methods, assumptions, estimates, and parameters necessary to understand the sensitivity analysis disclosure would also be required.

Disclosure-Related Changes

Prospectus Cover Page Disclosure

- With respect to SPAC IPOs, proposed Item 1602(a) would require information on the prospectus cover page in plain English about, among other things, the time frame for the SPAC to consummate a de-SPAC transaction, redemptions, sponsor compensation, dilution (including simplified tabular disclosure), and conflicts of interest.

- With respect to de-SPAC transactions, proposed Item 1604(a) would require that SPACs include information on the prospectus cover page in plain English about, among other things, the fairness of the de-SPAC transaction, material financing transactions, sponsor compensation and dilution, and conflicts of interest.

Disclosure-Related Changes

Prospectus Summary Disclosure (SPAC IPOs)

- With respect to SPAC IPOs, proposed Item 1602(b) would require that SPACs include the following information in the prospectus summary in plain English:
  - The process by which a potential business combination candidate will be identified and evaluated;
  - Whether shareholder approval is required for the de-SPAC transaction;
  - The material terms of the trust or escrow account, including the amount of gross offering proceeds that will be placed in the trust;
  - The material terms of the securities being offered, including redemption rights;
  - Whether the securities being offered are the same class as those held by the sponsor and its affiliates;
  - The length of the time period during which the SPAC intends to consummate a de-SPAC transaction, and its plans if it does not do so, including, whether and how the time period may be extended, the consequences to the sponsor of not completing an extension of this time period, and whether shareholders will have voting or redemption rights with respect to an extension of time to consummate a de-SPAC transaction;
  - Any plans to seek additional financing and how such additional financing might impact shareholders;
  - Tabular disclosure of sponsor compensation and the extent to which material dilution may result from such compensation; and
  - Material conflicts of interest.

Disclosure-Related Changes

Prospectus Summary Disclosure (De-SPAC Transactions)

- With respect to de-SPAC transactions, proposed Item 1604(b) would require that registrants include the following information in the prospectus summary in plain English:
  - The background and material terms of the de-SPAC transaction;
  - The fairness of the de-SPAC transaction;
  - Material conflicts of interest;
  - Tabular disclosure on sponsor compensation and dilution;
  - Financing transactions in connection with de-SPAC transactions; and
  - Redemption rights.

Disclosure-Related Changes

Disclosure and Procedural Requirements in De-SPAC Transactions

- The proposed rules would require:
  - (1) additional disclosures on the background of and reasons for the transaction;
  - (2) a statement from the SPAC as to whether it reasonably believes that the de-SPAC transaction and any related financing transaction are fair or unfair to unaffiliated security holders;
  - (3) disclosure on any outside report, opinion, or appraisal relating to the fairness of the transaction; and
  - (4) additional information in a Schedule TO filed in connection with a de-SPAC transaction, as well as clarify the need to comply with the procedural requirements of the tender offer rules when filing such a Schedule TO.

Disclosure-Related Changes

Structured Data Requirement

- The proposed rules would require SPACs to tag all information disclosed pursuant to proposed Subpart 1600 of Regulation S-K in Inline XBRL.
- The proposed requirements would include detail tagging of the quantitative disclosures and block text tagging of the narrative disclosures that would be required under Subpart 1600.

Liability-Related Changes

- ***Deemed Underwriter Status for deSPAC transactions*** – proposed Rule 140a (which is characterized as a "clarification of existing law" and could apply retroactively) would subject underwriters to potential Section 11 liability if they:
  - acted as an underwriter in the SPAC's IPO and
  - take steps to facilitate a deSPAC transaction or any related financing transaction or otherwise participate (directly or indirectly) in the deSPAC transaction

  SEC states 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 deSPAC transaction, among other activities, could all constitute underwriter participation in the deSPAC transaction and expose the underwriter to potential liability
- ***Co-registrant Status*** - private target company in a deSPAC transaction is a co-registrant when a SPAC files a Form S-4 or Form F-4 for a deSPAC transaction, causing the target company and its signing persons – 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 – to be subject to potential liability under Section 11 of the Securities Act
- ***Eliminate Safe Harbor for Forward Looking Statements*** - new definition for "blank check company" that would encompass SPACs and eliminate the safe harbor for forward-looking statements under the PSLRA for SPACs, including with respect to projections of target companies seeking to access the public markets through a deSPAC transaction

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Business Combinations Involving Shell Companies

The De-SPAC Transaction as a "Distribution" of the Combined Company's Securities

- Equating "De-SPAC Transaction" and Initial Public Offering
  - The SEC's use of the term "De-SPAC Transaction" collapses multiple offers of securities to support the equation to an initial public offering, which is a single offer of securities.
- Proposed Rule 145a
  - Proposed Rule 145a indicates that a business combination involving a reporting shell company and an operating company is deemed to involve an offer of securities to the reporting shell company's shareholders.
    - The SEC states that, even if there is no actual exchange of securities, shareholders of a reporting shell company can be viewed as "surrendering value" for purposes of Section 2(a)(3).
  - The premise of this proposal is that shell company transactions, including de-SPAC transactions, create a public market in the securities of a private company without comprehensive disclosure. The SEC says the aim of this proposal is to address potential disparities in disclosure and liability protections available to reporting shell company shareholders.
  - Reporting Shell Company Transactions v De-SPAC Transactions
    - In the context of a de-SPAC transaction, the SEC writes that it is their "preliminary view that such a transaction would be deemed a 'disposition of a security or interest in a security … for value,' regardless of the form or structure deployed, and regardless of whether a shareholder vote or consent is solicited."
- Compare and Contrast Proposed Rule 145a and Existing Securities Laws
  - Integration of Multiple Offers of Securities
    - Integration of "deemed offer" to reporting shell company shareholders and target company shareholders
    - SEC's Section 3(a)(9) Analysis
  - Proposed Rule 145a Lacks "Investment Decision" Basis of Rule 145
  - Available Exemptions from Registration?
- Aim to Apply Section 11 Liability to All Reporting Shell Company Transactions
- Consideration of Disclosure Shortfalls in De-SPAC Transactions

Financial Statements in Shell Company Transactions

- Many proposals codify interpretive positions of the Staff
- Significant New Proposal is to align number of fiscal years required to be included in the financial statements of a private company

Earlier Redetermination of Smaller Reporting Company Status

- The proposals provide that the Smaller Reporting Company status of a combined company would be redetermined based on public float as a date within four business days after the consummation of a de-SPAC transaction.
  - Consequences of this proposal on follow-on registration statements can be severe, including the need to provide an additional year of financial information.
- Areas Not Addressed
  - Proposals do not seek to align Emerging Growth Company, Accelerated Filer, Large Accelerated Filer, Foreign Private Issuer determinations with that of an IPO.
  - Internal Control of Financial Reporting not addressed although there is a fair amount of confusion.
  - Transition Period for adoption?

Projections-Related Proposals

Use of Projections in De-SPAC Transactions

- PIPE Investors
- Due Diligence of SPAC's Board of Directors
  - Disclosure Requirements pursuant to Regulation M-A and Delaware law

Proposed Revisions to Item 10(b)

- The proposal states that Item 10(b) principles apply to projections of the registrant and the projections of any other person other than the registrant included in a filing with the SEC.
- The proposal further states that projections based on historical results should be distinguished from projections that are not based on historical results. Also, the historical results should be presented with the projections to avoid misleading disclosure. The presentation of non-GAAP measures should include a definition of such measures.
- Revised Item 10(b) retains the reference to an “outside review” of management’s projections. Such reviewer would be deemed an expert in the case of a registration statement.
  - Consider in light of Proposed Rule 140a

Proposed 1609 (Financial Projections in De-SPAC Transactions)

- This proposed rule applies solely to the disclosure of projections in de-SPAC transactions.
- Proposed Items 1609(a) and (b) require the disclosure of the purpose for which the projections were prepared and the identity of the party that prepared the projections. Disclosure is required for material bases, material assumptions and factors that may affection assumptions.
- Proposed Item 1609(c) requires management of the company to which the projections relate to affirm that the projections reflect the view of the SPAC or target company as of the date of the filing. If the projections no longer reflect the view of the SPAC or target company, the proposal requires the explanation of why the projections are disclosed and the reasons for any continued reliance by management or the board on the projections.
  - Does this create a duty to update?
  - Does this create an option on the de-SPAC transaction?

Investment Company Act Safe Harbor

Investment Company Act Safe Harbor

Background

- The Investment Company Act of 1940 regulates the organization of companies, including mutual funds, that engage primarily in investing, reinvesting, and trading in securities, and whose own securities are offered to the investing public.
- The Investment Company Act requires investment companies to register as such with the SEC. Investment companies must disclose their financial condition and investment policies to investors when stock is initially sold and, subsequently, on a regular basis.
- Historically, SPACs have invested the proceeds that they raise in connection with their IPOs in U.S. Government securities or mutual funds, which some have used as a basis to allege that SPACs are operating as unregistered investment companies.
- As a result, the SEC proposed Rule 3a-10, which would provide a safe harbor from the definition of “investment company” under the Investment Company Act for SPACs that meet certain conditions.

Investment Company Act Safe Harbor

Nature and Management of SPAC Assets

- In order to rely on the proposed safe harbor, a 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.
  - Thus, all proceeds obtained by the SPAC, including those from any SPAC offering, cash infusion from the sponsor, or any interest, dividend, distribution or other such return derived from the SPAC's underlying assets would need to be held in these assets.
- The assets set forth above may not at any time be acquired or disposed of for the primary purpose of recognizing gains or decreasing losses resulting from market value changes.

SPAC Activities

- The proposed rule would provide a safe harbor only to those SPACs that seek to complete a single de-SPAC transaction as a result of which the surviving public entity (the “surviving 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.
  - Thus, to rely on the rule, the SPAC must have a business purpose aimed at providing its shareholders with the opportunity to own interests in a public entity that, in contrast to an investment company, will either be an operating company, or will, through a primarily controlled company, operate such operating company.
- In addition, 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.
- A SPAC would be able to engage in only one de-SPAC transaction while relying on the safe harbor, but such transaction may involve the combination of multiple target companies, provided that the SPAC treats them for all purposes as part of a single de-SPAC transaction.
  - Such intentions would be evidenced by the description in any disclosure or reporting documents, and that the closing with respect to all target companies occurs contemporaneously and within the required time frames.

SPAC Activities (cont'd)

- The proposed rule would require a SPAC wishing to rely on the safe harbor to be primarily engaged in the business of seeking to complete a de-SPAC transaction in the manner and within the time frame set forth in the rule.
  - Such engagement must be evidenced by the activities of the SPAC's officers, directors and employees, its public representations of policies, and its historical development. For example, the officers, directors and employees of a SPAC wishing to rely on this safe harbor would need to be primarily focused on activities related to seeking a target company to operate and not on activities related to the management of its securities portfolio.
- To rely on the safe harbor, the SPAC's board of directors would also need to adopt an appropriate resolution evidencing that the company is primarily engaged in the business of seeking to complete a single de-SPAC transaction, and which is recorded contemporaneously in its minute books or comparable documents.
- A SPAC relying on the proposed rule also may not hold itself out as being primarily engaged in the business of investing, reinvesting or trading in securities.

Investment Company Act Safe Harbor

Duration Limitations

- The proposed rule would require a SPAC to file a Form 8-K with the SEC announcing that it has entered 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 the SPAC's registration statement for its IPO.
- 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.
  - Following the completion of the de-SPAC transaction, any assets that are not used in connection with the de-SPAC transaction would need to be distributed in cash to investors as soon as reasonably practicable thereafter.
- The SPAC would also 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.

Empty Voting Concerns

- SEC cites a “moral hazard” resulting from the decoupling the redemption right and voting against a proposed deSPAC business combination, such that the vote is decoupled from any “[…] continuing share ownership in the post-business combination company (unless and until the warrants are exercised)”
- SEC Office of the Investor Advocate sent letters to the NYSE, Nasdaq and NYSE American on April 21, 2022 recommending that the exchanges amend their listing standards for SPACs to prohibit consummation of a business combination when public SPAC shareholders exercise their conversion rights for a majority of the shares
- Stock exchanges currently discussing with industry whether and how to implement

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What's Next?

- Over 80 public comment letters submitted, including from 12 major US law firms, the American Bar Association, the New York City Bar Association and SIFMA (Securities Industry and Financial Markets Association), a significant majority disagreeing with the proposal changes
- Typically significant regulatory changes, particularly those meeting strong headwinds in the public comment process, will take 18-24 months with the possibility of revision and reproposal
- Continue market downtrends and media hyperbole may accelerate this process
- Many industry participants anticipating changes by seeking 10b-5 letters from counsel and comfort letters from auditors in current transactions, particularly in view of potential for retroactive application

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Thank You

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