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SEC proposes new SPAC rules that are expected to significantly reduce SPAC activity

April 4, 2022 | Client Update | 11-minute read

SPACs remain in the SEC's crosshairs with this comprehensive rule proposal that expands the scope of underwriter liability, amends the scope of a safe harbor for financial projections and adopts a new safe harbor under the Investment Company Act of 1940. If adopted, the proposal would represent the most expansive regulatory consequences to SPAC business combination transactions since their creation in the early 1990s, and will likely chill SPAC activity.

After an unprecedented run of initial public offerings by special purpose acquisition companies that raised nearly a quarter trillion dollars in the last two years, on March 30th the SEC proposed a sweeping set of rules in a 3-1 vote that the majority indicated would ensure "greater transparency and more robust investor protections" that "could assist investors in evaluating and making investment, voting, and redemption decisions with respect to these transactions." In contrast, the lone dissenting Commissioner indicated that the proposal "seems designed to stop SPACs in their tracks," noting that while there are legitimate disclosure concerns, she would have supported "sensible disclosures around SPACs and de-SPACs." We tend to agree with the dissent that if the rules are adopted as proposed, SPAC activity will be significantly reduced. This proposal is consistent with a number of recent SEC proposals on stock and option transactions involving companies and their "insiders", climate change disclosures and cybersecurity disclosures where the SEC is effectively seeking to act as a merit regulator and prohibit certain activity, an expansion of its historical mission of investor protection through disclosure requirements.

The proposals are in significant part motivated by Chair Gensler's view that de-SPAC transactions in which a private target operating company completes a business combination with a SPAC are functionally the equivalent of a traditional IPO by that private operating company. He has regularly stated that the SEC needs to treat like cases alike, and investors in de-SPAC transactions deserve the same protections of traditional IPOs. But, the proposal goes further than treating "like cases alike" and, instead, extends the SEC's regulatory authority by imposing a set of substantive requirements with respect to SPAC business combinations that go beyond what would be required in a traditional IPO.

The proposal is open for public comment through at least May 31, 2022, reflecting another recent SEC trend of shrinking comment periods for major rulemaking. We plan to submit a comment letter on the proposal and hope that the SEC will be open to a dialogue with market participants.

Overview and insights

- **Underwriter liability:** The proposal would deem a SPAC IPO underwriter that "takes steps to facilitate" or "otherwise participates (directly or indirectly)" in a subsequent de-SPAC transaction "or any related financing transaction" to be a statutory underwriter for purposes of the de-SPAC transaction, greatly expanding the liability profile for a bank providing services in connection with a de-SPAC transaction. In addition, the proposed rules would require that the registration statement filed in connection with the de-SPAC transaction register not just the offering of shares to the target company's shareholders but also register an offering to the existing SPAC shareholders, who are deemed to be

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electing to receive shares at such time. As a result, if the rules are adopted as proposed, SPAC IPO underwriters would be subject to liability to a broad set of plaintiffs for any material misstatement or omission of fact in the registration statement filed in connection with the de-SPAC transaction. The SEC commentary indicates that this would apply to investment banks acting in connection with de-SPAC transactions in a number of different capacities that have not historically been understood to result in underwriter status, including acting as M&A financial advisor or capital markets advisor to the SPAC or the private operating company and as placement agent in connection with any PIPE financing in connection with a de-SPAC transaction. The scope of this proposal "could" even apply to a SPAC underwriter that simply receives its deferred underwriting compensation from the SPAC IPO in connection with the merger, while undertaking no other activities, given this deferred underwriting fee was earned at the time of the SPAC IPO. Commissioner Lee, in her statement, flatly indicated that in her view, the proposed rule will make all SPAC underwriters liable as underwriters in a de-SPAC transaction. Importantly, the proposing release conveniently characterizes this novel change in the application of underwriter liability to de-SPAC transactions as a "clarification", thereby suggesting that banks may have had underwriter liability for past de-SPAC transactions and, in turn, opening the door to a retroactive application of the proposed rule. Of additional concern, the proposing release indicates that the new proposed rule is not intended to be an exhaustive assessment of underwriter liability in de-SPAC transactions and that the SEC or federal courts may in the future find that other parties involved in a de-SPAC transaction, including financial advisors, PIPE investors or other advisors, are "statutory underwriters" if they are purchasing from an issuer with a view to distribution, selling for an issuer or are merely "participating" in a distribution of securities in a de-SPAC transaction, regardless of whether they also acted as underwriter in connection with the SPAC's IPO.

Key takeaways: Investment banks have historically avoided underwriter status for de-SPAC transactions for a number of reasons, including that registration statements for de-SPAC transactions frequently include projections and banks are uncomfortable assuming liability for that information due to its inherent uncertainty. For the same reason, company projections are not included in registration statements for traditional IPOs and instead information derived from company projections is conveyed to investors by other means. In a traditional IPO, the SEC does not mandate the inclusion of projections, and the SEC does not seek to impose liability on financial advisors, placement agents or banks who are simply paid pursuant to the terms of an existing engagement letter. Given that the registration statement in a de-SPAC transaction must include any projections provided to the SPAC's board of directors under existing SEC rules and practice and a SPAC board of directors fulfilling its fiduciary duties has incentives to request and review target company projections, we expect that this expansive interpretation will cause many banks to simply refuse to participate in de-SPAC transactions and insist on receiving their full underwriting compensation in the SPAC IPO rather than deferring a portion of it, as is current market practice in many transactions. This would make executing de-SPAC transactions more difficult and would increase the upfront costs of a SPAC IPO, thereby having a chilling effect on SPAC activity.

Projections: The proposal includes additional rules that would provide for enhanced disclosure regarding projections in de-SPAC transactions and remove the Private Securities Litigation Reform Act of 1995 (PSLRA) safe harbor that some practitioners believe provides a measure of protection against liability for the use of projections in de-SPAC transactions.

- **Disclosure regarding projections:** The proposal would require additional disclosure regarding projections in de-SPAC transactions, including disclosure of:
  - the purpose for which the projections were prepared and the party that prepared them;
  - the material bases of the disclosed projections and all material assumptions underlying the projections, and any factors that may materially impact such assumptions; and
  - whether the disclosed projections still reflect the view of the board or management of the SPAC or target company as of the date of filing.
- **PSLRA safe harbor:** The PSLRA provides a safe harbor for forward-looking statements under the Securities Act and the Securities Exchange Act, pursuant to which a company is protected from liability in any private right of action for forward-looking statements when, among other things, the forward-looking statement is identified as such and is accompanied by meaningful cautionary statements. The safe harbor is not available in initial public offerings

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and is also not available to "blank check companies." The proposal would amend the definition of "blank check company" to include SPACs, which would have the effect of making the safe harbor unavailable for disclosure in de-SPAC registration statements, including projections.

Key takeaways: The availability of the PSLRA safe harbor in connection with de-SPAC transactions has not been considered settled law and, even if the safe harbor were available, its availability would be subject to a number of conditions. Accordingly, while the potential benefits of the safe harbor for projections disclosure in the context of de-SPAC transactions has provided some comfort to parties to such transactions in the abstract, it has never operated as a complete shield from liability and therefore we do not expect that the absence of the safe harbor will have a substantial impact on current market disclosure practices. However, IPO underwriters have traditionally taken a conservative approach to the use of projections in IPO disclosures because of their potential liability for the projections as "underwriters". For this reason, and because the inclusion of projections in registration statements for de-SPAC transaction is effectively required as noted above, if investment banks are deemed to be statutory underwriters in de-SPAC transactions as described above, we expect that the underwriting investment banks will refuse to participate in de-SPAC transactions to avoid liability.

Investment Company Act: The SEC proposal includes a safe harbor for SPACs that would deem a SPAC to not be an investment company under the Investment Company Act of 1940, if certain conditions are met.

- SPACs must meet the following conditions to take advantage of this new safe harbor:
  - a SPAC's assets must consist solely of government securities, government money market funds and cash
  - a SPAC's activities must be limited to seeking to complete a single de-SPAC transaction as a result of which the surviving public entity will be primarily engaged in the business of the target company or companies and will have a class of securities registered on a national securities exchange;
  - the activities of a SPAC's officers, directors and employees must be primarily focused on activities related to seeking a target company, and the board of directors of the SPAC would need to adopt an appropriate resolution of this business purpose; and
  - a SPAC must announce a business combination within 18 months of its IPO and complete a business combination within 24 months of its IPO.
- The proposing release makes clear that the safe harbor is only intended to provide clarity for circumstances in which a SPAC will not be deemed to be an investment company, and that a SPAC that does not meet the conditions will not automatically be an investment company and that SPACs that do not satisfy the requirements for the safe harbor should carefully assess with their advisors whether that SPAC otherwise constitutes an investment company under the SEC's existing rules.

Key takeaways: While we welcome greater clarity on this issue, including in light of lawsuits against several SPACs alleging they were unregistered investment companies within the meaning of the Investment Company Act, we do not view the safe harbor as meaningfully changing well settled law and believe it may be counterproductive as market participants may grow to view the safe harbor as exclusive. In September 2021, more than 60 law firms, including Davis Polk, issued a joint statement (available here) that noted that the assertion that SPACs are unregistered investment companies is without factual or legal basis. Nonetheless, if market participants view this safe harbor as exclusive, it could have the effect of shortening the time period in which SPACs have to announce, and then complete, a business combination. The economic analysis included with the proposal found that approximately 40% of SPACs had not announced a transaction within 18 months following IPO and 35% had not completed the transaction within 24 months following IPO, and would therefore not be able to meet the requirements of the safe harbor as proposed. For those SPACs that are unable to complete a business combination within the requisite period required by the safe harbor, the proposed safe harbor does not otherwise amend or modify the existing SEC rules regarding investment companies, which as noted above, we and the law firm community continue to believe do not apply to SPACs.

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Enhanced disclosures: The SEC proposal includes a number of technical changes to disclosure requirements for SPAC IPOs and de-SPAC transactions and technical reporting requirements for post-de-SPAC companies, including to harmonize the reporting rules for de-SPAC transactions and traditional IPOs.

- The enhanced disclosure requirements focus on:
  - the sponsor's experience, the arrangements between the persons that control the sponsor, and all compensation that has or will be awarded to the sponsor or any affiliates or promoters
  - conflicts of interest between the unaffiliated security holders of the SPAC and the sponsor, its affiliates or the SPAC's officers, directors or promoters;
  - dilution that shareholders may experience in both the SPAC initial public offering and in the de-SPAC transaction; and
  - the fairness of the consideration paid to the target equityholders and to the unaffiliated security holders of the SPAC, including:
    - a statement from the SPAC as to whether it reasonably believes that the de-SPAC transaction and any related financing are fair or unfair to unaffiliated security holders; and
    - disclosure of any outside report, opinion or appraisal relating to the fairness of the transaction.
- Additionally the SEC proposal includes technical changes to the reporting requirements in de-SPAC transactions to harmonize the financial statement requirements with the analogous requirements for a traditional IPO. These changes are generally welcome.
- The SEC proposal includes a requirement that the target company be listed as a co-registrant in any registration statement filed in connection with the de-SPAC transaction and that all de-SPAC transactions, regardless of structure, will be deemed to be a sale of securities to the SPAC's shareholders.

Key takeaways: As the SEC noted in its release, many of the SEC's proposals for enhanced disclosures and harmonizing financial statement requirements are consistent with current market practice for disclosures in SPAC IPOs and de-SPAC transactions, and do not appear to be overly burdensome. The disclosure requirements with respect to the fairness of the transaction, while not specifically requiring a fairness opinion, are clearly intended to push market participants towards obtaining a fairness opinion more typical for public M&A transactions, including disclosure of the corresponding reports/opinions provided by outside advisors. The requirement that all de-SPAC transactions, regardless of structure, be deemed to be a sale of securities to the SPAC's shareholders would effectively end the practice of effecting certain de-SPAC transactions through a proxy statement without filing a registration statement, which in turn may have the practical effect of increasing the liability profile of the transaction.

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