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SEC adopts final SPAC rules

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The SEC backpedaled on its proposed rules that would have expanded the scope of underwriter liability and included a new safe harbor under the Investment Company Act of 1940. But the final rules do follow through on imposing disclosure requirements for sponsor compensation, conflicts of interest, dilution and projections – in a way that, in our view, largely codifies current market practice in SPAC IPOs and de-SPAC transactions.

On January 24, 2024, the SEC, in a 3-2 vote, adopted final rules that mandate expanded disclosures and other obligations with respect to initial public offerings by SPACs and subsequent de-SPAC transactions. The final rules come almost two years after the SPAC IPO boom in which we saw an unprecedented run of SPACs raising more than a quarter trillion dollars.

In a somewhat surprising change from the rule proposal, the SEC jettisoned from the final rules the proposed rule that would have unilaterally expanded the statutory underwriter definition in the Securities Act of 1933 in connection with de-SPAC transactions. The SEC also declined to adopt the proposed non-exclusive safe harbor for SPACs from the "investment company" definition under the Investment Company Act of 1940. Instead, the SEC said it was opting to provide guidance on those topics – but the guidance takes a relatively minor role in the 581-page adopting release and reads more like a hornbook or treatise on these topics instead of using the opportunity to clarify any meaningful areas of ambiguity.

Nonetheless, the final rules do require additional disclosures with respect to SPAC sponsor compensation, conflicts of interest, dilution and projections and other items aimed at investor protection such as requiring the target operating company to be a co-registrant in a de-SPAC registration statement and mandating a 20-day dissemination period for proxy statements being delivered to SPAC shareholders.

In voting against the final rules, Commissioners Peirce and Uyeda shared the view that certain aspects of SPAC rules needed to be fixed and they would have generally welcomed more tailored rules on SPACs, but that these final rules overreach into an area that was already being fixed by market practice. We tend to agree with the dissent in this regard. The amendments will generally codify, in our view, the status quo as it relates to market practice in the wake of the proposed rules from March 2022. We do not expect the new requirements to meaningfully change the way the vast majority of SPAC IPOs and de-SPAC transactions are currently being conducted.

Overview and insights

Underwriter liability

The March 2022 rule proposal would have deemed 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. The SEC's proposed rule (Rule 140a) conveniently characterized this as a "clarification" – but the practical effect of the rule would have been to greatly expand the liability profile for a bank providing services in connection with a de-SPAC transaction. This liability would have applied to a number of roles that have not historically been understood to result in statutory underwriter status, including acting as

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M&A financial advisor for the target company or the SPAC in a de-SPAC transaction, acting as placement agent in connection with a private offering of securities as part of the de-SPAC transaction or acting as capital markets advisor to either the SPAC or the target company in a de-SPAC transaction. The proposed rule could also have been interpreted to apply to a SPAC IPO underwriter that simply received a deferred underwriting commission but otherwise was not involved in the back-end de-SPAC transaction. For all these reasons, a number of market participants and others (including Davis Polk) submitted comment letters to the SEC expressing concern about the novel approach associated with the proposed rule.

In the final rules, the SEC did not adopt proposed Rule 140a and, instead, opted to provide guidance on statutory underwriter status in a de-SPAC transaction. The adopting release states that the SEC views a de-SPAC transaction as a distribution of securities in that the purpose of a "de-SPAC transaction is to provide the target company with capital and access to the public markets" even though the target company does not sell its securities in the market. While there is no traditional underwriter in a de-SPAC transaction, the SEC noted that in some transactions "someone is selling for the issuer or participating in the distribution of securities in the combined company to the SPAC's investors and the broader public" who, depending on the facts and circumstances, may be considered a statutory underwriter even though not named as one in any given offering. In other words, the SEC seems to be saying we really do not need this rule for one to reasonably conclude that in certain situations there may be parties "participating" in the de-SPAC transaction in a way that gives rise to statutory underwriter liability.

Key takeaways: In the absence of proposed Rule 140a, and under existing case law, we believe there are very strong arguments that, in most circumstances, financial institutions participating in de-SPAC transactions should not be subject to statutory underwriter liability. Nonetheless, given the lack of concrete or meaningful guidance from the SEC in the release on who is and is not "participating" in these de-SPAC transactions, and absent further clarity from the courts, we think financial institutions participating in de-SPAC transactions are going to continue to take a conservative approach, as they largely have done since the announcement of proposed Rule 140a – treating these transactions more akin to a traditional IPO than a traditional public M&A transaction in terms of potential liability pitfalls. We expect this to result in these financial institutions generally continuing to insist upon receiving customary negative assurance letters from law firms and comfort letters from auditors to continue to support a due diligence defense as a condition to their participation in these types of de-SPAC transactions, particularly in situations where they are advising the SPAC and/or participated in the SPAC's IPO. This will continue to mean some incremental cost associated with such procedures and deliverables, but the cost should not be prohibitive if the requirement for these deliverables is known at the outset of the de-SPAC transactions when the broader M&A diligence process is being kicked off. The market will also be keeping a close eye on a handful of lawsuits that are working their way through the courts arguing for "underwriter" liability for financial institutions with roles in transactions that have not been historically seen as statutory underwriters. Presumably the plaintiffs in those cases have more of an uphill road to climb as a result of the SEC backpedaling on proposed Rule 140a and the "clarification" of underwriter status that the SEC sought. We expect the ultimate resolution of these cases may further impact market practice in this area.

Investment Company Act

While the SEC did not adopt the proposed safe harbor that would deem a SPAC not to be an investment company under the Investment Company Act of 1940 if certain conditions were met, the SEC did provide guidance on activities that may raise concerns as to investment company status:

- **Nature of SPAC assets and income**. For instance, a SPAC that owns or proposes to acquire 40% or more of its total assets in investment securities (such as corporate bonds) or a SPAC whose income is substantially derived from such assets would likely be considered an investment company. Holding U.S. government securities, U.S. registered money market funds and cash items, as is customary for SPACs during the period between the SPAC IPO and de-SPAC transaction, should not result in investment company status. Notably, the SEC's guidance that a SPAC's holding of money market fund shares in this context should not raise investment company status issues was not limited only to U.S. government money market funds, which were the only type of money market fund investment expressly covered by the proposed safe harbor.
- **Management activities**. Certain activities of the SPAC's officers, directors and employees may be factors in the investment company determination, such as spending a considerable amount of time in managing the SPAC's portfolio to achieve returns and not actively seeking a de-SPAC transaction. The SEC guidance also stated that certain management activities could cause SPAC sponsors to come within the definition of "investment adviser" under the Investment Advisers Act of 1940.
- **Duration.** While the SEC does not offer a bright line rule as to the duration of the SPAC, if a SPAC continues to operate without completing a de-SPAC transaction and its assets are substantially composed of, and its income derived from, securities, its activities may be more difficult to distinguish from those of an investment company. The

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SEC guidance indicated that the 12-month safe harbor for transient investment companies under Rule 3a-2 and the 18-month limit contemplated by Rule 419 were relevant analogies in analyzing the investment company status of a SPAC and that the further a SPAC operated beyond those timelines, the greater the investment company concerns would be, depending on the overall facts and circumstances.

- **Holding out**. If the SPAC holds itself out as primarily engaged in investing, reinvesting or trading in securities, it will likely be considered an investment company.
- **Merging with an investment company**. If the target company in a de-SPAC transaction is an investment company, the SPAC is likely to be considered an investment company.

Key takeaways: The guidance is not, in our view, terribly relevant to SPACs that have operated in the traditional sense of holding themselves out explicitly in their IPO prospectuses as seeking a private operating company to complete a business combination. During that search process, SPACs have traditionally invested their trust accounts in U.S. government securities, money market funds and/or cash. Management activities are not focused on achieving returns in the trust account but rather searching for a suitable business combination and closing a de-SPAC transaction. The NASDAQ and NYSE exchange listing rules impose a 36-month time limit as a condition to being listed on those exchanges, and the market practice has routinely accepted at least a 24-month period to complete a de-SPAC transaction (though we acknowledge that there may be situations where a well-advised SPAC decides to move its trust account to cash to take pressure off a longer than expected duration to achieve its business objective of closing a de-SPAC transaction). SPACs generally do not hold themselves out as investing or trading in securities or complete business combinations with investment companies. For all these reasons, we believe the law is well settled and we remind readers of the joint statement issued by more than 60 law firms in September 2021, including Davis Polk (and available here), that noted that the assertion that traditional SPACs are unregistered investment companies is without factual or legal basis.

Disclosure related to projections and the PSLRA safe harbor

New Item 1609 of Regulation S-K calls for enhanced disclosure regarding projections in de-SPAC transactions, including the disclosure of:

- the purpose for which the projections were prepared and the preparing party;
- all material bases of, and material assumptions underlying, the projections and any material factors that may affect the assumptions; and
- whether the disclosed projections still reflect the views of the board or management of the SPAC or target company as of the most recent practicable date prior to the date of the disclosure document required to be disseminated to shareholders.

The final rules also explicitly disallow SPACs from taking advantage of the Private Securities Litigation Reform Act of 1995 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 final rules amend the definition of “blank check company” to include SPACs, which has the effect of making the safe harbor unavailable for disclosure in de-SPAC registration statements, including projections. The final rules explicitly state, however, that this change is not intended to have any retroactive effect to statements made prior to the rule change.

In addition to new Item 1609 of Regulation S-K, which only applies to de-SPAC transactions, the SEC amended Item 10(b) of Regulation S-K to expand and update the SEC’s views on the use of projections in all SEC filings. These amendments mandate that: (i) projections that are not based on historical results be clearly distinguished from projections that are based on historical results; (ii) projections based on historical results also present the historical results with equal or greater prominence; and (iii) the projections that include non-GAAP measures include a clear definition of those measures, a description of the GAAP measure that is most directly comparable and an explanation as to why the non-GAAP measure is used instead of the GAAP measure. The SEC clarified that these guidelines also apply to projections of persons other than the registrant, such as the target company in a business combination transaction, that are included in the registrant’s filings.

Key takeaways: We do not expect these changes to materially change market practice as it relates to projections. The potential availability of the safe harbor in connection with de-SPAC transactions had not been considered settled law. Projections have historically been included in de-SPAC disclosure documents where they are part of the materials that the SPAC board considers for the purpose of approving the de-SPAC transaction and are, therefore, considered material information that is required to be disclosed to investors given well-settled Delaware and Cayman corporate law,

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irrespective of whether the transaction avails itself of the PSLRA safe harbor. For this same reason, we have disagreed with the assertion that we have heard numerous times that private operating companies were pursuing de-SPAC transactions because of the ability to use projections as part of their de-SPAC transactions, versus a traditional IPO where market practice is not to provide projections in the disclosure documents given the liability profile for financial institutions serving as underwriters.

We believe the market practice of scrutinizing any projections, including the assumptions underlying the projections and the time period covered by the projections, will continue. This will particularly be the case where financial institutions are advising on de-SPAC transactions, given the potential for liability as described above. It is worth noting that, given the non-retrospective applicability of the rule change, defendants will remain free to rely on the PSLRA safe harbor as a defense in connection with historical disclosures related to de-SPAC transactions. It is also worth noting that none of the changes the SEC is making in the final rules impact the ability to rely on any other safe harbor (such as Rule 175) or to assert a defense based on the "bespeaks caution" doctrine, which is a judicially made doctrine that allows defendants to avoid liability when forward-looking statements are accompanied by sufficient cautionary language.

Enhanced disclosure obligations

The final rules include a number of new disclosure requirements for SPAC IPOs and de-SPAC transactions in an effort to harmonize the reporting rules for de-SPAC transactions and traditional IPOs.

- **Information regarding SPAC sponsors**. New Item 1603(a) of Regulation S-K requires disclosure of the SPAC sponsors' business, experience, material roles and responsibilities and any agreement between the SPAC sponsor and the SPAC, its officers, directors, or affiliates with respect to determining whether to proceed with a de-SPAC transaction. A description of the nature and amount of all compensation that has been or will be awarded to, earned by, or paid to the SPAC sponsor, its affiliates and any promoters is also required.
- **Conflicts of interest**. New Item 1603(b) requires disclosure of any actual or potential material conflicts of interest between the SPAC sponsor or its affiliates, the SPAC's officers, directors or promoters or the target company's officers and directors, on the one hand, and unaffiliated security holders of the SPAC, on the other.
- **Dilution**. Disclosure regarding, among other things, the material dilutive effect of compensation and security issuances to the SPAC sponsor, its affiliates and promoters and dilution based on percentages of the maximum redemption threshold are required on the outside front cover of the prospectus and the prospectus summary.
- **Board determination and fairness opinions**:
  - Under new Item 1606(a), if state law requires that the SPAC's board of directors determine whether the de-SPAC transaction is advisable and in the best interests of the SPAC and its shareholders, the SPAC is required to disclose the determination, which is already common practice in the market.
  - Under new Item 1607, if the board of directors of the SPAC received any outside report, opinion or appraisal that materially relates to the fairness of the de-SPAC transaction, the SPAC is required to disclose certain information about the report, opinion or appraisal.

Key takeaways: The SEC's rule proposal originally sought a statement from the SPAC as to whether it reasonably believed that the de-SPAC transaction and any related financing was fair or unfair to unaffiliated security holders. Numerous comment letters (including the Davis Polk letter) expressed concern at this requirement, suggesting it was a thinly veiled "suggestion" for the SPAC to obtain a fairness opinion. The SEC backpedaled from this requirement in favor of the above requirements. We believe these requirements are redundant – SPACs almost universally provide in their registration statements and proxy statements a statement of their board of directors' approval of the de-SPAC transaction and a recommendation to shareholders voting on the transaction as well as the supporting reasons for these statements. Likewise, given well-settled principles of good disclosure, SPACs obtaining a fairness opinion have already been disclosing that as part of the de-SPAC proxy statement and/or registration statement.

Other investor protections in de-SPAC transactions

The final rules also include amendments intended to enhance investor protections in de-SPAC transactions, including notably the following:

- A requirement that the target company in a de-SPAC transaction be a co-registrant with the SPAC and be subject to Section 11 liability and the adoption of new Rule 145a, which provides that all de-SPAC transactions, regardless of structure, be deemed to be a sale of securities to the SPAC's shareholders, both of which we believe may have the

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practical effect of increasing the liability profile of the transaction by subjecting the de-SPACed company to a cause of action under Section 11 of the Securities Act and increasing the pool of potential plaintiffs.

- A requirement for a 20-calendar day minimum dissemination period for prospectuses and proxy and information statements filed for de-SPAC transactions where consistent with local law.
- A requirement to re-determine smaller reporting company status following the completion of the de-SPAC transaction and to have filings reflect such determination 45 days after the completion of the de-SPAC transaction.

Compliance dates

The final rules will become effective 125 days after publication in the Federal Register. Registrants will be required to tag information disclosed pursuant to new subpart 1600 of Regulation S-K in Inline XBRL beginning one year after the initial compliance date for the disclosure requirement.

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