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SPACs' wild ride sets stage for SEC smackdown in 2022

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Special purpose acquisition companies (SPACs) have seen a meteoric rise in the past two years, surging dramatically past traditional IPOs as a means for companies to go public. Buoyed by the perception of providing a faster, cheaper route to the public markets, IPOs involving SPACs now account for three-fifths of all IPOs.

But the massive influx of investor funds has attracted SEC scrutiny. Throughout 2021, the SEC has issued a steady stream of statements raising concerns about conflicts of interest, disclosure adequacy, and investor protection. Most significantly, this year the SEC brought three major enforcement actions against SPACs and issued accounting guidance in April that led to hundreds of financial restatements by SPACs, cooling the market dramatically.

As SEC concerns have grown, the agency has added SPACs to its rulemaking list, with a tentative date of April 2022 for issuance of a proposal. SEC Chair Gary Gensler said he has asked staff for recommendations for clarification and enhancements relating to disclosures, marketing practices, and gatekeeper obligations.

With SEC rulemaking or other action looking likely in 2022, SPACs' wild ride may be reined in, with a tamer future in store.

Market trends

SPACs have been around since 1993, but only began to really take off in 2017. SPACs overtook traditional IPOs for the first time in 2020, and significantly outnumbered traditional IPOs in 2021. According to Chair Gensler, SPAC blank-check IPOs now account for more than three-fifths of all U.S. IPOs. As to the second phase in the SPAC process, which some call the "de-SPAC" and others the "SPAC target IPO," the number soared from 26 in 2019 to 181 in 2021, with a total deal value of $370 billion.

According to Sarah Solum, U.S. managing partner and head of U.S. Capital Markets at Freshfields Bruckhaus Deringer US LLP, SPACs were first popularized by a few prominent investors, but now everyone wants to get on the bandwagon. Celebrities have attracted retail investor interest, and private company targets are attracted by SPACs competing to give them money. Companies also like the benefit of locking in a valuation, in contrast with traditional IPOs in which the valuation is not locked in until the end of the roadshow.

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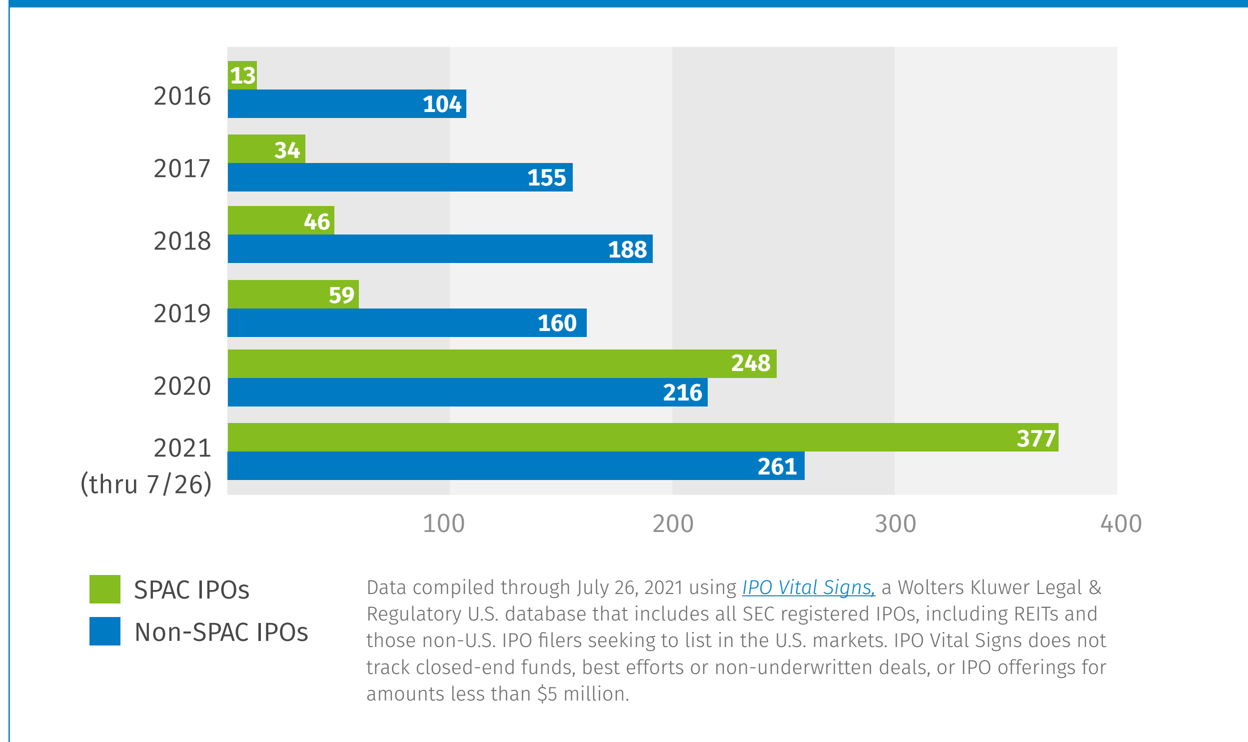
Figure 1. SPACs vs. Traditional IPOs



Data compiled through July 26, 2021 using *IPO Vital Signs*, a Wolters Kluwer Legal & Regulatory U.S. database that includes all SEC registered IPOs, including REITs and those non-U.S. IPO filers seeking to list in the U.S. markets. IPO Vital Signs does not track closed-end funds, best efforts or non-underwritten deals, or IPO offerings for amounts less than $5 million.

But what goes up must come down. According to Kristen Grippi, senior managing director and head of equity capital markets at Evercore, there were over 30 SPAC IPOs a week in the first quarter of 2021, but the numbers came to a "screeching halt" after that. The market was oversaturated, with not enough quality companies to sustain such an elevated level. Later in the year, the market rebounded to a "healthy level" of between about three and seven SPAC IPOs a week, said Grippi.

Grippi expects a healthy pace to continue into 2022, with repeat SPAC issuers like large banks continuing to raise money. However, she sees new patterns emerging. There may be a trend of SPACs changing from being led by a specific individual to being led by a board of ex-operating executives. SPACs are also increasingly "purpose-driven," with an announced interest in a specific sector or type of company, for example a specific type of software company or consumer. Also, one advantage that SPACs have previously offered—rapid time to IPO—has diminished due to the SEC slowing down the process for de-SPAC transactions. Previously, a de-SPAC transaction could take place as fast as three to four months, but this has now expanded to about six months, said Grippi.

2021 SEC guidance and statements

Over the past year, SEC divisions and officials have issued a steady drumbeat of guidance and statements that raise persistent concerns about SPAC investor protections and signal increased regulatory scrutiny.

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In December 2020, the Division of Corporation Finance effectively put SPACs on notice that the SEC was scrutinizing their disclosures to investors in very specific areas. CorpFin staff issued guidance stating that inherent conflicts of interest may arise due to differing economic interests between public shareholders and the entity or management team that forms the SPAC (sponsors) and the directors, officers, and affiliates. Staff directed that SPACs must make clear disclosures and provided specific questions for SPACs to consider, including whether the SPAC has clearly described financial incentives and control by SPAC sponsors, directors, and officers.

Next, CorpFin and the Office of the Chief Accountant (OCA) signaled what could be interpreted as an increased focus on gatekeeper obligations. In March 2021, CorpFin staff issued a statement reminding persons involved with SPACs of securities law obligations, including issues relating to shell company restrictions, books and records and internal controls requirements, and initial listing standards of national securities exchanges.

In a separate statement the same day, SEC Acting Chief Accountant Paul Munter addressed some of the same issues but with a more accounting-centric view. Munter emphasized five areas for SPAC participants to consider: (1) market and timing considerations; (2) financial reporting; (3) internal controls; (4) corporate governance and audit committee considerations; and (5) auditor considerations. The topic of considerations for auditors and audit committees was later expanded upon in guidance by the Center for Audit Quality.

CorpFin next tamped down the percolating theory that SPACs enjoy greater legal protections than traditional IPOs. Some have suggested that the safe harbor for forward-looking projections provided by the Private Securities Litigation Reform Act (PSLRA) applies to de-SPAC transactions even though it does not apply to conventional IPOs. In a statement, then-Acting Director John Coates said this view is "overstated at best, and potentially seriously misleading at worst." The PSLRA excludes "initial public offerings" from the safe harbor. This phrase may include de-SPAC transactions, said Coates, since it is the de-SPAC transaction and not the SPAC IPO that is the transaction in which a private operating company itself goes public.

Coates suggested that it may be time to provide greater clarity through rulemaking or staff guidance on the scope of the safe harbor in the PSLRA. Concerns raised by many at a later meeting of the Small Business Capital Formation Advisory Committee confirmed that the safe harbor issue is indeed top-of-mind for many SPAC participants.

Then, in a joint statement in April that sent shockwaves through the SPAC market, Coates and Munter stated the view of CorpFin and OCA staff that some warrants issued in connection with SPAC formations and initial offerings may need to be accounted for as liabilities rather than equity. The guidance had a profound impact. According to Sarah Solum, the guidance caused "hundreds" of restatements and caused new SPACs to change the terms of their warrants to get equity accounting. Andrew Ceresney, former SEC co-Enforcement director, reported that an astonishing 85 percent of SPACs restated due to the accounting guidance.

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As a result, the number of SPAC IPOs cratered. An analysis by Pitchbook showed that in Q2, the number of SPAC IPOs fell by 66.5% and the amount of capital raised dropped by 81.3% relative to Q1.

Following the accounting guidance, the SEC added SPACs to the Spring 2021 Unified Agenda of Regulatory and Deregulatory Actions in June. The entry lists a date of April 2022 for issuance of a rulemaking proposal.

Preview of 2022 SEC rulemaking and staff action

With a rulemaking proposal likely coming in 2022, what might it contain? Indications point toward mitigating conflicts of interest and protecting investors via a focus on disclosures, marketing practices, and gatekeeper obligations.

- The Investor Advisory Committee recommended in September that the Commission require specific disclosures for SPACs, including relating to the role of the sponsor and the economics of the various participants, among other areas.
- CorpFin Associate Director Michelle Anderson indicated in October that staff is looking at how well investors understand SPACs, including risks and potential conflicts of interests of SPAC sponsors and other SPAC insiders, and how to enhance disclosures to improve investor understanding. Staff is also examining the potential for regulatory arbitrage associated with going public via de-SPAC, and the lack of traditional gatekeepers that are normally present in traditional methods of going public.
- Chair Gensler stated in December that SPAC investors may not receive adequate protections due to differences from traditional IPOs in the areas of disclosures, marketing practices, and gatekeeper obligations. Gensler listed specific issues for which he has asked staff to provide recommendations, including disclosure of fees, projections, dilution, and conflicts of interest; prohibiting improper “priming” of the market; and better alignment of incentives between investors and gatekeepers.

Beyond formal rulemaking, the SEC may also act in the form of guidance or other measures. At the Investor Advisory Committee meeting in September, Commissioner Allison Herren Lee observed that SPAC developments are “happening in real time” and it might be appropriate for the Commission to act on some suggestions via guidance rather than waiting for formal rulemaking. Further, in his December remarks, Gensler said he has asked staff to consider clarifying disclosure obligations under existing rules.

Finally, alongside the many statements and guidance to market participants, the SEC has also spoken directly to investors. In March, the Office of Investor Education and Advocacy (OIEA) issued an investor alert warning about investing based on celebrity endorsements of SPACs. The alert described conflicts of interest and noted that like anyone else, celebrities can be lured into participating in a risky investment. In May, OIEA issued an updated investor bulletin describing the SPAC structure and process in greater depth, again emphasizing the potential for risk and conflicts of interest.

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SEC enforcement

Following through on Gensler's statement in late May testimony before the House Financial Services Committee that the agency is closely monitoring SPAC transactions, the SEC has brought three significant enforcement actions against SPACs this year.

In July, the SEC brought mostly settled charges in an administrative action, *In the Matter of Momentus Inc.*, against a SPAC, its sponsor, its CEO, the merger target, and the merger target's former CEO in connection with alleged misleading claims about the target's products prior to a planned August 2021 business combination. The respondents repeatedly told investors that the company had successfully tested its rocket propulsion technology in space. However, the company's only in-space test had failed to achieve its primary objectives or demonstrate the technology's commercial viability. The respondents also misleadingly downplayed the extent to which national security concerns involving the former CEO undermined the company's ability to secure required governmental licenses for its operations. Further, the SEC found that the SPAC, Stable Road Acquisition Corp., had repeated Momentus's misleading statements in public filings associated with the planned merger and did not discharge its due diligence obligations to investors, as it had claimed.

As to sanctions, Momentus, Stable Road, and Stable Road's CEO agreed to pay civil penalties of $7 million, $1 million, and $40,000, respectively. In addition, Momentus and Stable Road agreed to give PIPE investors the right to terminate their subscription agreements prior to the shareholder vote to approve the merger, the SPAC sponsor agreed to forfeit 250,000 founders' shares it would have received in the merger, and Momentus agreed to enhance its disclosure controls, including creating an independent board committee and retaining an internal compliance consultant for two years. Litigation is ongoing against the former Momentus CEO.

In another action in July, the SEC brought charges against Trevor R. Milton, the founder, former CEO and former executive chairman of electric vehicle manufacturer Nikola Corporation. Milton allegedly helped Nikola raise more than $1 billion in private offerings and go public through a SPAC business combination. The SEC alleged that Milton repeatedly disseminated false and misleading information about the company's products and technological accomplishments, often through social media. For example, Milton distributed a video on social media that appeared to show a Nikola truck moving under its own power, but in fact was simply rolling down an incline. The company announced in a Form 8-K in early November that it had reached a tentative settlement with the SEC to pay a $125 million civil penalty.

In the third action, the SEC settled charges in October against Akazoo S.A., a post-SPAC purported music streaming business based in Greece. Akazoo entered into a SPAC business combination in 2019 on the basis of misrepresentations that it had 4.6 million paying subscribers and over $120 million in annual revenue. In reality, the company had no paying users and negligible revenue at best. Notably, the SPAC involved, Modern Media Acquisition Company (MMAC), had identified Akazoo as an acquisition target after MMAC failed to meet its original deadline of February 2019 to consummate a business combination and many of its shareholders chose to redeem their shares.

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In April 2020, a short-seller report exposed the Akazoo fraud, and Nasdaq delisted the company's stock in June 2020. The SEC obtained an emergency asset freeze against the company in September 2020 to preserve the company's remaining assets. In the 2021 settlement, Akazoo agreed to pay $38.8 million in disgorgement, which was deemed satisfied by its payment of $35 million to the investor victims and settlements in connection with several private class action lawsuits.

Together, the three enforcement actions show that the SEC is watching SPACs closely and is ready, willing, and able to crack down against fraud, whether pre- or post-SPAC. As David Peavler, Regional Director of the SEC's Fort Worth Regional Office, stated regarding the Akazoo matter, "The SEC is intently focused on SPAC merger transactions, and we will continue to hold wrongdoers in this space accountable."

SEC filing reviews relating to SPACs involved in enforcement matters

Taking a closer look at the enforcement matters through the eyes of CorpFin offers insights as to disclosures by companies that ultimately became involved with the Division of Enforcement.

Like most filing review dialogues, correspondence between the SEC staff and SPACs tend to follow a pattern consistent with other types of entities: they begin with basic inquiries such as whether the entity is an emerging growth company or with some basic questions about why certain information does not appear on the prospectus cover page before turning to issues that mostly concern financial disclosures and occasionally deal with corporate management issues. Of course, with SPACs, there are some issues that are much less common in other staff comment letters, such as the emphasis on the redemption process. Nevertheless, staff comment letters to SPACs, like other staff comment letters, tend to be highly focused on the specific issues facing the issuer despite the general applicability of some types of questions. Perhaps a more interesting question is whether SEC staff comment letters can tip off investors to potential enforcement issues with an entity? In retrospect, the answer is likely "Yes" in many instances. But in the time frame in which staff comment letters are posted on the public side of EDGAR, the answer is less clear and professional securities analysts examining both a SPAC's SEC filings (including SEC staff comment letters) and other publicly-available data are perhaps in the best position to identity SPACs that may not live up to their promises. Still, the filing review process does provide a window into the SEC staffs' thinking about SPACs.

The following discussion looks at the SEC staff comment letters made public thus far for three SPAC transactions that drew SEC enforcement scrutiny in 2021. The discussion closes with a review of high profile, and highly controversial, SPAC for which the SEC has not yet announced any formal enforcement action.

Stable Road Acquisition Co/Momentus Inc. The SEC issued multiple comment letters to Stable Road Acquisition Co/Momentus Inc. on a variety of topics. The first substantive set of comments addressed the SPAC's preliminary proxy statement on Schedule 14A. Here the SEC asked about the SPAC's need for approvals by the Committee on foreign Investment in the U.S. (CFIUS) and for more information about Momentus' operational status and prospects. The SPAC replied that is had added a new disclosure section dealing with its status and other recent developments regarding

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its planned business combination (See, Letter from SEC to Stable Road Acquisition Corp. (April 5, 2021) and Letter from Stable Road Acquisition Corp. to SEC (April 7, 2021)).

In a second, more focused set of comment letters, SEC staff inquired about the SPAC's sponsors, affiliates, officers, and directors may benefit from the acquisition of a less favorable target or from less favorable merger terms rather than liquidate the SPAC. The SPAC replied that it had added more disclosure to its filings in order to explain that these persons "may have different (and potentially conflicting) interests in completing the Business Combination than the public stockholders and may be incentivized to complete the Business Combination rather than liquidate."

SEC staff also asked about a complex national security agreement that would impact the resulting public company's oversight by its managers and directors. Specifically, the staff wanted to know how an arrangement in which the national security agreement provides for a security director who can only be removed with approval of the CFIUS monitoring agencies and how that same security director would have sole authority to remove or replace officers and directors. In particular, the staff asked how this arrangement could be squared with Delaware law? The SPAC replied that DGCL Section 141(a) permits many arrangements except as otherwise stated in a company's certificate of incorporation. Moreover, DGCL Section 102(b)(1) states that a company's certificate of incorporation can contain any provision that is not contrary to Delaware law. According to the SPAC, Delaware law allows sufficient flexibility to embrace the oversight structure contemplated by the SPAC, although the SPAC said it would add additional risk factor disclosures to explain the uncertainties associated with the proposed oversight arrangement (See, Letter from SEC to Stable Road Acquisition Corp. (July 9, 2021); Letter from Stable Road Acquisition Corp. to SEC (July 12, 2021)).

VectoIQ Acquisition Corp./Nikola Corp. The SEC commented on VectoIQ Acquisition Corp.'s Form S-4 filed as the SPAC proceeded with its merger with Nikola Corp. In 2020, for example, The SEC staff asked VectoIQ several questions about the status of its products, including the "development status" of its competitors' vehicles to that of its own vehicles, and about the lifecycle and efficiency of the batteries that would power its vehicles. VectoIQ replied that it had revised its disclosures as requested by the SEC staff. A follow-up letter would ask VectoIQ to further clarify its own and its competitors' target availability and production timelines.

SEC staff also inquired about the exclusive forum provision in VectoIQ's articles. Specifically, the staff noted the differences between Exchange act claims, which must be brought in federal court, and Securities Act claims for which there is concurrent jurisdiction. By way of background, the U.S. Supreme Court reaffirmed the concurrent jurisdiction applicable to Securities Act Claims, but the Delaware Supreme Court has put its own gloss on that decision by allowing forum selection clauses that mandate Securities Act claims be brought in federal court (specifically, the court said these provision are facially valid under Delaware law). The time frame for this comment letter dialogue was the several months after the Delaware Supreme Court's decision. SEC staff said VectoIQ must revise its disclosures to state that, if the exclusive forum provision applies to Securities Act claims, there is uncertainty that a sate court would enforce the provision. In a follow-up letter, the SEC staff partially reissued this comment and asked VectoIQ to describe the full scope of its exclusive forum provision.

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Among the various corporate-themed questions, one question asked VectoIQ to explain from whom it had repurchased shares and why. VectoIQ explained that it had repurchased shares from a related party in anticipation of a new round of financing in order to terminate the related party's right to elect a board member so that that right could be extended to the lead investor of the next round of financing. VectoIQ also made a second repurchase from the related party to compensate the related party for having relinquished its redemption rights (SEC letter to VectoIQ Acquisition Corp. (April 9, 2020); VectoIQ Acquisition Corp. letter to SEC (April 15, 2020); SEC letter to VectoIQ Acquisition Corp. (April 29, 2020)).

In yet another comment letter dialogue regarding Nicola Corporation's (f/k/a VectoIQ) Form S-1, the SEC staff inquired about the status of an issuance of shares that are issuable upon the exercise of related warrants originally issued in a private placement. SEC staff noted that a transaction commenced privately cannot be converted to a registered offering. The staff also asked VectoIQ to explain if it believed the warrants were immediately exercisable (i.e., within one year) when issued privately. SEC staff further pointed to guidance contained in SEC Compliance and Disclosure Interpretations, Securities Act Sections, Questions 103.04 and 134.02.

The answer to Question 103.04 provides, in part: "If such securities are not convertible or exercisable within one year, the issuer may choose not to register the underlying securities at the time of registering the convertible securities or warrants. However, the underlying securities must be registered no later than the date such securities become convertible or exercisable by their terms, if no exemption for such conversion or exercise is available."

The answer to Question 134.02 provides, in part: "The filing of a registration statement for a specific securities offering (as contrasted with a generic shelf registration) constitutes a general solicitation for that securities offering, thus rendering Section 4(2) unavailable for the *same offering*" (emphasis in original).

Nikola Corporation replied that the warrant agreement contained terms that ensured the warrants would not be exercisable within one year of their issuance. More specifically, Nikola Corporation paraphrased the language of C&DI Question 103.04: "if the warrant is not exercisable within one year, the issuer may choose not to register the underlying security at the time of registering the warrant, provided that the underlying security is registered no later than the date the warrant becomes exercisable." Nicola Corporation concluded that "there was no 'offering' of the underlying shares of Common Stock at the time the of the issuance of the Private Warrants" (SEC letter to Nikola Corporation (June 29, 2020); Nikola Corporation letter to SEC (July 1, 2020)).

Modern Media Acquisition Corp. S.A./Akazoo S.A. SEC staff commented to Modern Media Acquisition Corp. S.A. (MMAC) regarding its Form F-4 reflecting a planned acquisition of Akazoo S.A. Early comments focused on a key contractual condition and data on users of Akazoo's music streaming service. With respect to the condition, MMAC was to have at least $60 million in cash for distribution upon the happening of the business combination, but MMAC would not redeem shares in a manner that would reduce net tangible assets below $5,000,001.

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If Akazoo were to waive this condition, MMAC would not seek additional shareholder approval and no more time would be granted for public shares to be redeemed. The SEC staff asked for more disclosure about the $5,000,001 scenario, how shareholders would be informed of an Akazoo waiver of the condition, and disclosure of the number and percentage of MMAC shareholders whose redemptions would cause MMAC to not meet the $60 million and $5,000,001 cash conditions.

MMAC said it would revise its disclosures to clarify that if Akazoo waives the $60 million condition, a business combination may still occur even if redemptions reduce MMAC's net tangible assets to $5,000,001. MMAC also planned to notify MMAC shareholders promptly if Akazoo waives the condition. In a follow-up comment, SEC staff asked MMAC to add a pro forma presentation for the scenario in which MMAC's net tangible assets fall to $5,000,001.

Another series of staff comments focused on user metrics. First, the SEC staff noted that Akazoo had previously been impacted by third-party manipulation of stream counts and, thus, asked MMAC how fraudulent streams would be detected and remedied as well as whether and to what extent manipulation may have affected key performance indicators relied upon by management. MMAC replied that past attempts at manipulation were not material and that Akazoo used algorithms to detect manipulation.

Second, SEC staff inquired about reliance on third-party services tracking user and subscriber activity and what challenges exist for measuring how Akazoo services are used. MMAC replied that Akazoo used Third-party data and compared internal data with that of its billing partners on a monthly basis, so there were no significant challenges.

Yet another inquiry addressed how Akazoo makes money. Here, the SEC staff asked about how to monetize Akazoo's ad-supported radio service while emphasizing mobile monetization. The SEC staff also asked MMAC to qualify a presentation regarding "explosive demographic trends" and factors that may be a drag on Akazoo's prospects. MMAC replied that that it had made such revisions to its Form F-4 Amendment No. 1 filed March 29, 2019 (pp. 130 and 133). For one, the company said Akazoo is focused on local markets with "success" in expanding total user subscriber bases via partnering with telecom operators, mobile app providers, and original equipment manufacturers regarding its ad-supported radio business. With respect to the "explosive demographics" claim, the revised filing stated that this claim was driven by the growth in smartphone use and social media use and will aid Akazoo's business model, which emphasizes "serving local markets in a culturally relevant manner with individually curated, local content."

SEC staff follow-up questions again focused on subscriber metrics, such as whether there is any tracking of which subscribers sign up directly versus those who sign up via third-parties; the company was asked to disclose any changes or trends in this metric. MMAC replied that there is no direct tracking and that the metric is unreliable. MMAC further stated that the metric presents a muddled picture because subscribers can be signed up directly even if "driven through partners." SEC staff again followed up with a request for more disclosure about data on the number of subscribers, registered users, expected revenues, and expected net income for Q1 2019.

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The last several series of SEC staff comment letters focused on the PIPE transaction and historic financial data. First, the SEC staff asked several question on the PIPE, including requesting expanded disclosure. MMAC replied that it provided more information about the public company shares and incentives to PIPE investors. MMAC also said that the PIPE terms and conditions can change because each PIPE subscription is negotiated individually on an arms-length basis. SEC staff followed with a request that MMAC explain the role played by shares and warrants to be forfeited by the sponsor and shares and warrants to be issued to PIPE investors and Akazoo shareholders in connection with the business combination. MMAC replied that "[s]ponsor's forfeitures were primarily intended to limit the dilution that MMAC public stockholders and legacy Akazoo equityholders would experience due to the contemplated PIPE financing."

The comment letter dialogue between the SEC staff and MMAC ended with a request that MMAC revise historic per share data for Akazoo to reflect the pro forma effects of a 100-1 stock split (SEC letter to Modern Media Acquisition Corp. S.A. (March 11, 2019); Modern Media Acquisition Corp. S.A. letter to SEC (March 29, 2019); SEC letter to Modern Media Acquisition Corp. S.A. (April 8, 2019); Modern Media Acquisition Corp. S.A. letter to SEC (June 10, 2019); SEC letter to Modern Media Acquisition Corp. S.A. (June 21, 2019); Modern Media Acquisition Corp. S.A. letter to SEC (July 29, 2019); SEC letter to Modern Media Acquisition Corp. S.A. (August 9, 2019); Modern Media Acquisition Corp. S.A. letter to SEC (August 12, 2019); SEC letter to Modern Media Acquisition Corp. S.A. (August 14, 2019); Modern Media Acquisition Corp. S.A. letter to SEC (August 14, 2019)).

Digital World Acquisition Corp./Trump Media & Technology Group Corp. According to a Form 8-K submitted by Digital World Acquisition Corp., Digital World has been asked by the SEC and FINRA to provide information about a SPAC whose goal is to effect a merger with Trump Media & Technology Group Corp. (TMTG). The Form 8-K described the regulatory inquiries as "preliminary, fact-finding inquiries" and stated that Digital World is cooperating with investigators. FINRA is said to be investigating trading around the time Digital World announced the merger agreement. Digital World said the SEC sought information about "DWAC's Board of Directors, policies and procedures relating to trading, the identification of banking, telephone, and email addresses, the identities of certain investors, and certain documents and communications between DWAC and TMTG." A press release issued by TMTG states that former U.S. President Donald Trump is Chairman of TMTG; Representative Devin Nunes (R-Calif), according to a second Digital World Form 8-K, will leave Congress to become TMTG's CEO in January 2022.

According to Digital World, the FINRA and SEC inquiries began in October and early November 2021. Also in that time frame, Sen. Elizabeth Warren (D-Mass) sent a letter to the SEC asking Chair Gary Gensler to take action against Digital World for alleged federal securities violations regarding undisclosed discussions about the company's merger target.

The SEC staff has engaged in a limited series of filing review letters with Digital World, as compared to other SPACs in which SEC staff have issued numerous questions. The SEC staffs' dialogue with Digital World primarily concerned whether Digital World will meet Nasdaq listing standards. The SEC staff had noted that Digital World indicated that its units may be concentrated in a few anchor

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investors. The SEC staff asked if, in these circumstances, the allocation by the underwriters will meet Nasdaq's initial listing requirements. Digital World replied initially that it planned to meet Nasdaq's listing standards and that its had revised its disclosures to state that concentration of its units in a few anchor investors poses risks to meeting those standards. In reply to a follow-up letter in which the SEC staff reissued its comment about the allocation by underwriters, Digital World replied that allocations by the underwriters will be subject to Nasdaq's initial listing requirements. (SEC letter to Digital World Acquisition Corp. (July 22, 2021); Digital World Acquisition Corp. letter to SEC (July 26, 2021); SEC letter to Digital World Acquisition Corp. (August 27, 2021); Digital World Acquisition Corp. letter to SEC (August 30, 2021); SEC letter to Digital World Acquisition Corp. (August 31, 2021); Digital World Acquisition Corp. letter to SEC (August 31, 2021)).

Private litigation

The SEC is not the only litigation threat for SPACs. According to Cornerstone Research, private actions against SPACs ticked up sharply in 2020 despite an overall steep decline in securities class actions. In a mid-year report released in July, Cornerstone reported the following:

- Federal filings related to SPACs doubled in the first half of 2021 compared to all of 2020. From January through June, there were 14 SPAC class action filings.
- In 2020, all new SPAC class action lawsuits involved M&A issues, but as of July none of the 2021 cases were M&A-related. Instead, all the 2021 SPAC suits involve Section 10(b) claims.
- The median number of days between the closing date of a de-SPAC transaction and the filing of a class action suit declined from 271 days in 2019 and 2020 to 136 days in the first half of 2021.

A presumptive class action suit against Stable Road Acquisition Corp. exemplifies these trends. The day after the SEC announced its settlement with Stable Road, the SPAC involved with Momentus, a Stable Road investor filed a complaint alleging facts along the same lines as the SEC to support its Section 10(b) and 20(a) claims.

In contrast, a line of lawsuits brought by former SEC Commissioner Robert Jackson, Jr. and Yale Law professor John Morley take a very different tack. Three lawsuits filed by an investor in three separate SPACs all argue that although structured as SPACs, the entities at issue were in reality being used as unregistered investment companies in violation of the Investment Company Act. The first lawsuit was brought against Pershing Square Tontine Holdings, Inc., the largest SPAC ever to have offered shares to the public. Suits against Go Acquisition Corp. and E.Merge Technology Acquisition Corp. quickly followed.

The Jackson-Morley ICA lawsuits made a big splash, drawing a sharp joint response from over 50 large law firms. But the lawsuits also found support from the Council for Institutional Investors, which filed an amicus brief. Although CII skirted the central claim of whether the SPACs were operating as unregistered investment companies, the association took the opportunity to discuss investor protection concerns relating to share dilution, compensation, and disclosures. Meanwhile, the lawsuits continue to move forward. Most recently, the plaintiff defended his claims in a memorandum in opposition to motion to dismiss in the Pershing Square action.

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Whether or not the novel legal claims in the Jackson-Morley ICA lawsuits ultimately succeed, they are keeping a spotlight on potential conflicts of interest in the SPAC structure and assertions of resulting unfairness to investors. Thus, the claims contribute to an environment of enhanced scrutiny and lend support to possible reforms to come.

Again, examining SEC staff comment letters provides a view into the concerns of SEC staff for a SPAC that ultimately became embroiled in litigation.

SEC filing review: Pershing Square Tontine Holdings, Ltd. The SEC staffs' dialogue with Pershing Square Tontine Holdings, Ltd. began with a limited number of questions on a variety of topics, but by the last staff comment letters posted on EDGAR, the dialogue had become more detailed, with the SEC staff issuing 37 comments on a ten page letter that asked what was perhaps the penultimate question: how could warrants PSTH planned to issue could be listed on securities exchanges.

Specifically, SEC staff noted that PSTH planned to list the warrants on NYSE or Nasdaq, but hat those exchange's listing standards would likely bar listing of the warrants. The SEC staff explained that the SPARC warrants might not be listed because the underlying SPARC securities would not be listed at the time the warrants would be initially listed. This would prove to be the staff question that likely resulted in PSTH backing away from the controversial SPAC structure it has sought to employ.

In a July 19, 2021 letter to shareholders as the SEC's filing review was drawing to a close, Bill Ackman, CEO of Pershing Square, announced that the contemplated SPAC would be withdrawn. Said Ackman: "Our decision to seek an alternative initial business combination ("IBC") was driven by issues raised by the SEC with several elements of the proposed transaction – in particular, whether the structure of our IBC qualified under the NYSE rules." Ackmann indicated that any new venture would be structured as a "conventional SPAC merger."

In a second letter to shareholders dated August 19, 2021, Ackman denied the allegations contained in a lawsuit claiming that PSTH was an investment company. Ackman said that if the lawsuit was successful it would call into question the legal status of all SPACs. With respect to the path forward for PSTH, Ackman said the following:

> PSTH has about 11 months remaining to enter into a letter of intent with a transaction counterparty for its initial business combination, and six additional months to close that transaction. This period may be extended by up to six months by a vote of PSTH shareholders. While we have been working diligently to identify and close a transaction, and we have begun discussions with potential merger candidates, our ability to complete a transaction in the required time frame has been impaired by the lawsuit.
>
> All is not lost, however. As we have previously disclosed, we have been working on obtaining approval for the launch of Pershing Square SPARC Holdings, Ltd. ("SPARC"). If we are successful in securing SPARC's approval, and I am confident that we will get it done, we will have a clear path to mitigate the harm that this litigation has and will continue to cause to PSTH shareholders and warrant holders.

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Previously, staff questions to PSTH recited the same concerns about forum selection clauses that staff had voiced to other SPACs (see in this paper the discussion supra. regarding VectoIQ Acquisition Corp.). There also were questions about conflicts of interest, especially regarding how PSTH and funds managed or advised by the sponsor or affiliates would handle those conflicts. Also, SEC staff inquired about conflicts that may arise between PSTH management and investment team members and their unrelated business activities. SEC staff further asked for more details about the possibility that underwriters take a naked short position.

Lastly, although not dispositive of PSTH's decision to abandon its initial plans, PSTH commented in some detail in reply to SEC staff questions regarding IPO/SPAC market conditions. For the last five or more years there has been an ongoing debate over why certain "Unicorn" companies have remained private instead of conducting traditional IPOs. Many reasons have been advanced to explain this phenomenon, including plentiful amounts of private capital that make it easier for increasingly large private companies to remain private. In PSTH's Form S-1 (Amendment No. 2) filed July 13, 2020 (See p. 105), PSTH offered the following explanation in which it suggested a tougher road ahead for some Unicorn companies:

> Second, over the past decade, numerous high-quality, venture-backed businesses have achieved significant scale, market share, competitive dominance and cash flow—we call these companies "Mature Unicorns." Many of these companies have chosen to remain private, as there has been, until recently, limited pressure from their investors for liquidity, and large amounts of growth capital available from investors, mutual funds and hedge funds. We believe that the recent dislocations in both the stock market and private growth equity markets, combined with a number of high-profile private investment failures and disappointing IPO outcomes, have likely reduced the amount of private funding available for these companies, while demands for liquidity from their investors are likely to have increased.

(See, SEC letter to Pershing Square Tontine Holdings, Ltd. (June 16, 2020); Pershing Square Tontine Holdings, Ltd. letter to SEC (June 22, 2020); SEC letter to Pershing Square Tontine Holdings, Ltd. (July 9, 2020); Pershing Square Tontine Holdings, Ltd. letter to SEC (July 13, 2020); SEC letter to Pershing Square Tontine Holdings, Ltd. (July 15, 2020); Pershing Square Tontine Holdings, Ltd. letter to SEC (July 16, 2020); SEC letter to Pershing Square Tontine Holdings, Ltd. (July 16, 2021).

Legislative proposals to regulate SPACs

The SPAC boom of the last several years has not evaded scrutiny by lawmakers. In addition to Congressional hearings, Senators Elizabeth Warren (D-Mass), Sherrod Brown (D-Ohio), Tina Smith (D-Minn), and Chris Van Hollen (D-Md) in September 2021 sent a letter to six high profile SPACs in an effort to gather information that could inform future legislation. One the senators' top priorities is to understand the asymmetries between SPAC sponsors and other investors, especially retail investors. Senator Warren also has written to the SEC seeking information regarding how the agency plans to address allegations that Digital World Acquisition Corp. failed to disclose details the SPAC's early discussions about acquiring former President Donald Trump's Trump Media and Technology Group.

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The legislative approach, although not yet producing results, has thus far been a bipartisan one aimed primarily at increasing SPACs' disclosures to investors, especially regarding how the financial structure of SPACs impacts investors at the merger or de-SPAC stage regarding redemption, fees, and valuation of the merger target. The two disclosure bills introduced to date, one by a Republican senator and one by a House Democrat, also place emphasis on disclosures to retail investors.

Targeting SPAC disclosures. The Senate and the House have both proposed legislation that would require additional disclosures by SPACs. The two main bills introduced thus far, although similar, would achieve this result in different ways, the Senate bill being more open-ended and the House bill being more prescriptive. Both bills also would seek to provide additional protections for retail investors in SPACs.

The Sponsor Promote and Compensation Act (S. 1504), sponsored by Sen. John Kennedy (R-La), would take perhaps the most direct route to further regulating SPACs by requiring three specific types of disclosures:

- Amount of cash per share expected to be held by the blank check company immediately prior to the merger under various redemption scenarios;
- Side payments or agreements to pay sponsors, blank check company investors, or private investors in public equity for their participation in the merger, including any rights or warrants to be issued post-merger and the dilutive impact of those rights or warrants;
- Fees or other payments to the sponsor, underwriter, and any other party, including the dilutive impact of any warrant that remains outstanding after blank check company investors redeem shares pre-merger.

In a press release announcing the introduction of the bill, Sen. Kennedy explained the need for SPAC disclosures thus:

> Most SPAC sponsors award themselves "founder shares" that convert into public shares after the merger between the SPAC and a private company. The founder shares typically represent as much as 20 percent of the total share value of the company.
>
> This type of compensation does not exist as part of traditional IPOs. When SPAC sponsors convert the shares that they receive in the merged company, the public's shares of that company are diluted and lose value. The valuation of SPAC shares may fall even further if a SPAC sponsor chooses a weak company with which to merge.

The Kennedy bill also contains what might be described as precatory language regarding retail investors. Specifically, the bill provides for "allowing the disclosures required under paragraph (1) to be more explicit to investors, in particular retail investors." This language suggests that all SPAC investors are due some greater specificity in the disclosures made by SPACs, but especially retail investors. However, the bill does not suggest what the contents of "more explicit" disclosures would be. For example, would the disclosures need to be clearly labeled or more prominently displayed? Would the Commission be required to issue regulations spelling out any additional disclosures and how they are

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to be presented? Sen. Kennedy's press release explained the rationale for these additional disclosures to retail investors: "Some market experts have called for SPACs to make their compensation structures more explicit in order to protect retail investors."

By contrast, the Protecting Investors from Excessive SPACs Fees Act of 2021 (H.R. 5913), sponsored by Rep. Brad Sherman (D-Calif), would amend the Investment Advisers Act and the Exchange Act to prohibit investment advisers and broker-dealers from recommending SPAC investments to anyone who is not an accredited investor unless the particular SPAC makes certain "accessible and user-friendly" disclosures to retail investors some "minimum number of days before a merger or redemption date" (to be determined by the Commission).

The information that would be required from SPACs includes:

- Cash per share held by the SPAC before the merger under various redemption scenarios;
- Graphical representation of how cash per share may be depleted under those redemption scenarios;
- Payments or agreements to pay sponsors or investors in public equity for participating in the merger and an assessment of the dilutive impact of issuing rights and warrants on shareholder voting rights;
- Fees or other payments to the sponsor, underwriter, or others and an assessment of the dilutive impact to shareholder voting rights of any warrant outstanding after pre-merger redemptions;
- Computation of the present value of securities the sponsor receives and the post-merger price that would make the merger more profitable for the sponsor than a liquidation;
- The redemption deadline and estimated redemption price per share;
- The pre-merger valuation of the target business;
- Identity and experience of key SPAC personnel (e.g., the sponsor and controlling members) and the standardized performance for the SPACs they have been involved with;
- Contact information where shareholders can ask questions about shareholder meetings and redemptions;
- Location where more information can be found regarding all of the prior topics;
- How long the sponsors will have skin in the game ("economic risk") regarding the post-merger company; and
- Any other information the Commission requires by rule.

The committee memorandum issued for the House FSC markup of the bill explained that it would target for disclosure the "promote" earned by SPAC sponsors, which often is 20 percent of post-IPO equity. Representative Sherman said that the presence of retail investors in the SPAC space coupled with data showing that 50 percent of funds recently raised via IPOs involves SPACS makes the SPAC fee structure an appropriate target for further disclosures. Committee Republicans pushed back against the notion that retail investors play a large role in SPAC investments by suggesting that institutional investors are still the primary investors in SPACs but a Republican amendment that would have replaced the bill with an SEC study was defeated on party lines. The Sherman bill was favorably reported by a vote of 29-23.

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Safe harbor for forward-looking statements. The Holding SPACs Accountable Act of 2021 (H.R. 5910), sponsored by Delegate Michael F.Q. San Nicolas (D-Guam), would deny the safe harbor for forward-looking statements to SPACs. As a result, SPACs would be subjected to liability to the same extent as companies conducting traditional IPOs. At least, that is the intention of the legislation.

The Holding SPACs Accountable Act would replace language contained in Securities Act Section 27A and Exchange Act Section 21E to replace the term "blank check" with language that mirrors the regulatory definition of "blank check" used by the Commission is other sections of its regulations under the Securities Act and the Exchange Act. The safe harbor for forward-looking statements protects from Exchange Act Section 10(b) liability certain statements made by issuers who are subject to Exchange Act reporting and certain persons who speak on an issuer's behalf. Forward-looking statements typically involve: (1) revenue projections and other financial items; (2) management's plans and objectives for future operations; (3) future economic performance; (4) assumptions about items (1) to (3); (5) outside reviewer reports assessing forward-looking statements; and (6) projections and estimates of other items specified by Commission rules or regulations. The Securities Act and Exchange Act also spell out specific instances when the safe harbor will apply, resulting in no liability.

The safe harbor, however, already does not apply to statements regarding the business or operations of an issuer that makes forward-looking statements in connection with an offering of securities by a blank check company, unless otherwise specifically provided for by Commission rule, regulation, or order. For purposes of the safe harbor, the term "blank check company" has the meaning provided by Commission rules or regulations (Securities Act Section 27A(b)(1)(B) and 27A(i)(7); Exchange Act Section 21E(b)(1)(B) and 21E(i)(5)).

Securities Act Section 7(b)(3) contains a definition of "blank check company" that also appears in Securities Act Rule 419, the primary regulation applicable to blank check companies. Thus, "blank check company" means "a development stage company that has no specific business plan or purpose or has indicated that its business plan is to engage in a merger or acquisition with an unidentified company or companies, or other entity or person" that is "issuing 'penny stock.'" By comparison, the Holding SPACs Accountable Act would define "blank check company" to mean "a development stage company that has no specific business plan or purpose or has indicated that its business plan is to acquire or merge with an unidentified company, entity, or person." The proposed legislation would apparently drop the requirement that a blank check company issue penny stock.

The Holding SPACs Accountable Act was reported favorably by the House Financial Services Committee on November 16, 2021 by a vote of 27-23. The House FSC, however, rejected Republican amendments that would have required an SEC study of how SPACs use forward-looking statements under the safe harbor and would have substituted the Helping Startups Continue To Grow Act regarding emerging growth companies.

The path forward. The bipartisan nature of the two main SPAC bills suggests that if lawmakers have the will to enact legislation on SPACs they could potentially do so. It is also significant that the Republican sponsor, Sen. Kennedy, although a staunch conservative on many issues, nevertheless has

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shown a demonstrable interest in enhancing investor protections, be it through his recent sponsorship of legislation further codifying the SEC's disgorgement authorities (legislation co-sponsored with Sen. Mark Warner (D-Va)) or legislation to delist foreign companies whose home country regulators disallow U.S. audit inspectors to review the audit work papers of such companies. In both instances, versions of bills sponsored by Sen. Kennedy became law, making him one of the most effective members of Congress in the securities space.

That said, however, there currently is a legislative logjam in Congress due to late-year must-pass legislation, some of which will not be resolved until Q1 2022. There also is a great deal of Congressional focus on the Biden Administration's Build Back Better Act, which the House has passed but which likely will be amended by the Senate, thus taking additional legislative time. The SEC's copious guidance, enforcement actions, and statements by Chair Gensler suggest that the SEC may advance its own rules to the point at which it achieves most of the goals of proposed SPAC legislation before Congress could resolve any differences between the two leading SPAC disclosure bills. Given the pressure on lawmakers to address other topics, including the Build Back Better Act and voting rights, legislation on SPACs may eventually serve more as a backstop in the event the SEC does not take further action to mandate more extensive disclosures by SPACs.

2022 overall outlook

The year to come looks to be an active one for the SEC regarding SPACs. With major enforcement actions, a steady stream of statements and guidance indicating concerns, and remarks from Chair Gensler signaling forthcoming rulemaking, the SEC has laid significant groundwork for actions in 2022.

Two SEC actions in particular appear likely in 2022, as signaled by Gensler in his December remarks.

First, staff may issue guidance to clarify the application of existing disclosure obligations in the SPAC context. Such guidance would likely build on the December 2020 guidance, but take a firmer and more specific stance on what SPACs need to disclose to investors regarding fees, projections, dilution, and potential conflicts of interest.

Second, the Commission may issue a rulemaking proposal. Gensler's December remarks provide a clear preview of the likely areas of focus:

- Disclosures—Requirements for disclosures relating to fees, projections, dilution, and conflicts of interest, including possible specification on when investors must receive disclosures;
- Marketing practices—Prohibitions against "priming" or "conditioning" the market. For example, this could include a requirement to provide more complete information when a SPAC target IPO is announced.
- Gatekeeper obligations—Requirements aimed at better aligning incentives between gatekeepers and investors, and addressing the status of gatekeepers' liability obligations.

In particular, Gensler's December remarks held a special caution for gatekeepers—a category that includes attorneys.

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"Make no mistake: When it comes to liability, SPACs do not provide a 'free pass' for gatekeepers," said the chairman.

In addition to forthcoming regulatory actions, SEC also appears likely to continue its aggressive enforcement approach. In turn, this raises the specter of related private litigation. Significantly, this could include actions against gatekeepers including attorneys and accountants.

Moreover, SEC action could be backstopped by legislation. Of course, the exact contours of any legislation would have to be hashed out in a contentious Congress, but given the bipartisan nature of the two main SPAC bills, this is at least a theoretical possibility.

Taken all together, all signs point to an aggressive SEC stance as well as significant risks of private litigation. All participants involved with SPACs would be well advised to examine possible legal obligations specific to their role—whether or not explicit in current law and regulation—and ensure they are making best efforts to meet those obligations.

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