Securities Regulation Daily Wrap Up, TOP STORY—SEC proposes rules on SPACs, shell companies, and financial projections, (Mar. 30, 2022)

Securities Regulation Daily Wrap Up

Click to open document in a browser

By Lene Powell, J.D.

The proposal would make changes to treat SPAC IPOs more like regular IPOs in the name of investor protection.

By a 3-1 vote, the SEC proposed rules that aim to extend traditional IPO investor protection measures to special purpose acquisition companies (SPACs), including requirements relating to disclosures, standards for marketing practices, and gatekeeper and issuer obligations. The proposal would also create a new safe harbor from registration as an investment company for SPACs that meet certain conditions. In addition, the proposal would make changes to financial reporting requirements for all business combinations between a shell company and a private operating company, along with changes intended to enhance the reliability of financial projections (*Special Purpose Acquisition Companies, Shell Companies, and Projections*, Release No. 33-11048, March 30, 2022).

SPAC surge and investor concerns. The past two years have seen an "unprecedented surge" in the amount of capital raised by SPACs, said Renee Jones, director of the Division of Corporation Finance.

- SPAC IPOs raised more than $83 billion in 2020 and more than $160 billion in 2021, said Jones.
- The amount of capital raised by SPACs in 2021 was a 15-fold increase over 2018, according to Commissioner Allison Herren Lee.
- The total number of SPACs in the entire 2011 to 2016 period was a mere tenth of the number in 2021 alone, according to Jessica Wachter, chief economist and head of the Division of Economic Risk Analysis.

According to Jones, the surge has heightened investment protection concerns about the SPAC structure, including potential conflicts of interest, the amount and nature of sponsor compensation, the amount of dilution experienced by non-redeeming shareholders, and the adequacy of disclosures provided to investors.

The SPAC structure is relatively complex, said Wachter, and the nuanced economic incentives and potential for conflicts of interest can be confusing to investors. This is a concern not only because investors may be harmed, but also because it can adversely affect willingness to invest, feeding into difficulties for other enterprises in raising capital. The proposed rules are expected to alleviate information asymmetries and other issues, said Wachter.

Among other concerns, some studies have found that returns are relatively poor for investors in companies following a de-SPAC transaction, the proposal stated.

Proposed enhanced disclosures. As SEC Chair Gary Gensler described, the proposal aims to strengthen investor protections by aligning SPACs more closely with traditional IPOs in the areas of disclosure, marketing practices, and gatekeeping obligations.

Before investors make voting, investment, or redemption decisions in connection with a proposed SPAC target IPO transaction, SPACs would have to:

- Make specialized disclosures regarding, among other things, SPAC sponsors, conflicts of interest, SPAC target IPOs, and dilution;
- Make additional non-financial disclosures about the target private operating company during the SPAC target IPO;

- Disseminate disclosure documents in SPAC target IPOs to investors at least 20 calendar days before shareholders would have to vote to approve the transaction; and
- Adhere to new financial statement requirements that are closer to traditional IPOs. These requirements apply to all business combinations between a public shell company and a private operating company, including for SPAC target IPOs (also called the "de-SPAC" transaction).

Proposed new marketing standards. According to Gensler, new proposed standards intend to prevent parties from using overly optimistic language or over-promising future results. The proposal would:

- Amend the definition of "blank check company" to encompass SPACs. As such, the Private Securities Litigation Reform Act (PSLRA) safe harbor would not be available to SPACs regarding projections of target companies;
- Update the Commission's views on disclosure of projected financial information; and
- Require additional disclosures regarding the use of projections in SPAC target IPO transactions.

Gatekeeper and issuer obligations. Finally, the rules would heighten potential liability for underwriters and other gatekeepers in the case of inaccurate disclosures or other fraud. The proposal would:

- Subject a target company and its signing persons to liability for a SPAC target IPO registration statement filed by a SPAC;
- Deem any SPAC blank-check IPO underwriter that takes steps to facilitate a SPAC target IPO or any related financing transaction to be an underwriter in the SPAC target IPO; and
- Require that any business combination of a public shell company (other than a business combination related shell company) with a non-shell company entity be deemed a sale to the shell company's shareholders subject to the Securities Act.

Costs. The SEC anticipates that the proposed rules would impose costs, said Wachter. The disclosure will come with costs to prepare statements, though this is mitigated to the extent that companies are already preparing similar disclosures. In addition, the availability of a new safe harbor for registration as an investment company could lead to the choice of suboptimal targets, closing down the search for a target early, or investing in cash instead.

Wachter said it is possible that some private companies may be deterred from going public through a de-SPAC transaction, or perhaps from raising capital in a traditional IPO if an IPO is more costly. However, the SEC anticipates the proposal would also promote capital formation by increasing investor confidence, thereby leading to a greater willingness to invest in ventures of all types, said Wachter.

Commissioner Peirce dissent. Commissioner Hester Peirce dissented strongly from the proposal, saying it seems designed to "damn, diminish, and discourage SPACs because we do not like them, rather than elucidate them so that investors can decide whether they like them."

"The proposal—rather than simply mandating sensible disclosures around SPACs and de-SPACs, something I would have supported—seems designed to stop SPACs in their tracks," said Peirce.

Peirce criticized many aspects of the proposal, including eliminating the PSLRA safe harbor for forward-looking statements in de-SPAC transactions and deeming underwriters to be underwriters at the de-SPAC stage. Peirce also objected to the proposed general changes to shell company business transactions.

Peirce noted that SPACs have brought many new companies into the public markets after decades of decline in the number of public companies. The SEC could use this opportunity to ask whether the SPAC revival of recent years reveals shortcomings with the traditional IPO process and to consider ways to properly calibrate the rules governing IPOs, SPACs, and direct listings, said Peirce.

MainStory: TopStory IPOs MergersAcquisitions PublicCompanyReportingDisclosure SecuritiesOfferings