ALERTS

SEC Proposes Rules to Increase SPAC Disclosure Requirements to More Closely Align with Traditional IPO Requirements

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The Securities and Exchange Commission ("SEC") has proposed new rules and amendments that would enhance disclosure requirements and investor protections in initial public offerings ("IPOs") by special purpose acquisition companies ("SPACs") and in business combination transactions involving shell companies, such as SPACs ("de-SPACs").[1]

Overall, the proposed rules aim to better align the regulatory treatment of SPAC transactions with that of traditional IPOs in light of the SEC's view that the method in which a company chooses to go public should not affect investor protections.[2] Such increased scrutiny may expose many of the entities involved in the SPAC process to increased liability due to increased disclosure requirements with respect to (1) sponsors, (2) conflicts of interest, (3) dilution and (4) the fairness of these business combination transactions.

The proposal also includes a new safe harbor provision that exempts SPACs that satisfy certain conditions from being considered investment companies under the Investment Company Act of 1940 ("1940 Act"), including a new fixed timeline for de-SPAC transactions.

This *Alert* highlights key aspects of the proposed SEC rules for SPAC participants to be aware of in this potentially evolving landscape.

New Specialized Disclosure Requirements

The four key specialized disclosure requirements applicable to SPACs focus on:

1. **Sponsors:** The proposed rules would require additional disclosures about the sponsor, its affiliates and any promoters of the SPAC in registration statements and schedules filed in connection with SPAC registered offerings and de-SPAC transactions, including disclosure regarding the experience and material roles played by, as well as a description of any material agreements between, each party to the de-SPAC transaction; structure charts showing the relationship between the SPAC and its sponsors, as well as details regarding control persons of the sponsor; and information regarding compensation paid to the sponsor and promoters of the de-SPAC transaction.[3]

2. **Conflicts of Interest:** Within a SPAC structure, there can be a number of conflicts of interest between the sponsor and public investors that could influence the actions of the SPAC, most importantly, conflicts that may influence whether a business combination transaction is recommended to shareholders. The proposed rules (i) set forth additional disclosure requirements relating to conflicts of interest experienced by SPAC sponsors or their affiliates, (ii) require disclosure of any actual or potential material conflicts of interest between (x) the sponsor or its affiliates or the SPAC's officers, directors or promoters and (y) unaffiliated security holders[4] and (iii) would require disclosure regarding the fiduciary duties each officer and director of a SPAC owes to other companies.[5]

3. **Dilution:** The proposed rules would require additional disclosure about the potential for dilution in (i) registration statements filed by SPACs, including those for IPOs, and (ii) de-SPAC transactions.[6]

Other than in connection with a de-SPAC transaction, the proposed rules would require:

- Tabular disclosure incorporating a range of potential redemption levels on the prospectus cover page in registered offerings by a SPAC on Form S-1 and F-1;

- A description of material potential sources of future dilution following a SPAC's IPO; and

- Tabular disclosure of the amount of potential future dilution from the public offering price that will be absorbed by non-redeeming SPAC

shareholders.[7]

In de-SPAC transactions, the proposed rules would require:

- Disclosure of each material potential source of additional dilution that non-redeeming shareholders may experience at different phases of the SPAC lifecycle by electing not to redeem their shares in connection with the de-SPAC transaction; and

- A tabular sensitivity analysis that shows the amount of potential dilution under a range of reasonably likely redemption levels and quantifies the increasing impact of dilution on non-redeeming shareholders as redemptions increase.[8]

4. **Fairness of the Business Combination Transaction:**

Prospectus Cover Page and Summary Disclosures – The proposed rules would require that certain information be included on the prospectus cover page and prospectus summary, including (i) the anticipated timeline for, and anticipated dilutive effects of, the de-SPAC transaction and details regarding sponsor compensation[9], (ii) a summary of the process used to identify potential business combination candidates[10], (iii) a description of the fairness of the de-SPAC transaction (if applicable)[11] and (iv) details regarding the financing of the overall transaction.

Disclosure and Procedural Requirements in De-SPAC Transactions – The proposed rules would require a number of significant disclosures, including:

- Background, material terms and effects of the SPAC transaction, including (i) a summary of the background of the transaction and any relevant negotiations, (ii) a description of any related financing transactions, (iii) the reasons for engaging in the particular de-SPAC transaction and (iv) a description of any material differences in the target company's shareholders' rights as a result of the transaction.[12]

- A statement as to whether a SPAC reasonably believes that the de-SPAC transaction and any related financing transaction are fair or unfair to the SPAC's unaffiliated security holders, as well as the basis for the statement and whether any director voted against or abstained from voting on the transaction or any related financing.[13]

- A detailed discussion of the material factors upon which a reasonable belief regarding the fairness of a de-SPAC transaction and any related financing is based on and the weight assigned to each factor.[14]

- Disclosure on whether the de-SPAC transaction sought, or was approved by, a majority vote of either unaffiliated shareholders or directors of the SPAC who are not employees of the SPAC, as well as whether such SPAC directors retained any unaffiliated representatives to assist with negotiating or assessing the fairness of the de-SPAC transaction.

- Disclosure as to whether or not the SPAC or its sponsor has received any report, opinion or appraisal obtained from an outside party[15] relating to the consideration to be offered to security holders or the fairness of the de-SPAC transaction or any related financing transaction to the SPAC, the sponsor or unaffiliated security holders.[16]

- Disclosure of, among other things, (i) the identity and qualifications of any such outside party, (ii) the material relationships, if any, between such outside party and the SPAC, its sponsor or their affiliates and (iii) whether compensation paid to or valuation of the target company were considered.[17] These proposed rules would also dictate the format for disclosures reporting the negotiation, opinion or appraisal reached by such parties.

- A Schedule TO filed in connection with a de-SPAC transaction should contain substantially the same information about a target private operating company that is required under the proxy rules that a SPAC must comply with the procedural requirements of the tender offer rules when conducting the transaction for which the Schedule TO is filed.[18]

Aligning De-SPAC Transactions with IPOs

Given the SEC's belief that a private company's method of becoming a public company should not negatively impact investor protections, the proposed rules and amendments are meant to provide investors with similar disclosures and protections to those present in a typical IPO. The proposed new rules and amendments would:[19]

- More closely align the non-financial statement disclosure requirements with respect to the private operating company in disclosure documents for a de-SPAC transaction with the disclosure required in a Form S-1 or F-1 for an IPO;

- Require a minimum dissemination period for disclosure documents in de-SPAC transactions;[20]
- Treat the private operating company as a co-registrant of the Form S-4 or Form F-4 for a de-SPAC transaction when a SPAC is filing the registration statement;[21]
- Require a re-determination of smaller reporting company status within 4 days after the consummation of a de-SPAC transaction;[22]
- Amend the definition of "blank check company" for purposes of the Private Securities Litigation Reform Act of 1995, such that the safe harbor for forward-looking information would not apply to projections in filings by SPACs and certain other blank check companies that are not penny stock issuers; and
- Provide that underwriters who participate in a SPAC IPO or related financing[23] are deemed to be engaged in the distribution of the securities of the surviving public entity in a subsequent de-SPAC transaction, meaning they are deemed underwriters.[24]

In an effort to also provide reporting shell company shareholders with more consistent protections regardless of transaction structure, the proposed rules would deem any business combination of a reporting shell company involving another entity that is not a shell company to involve a sale of securities to the reporting shell company's shareholders.

Enhanced Projections Disclosure

The SEC's proposal sets forth the SEC's concerns that projected financial information commonly used in de-SPAC transactions does not have a reasonable basis, is displayed more prominently than historical data and/or uses non-GAAP measures without clear explanations. The proposed amendment requires that such projections be clearly distinguished from projected measures based on historical financial results, and requires that any projections based on non-GAAP financial measures include clear explanations of such measures and why the most closely analogous GAAP measure was not used.[25]

The proposed rules would require a registrant in de-SPAC transactions to provide disclosures discussing, among other things, (i) the purpose for any projections disclosed and the identity of the party that prepared them, (ii) all material bases for such projections and (iii) whether such projections

still accurately reflect the views of the board and management as of the filing date.[26]

Proposed Safe Harbor under the Investment Company Act

In order to assist SPACs in identifying when they may be subject to investment company regulation, the proposed rule provides a safe harbor from the definition of "investment company" under Section 3(a)(1)(A) of the 1940 Act for SPACs that meet certain conditions, including:[27]

- *Nature and Management of SPAC Assets*. The SPAC's assets must consist solely of government securities, government money market funds and cash items prior to the completion of the de-SPAC transaction.[28] Further, such assets may not at any time be acquired or disposed of for the primary purpose of recognizing gains or decreasing losses resulting from market value changes.[29]

- *SPAC Activities*. The SPAC must seek to complete a single de-SPAC transaction as a result of which the surviving public entity (i) will primarily be engaged in the business of the target company, which is not that of an investment company and (ii) would have at least one class of securities listed for trading on a national securities exchange.[30] The SPAC is only able to engage in one de-SPAC transaction but such transaction may involve the combination of multiple target companies if the SPAC treats them for all purposes as part of a single de-SPAC transaction.[31] The SPAC must be primarily engaged (i) in the business of seeking to complete a de-SPAC transaction in the manner and within the time frame set forth in the rule and (ii) in a business other than that of investing, reinvesting or trading in securities.[32] Such engagement must be evidenced by the SPAC's board of directors adopting an appropriate resolution that is contemporaneously recorded in its minute books.[33]

- *Duration*. The SPAC would be required to file a report on Form 8-K announcing that it has entered into an agreement with the target company (or companies) to engage in a de-SPAC transaction no later than 18 months after the effective date of the SPAC's registration statement for its IPO and then complete the de-SPAC transaction no later than 24 months after the effective date of its registration statement for its IPO.[34] Any assets that are not used in connection with the de-SPAC transaction would need to be distributed in cash to investors as soon as reasonably practicable following the completion of

the de-SPAC transaction.[35] If the SPAC failed to meet either the 18- or 24-month deadline, the SPAC would be required to distribute the SPAC's assets in cash to investors.[36]

What This Might Mean

The proposed rules in many respects represent a significant deviation from the SEC's historical treatment of and stance towards SPACs. Among other things, many of the new disclosure-related rules, which include adjustments to address the use of projections and forward-looking statements in connection with de-SPAC transactions, mirror the enhanced disclosure requirements the SEC has typically used in connection with going-private transactions, where the SEC believes similar conflicts exist. In addition, if adopted, several of the rule changes will likely have a material impact on both de-SPAC transactions and the SPAC market generally, including:

- The shift in underwriter liability in connection with de-SPAC transactions will likely dampen the market for new SPAC IPOs, at least in the near term, while potential underwriters evaluate the relative risk they may face from the shift in liability to the de-SPAC portion of the SPAC lifecycle.

- The proposed 1940 Act "safe harbor" will likely create a de facto timeline for announcement and completion of de-SPAC transactions moving forward. While SPACs could potentially deviate from the time frames set forth in the proposed exemptive rule, the perceived risk of doing so may mean that most future SPACs follow the requirements of the safe harbor. Accordingly, some SPACs that may have sought extensions from shareholders in order to complete pending de-SPAC transactions may instead opt to liquidate in lieu of completing a business combination.

- The increased transparency regarding sponsor structures and potential conflicts – including with third-party investors – may discourage the use of some of the more creative structures SPACs have utilized recently to secure successful de-SPAC transactions. As a result, the new rules may lead to great uncertainty in general regarding the success of proposed de-SPAC transactions.

- There is significant uncertainty regarding the applicability of the proposed rules to existing SPACs that have not yet completed de-

SPAC transactions. In particular, SPACs that completed IPOs prior to the adoption of any proposed rules could nonetheless be subject to applicability of the more strict requirements at the time they announce and attempt to complete de-SPAC transactions.

Comments on these proposed rules should be received by May 31, 2022 or within 30 days after the date of publication on the Federal Register, whichever is later.

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If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or one of the authors.

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[1] *See* Securities and Exchange Commission, Proposed Rules, Special Purpose Acquisition Companies, Shell Companies, and Projections, Release No. 33-11048 (March 30, 2022), available at https://www.sec.gov/rules/proposed/2022/33-11048.pdf.

[2] *See id.* at 66.

[3] *See id.* at 29.

[4] *See id.* at 33.

[5] *See id.* at 34.

[6] *See id.* at 36.

[7] *See id.* at 36-37.

[8] *See id.* at 39.

[9] *See id.* at 41-42.

[10] *See id.* at 43-44.

[11] *See id.* at 42.

[12] *See id.* at 46-47.

[13] *See id.* at 52-53.

[14] *See id.* at 53.

[15] *See id.* at 57 (Proposed Item 1607(c) would require all such reports, opinions or appraisals to be filed as exhibits to Form S-4, Form F-4, and Schedule TO for the de-SPAC transaction or included in the Schedule 14A or 14C for the transaction, as applicable).

[16] *See id.* at 55.

[17] *See id.* at 56-57.

[18] *See id.* at 58.

[19] *See id.* at 66.

[20] *See id.* at 71. (The SEC proposes that the prospectuses and proxy and information statements filed in connection with de-SPAC transactions be distributed to shareholders at least 20 days in advance of a shareholder meeting or the earliest date of action by consent, or maximum period for disseminating such disclosure documents permitted under the applicable laws of the SPAC's jurisdiction of incorporation or organization if such period is less than 20 calendar days).

[21] *See id.* at 76-77. (This requirement would make the additional signatories to the form, including the principal executive officer, principal financial officer, controller/principal account officer and a majority of the board of directors or persons performing similar functions of the target company, liable under Section 11 of the Securities Act of 1933 for any material misstatements or omissions in Form S-4 and Form F-4, thereby mitigating the risk of the target company's directors and management not being held accountable for the accuracy of disclosures in the registration statement and incentivizing such additional signatories to more carefully review disclosures and conduct due diligence).

[22] *See id.* at 79-80.

[23] *See id.* at 97. (Activities that could constitute "participation" in the transaction include: (i) acting as a financial advisor to the SPAC; (ii) engaging in activities necessary to the de-SPAC transaction including identifying potential target companies, negotiating merger terms or finding investors for and negotiating PIPE transactions; and (iii) receipt of compensation in connection with the de-SPAC transaction).

[24] *See id.* at 96.

[25] *See id.* at 128-139.

[26] *See id.* at 133-134.

[27] *See id.* at 136.

[28] *See id.* at 142.

[29] *See id.* at 143.

[30] *See id.* at 145, 147.

[31] *See id.* at 145.

[32] *See id.* at 148.

[33] *See id.*

[34] *See id.* at 152-153.

[35] *See id.* at 152-153.

[36] *See id.* at 157.

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