September 8, 2021

SEC Investor Advisory Subcommittees' Recommendations Regarding SPACs

Investor Advisory Subcommittees Publish Draft Recommendations Addressing SPAC Disclosure Concerns; Recommend Further SEC Analysis

SUMMARY

On August 26, 2021, the Investor as Purchaser and Investor as Owner subcommittees of the Securities Exchange Commission's Investor Advisory Committee published draft recommendations regarding SPACs in advance of the IAC's upcoming September 9, 2021 meeting. The subcommittees' statement highlights a number of areas of disclosure on which, in its view, the SEC should exercise "enhanced focus and stricter enforcement," including disclosure about: (1) the role of the SPAC's sponsor (including conflicts and financial interests relative to retail investors); (2) the economic effect of the SPAC's securities and impact to dilution; (3) the mechanics and timeline of the de-SPAC process; (4) target company areas of focus with clearer discussion of "boundaries" for the target search; (5) competitive pressure and risks in finding appropriate targets; (6) the acceptable range of terms of additional funding that might be sought; (7) the sponsor's manner of assessment for public company readiness of potential targets; and (8) commitments to diligence target company accounting practices. As the SEC continues to focus on SPACs and companies going public through a de-SPAC process as well as increasing SPAC shareholder lawsuits and media attention on SPACs, we expect there will be continued focus on these issues from the SEC, whether in the form of public statements, comment letters, rulemaking and, in certain circumstances, enforcement actions.

IAC RECOMMENDATIONS

While the subcommittees recommend that the SEC exercise "enhanced focus and stricter enforcement," including on SPAC disclosures, its draft recommendations do not formally recommend specific changes to the Exchange Act or existing rules thereunder. The subcommittees offer the following draft recommendations for areas in which SPAC disclosure in SPAC IPO registration statements and post-IPO periodic reports could be enhanced through stricter SEC enforcement of existing disclosure rules:

- **Role of the Sponsor.** Disclosure of the role of the SPAC sponsor (and/or insiders or affiliates such as celebrity sponsors/advisors), including disclosure of the sponsor's appropriateness, expertise, and capital contributions, potential conflicts of interest and any divergence of the sponsor's financial interest relative to that of SPAC retail investors;
- **SPAC Economics.** Plain English disclosure (beyond mere financial footnotes) around the economics of the various participants in a SPAC process, including the "promote" (*e.g.*, "founder shares") paid, and their impact on dilution. To the extent particulars cannot be determined and disclosed because they are subject to future negotiation at the time of the de-SPAC transaction, the draft recommendations note that the SEC should consider ways to encourage disclosure around "guardrails" or ranges of acceptable terms;
- **Mechanics and Timeline.** Disclosure that includes a clear description (with diagrams or charts as appropriate) of the mechanics and timeline of the SPAC process, including the precise nature of the instrument being purchased, the events required in the next two years for value appreciation of that instrument, and the details of the shareholder approval process at the time of de-SPAC (*e.g.*, whether shareholders are permitted to vote for a deal while simultaneously redeeming their shares);
- **Focus of Target Search.** Disclosure regarding the opportunity set and target company areas of focus, with a clearer identification of the search area and the attributes of acceptable and unacceptable targets, as well as the ground rules for any changes to the search area;
- **Competitive Risks of Finding a Target.** Disclosure (beyond risk factors) regarding the competitive pressure and risks involved in finding appropriate targets and reaching market acceptable prices for those targets, as well as disclosure regarding the absorption of expenses by the sponsor in the event there is not a successful de-SPAC transaction;
- **Terms of Additional Funding.** Disclosure of the acceptable range of terms under which any additional funding (*e.g.*, public investment in private equity, or PIPEs) might be sought at the time of acquisition/redemption;
- **Public Company Readiness.** Disclosure regarding the manner in which the sponsor plans to assess the capability of potential targets to be a public reporting company from a governance and internal control perspective, and whether the sponsor will take any steps to ensure the target company can meet minimum preparedness/quality standards for operating as public company;
- **Accounting Due Diligence Commitments.** Disclosure about the minimum diligence the sponsor will commit to regarding the accounting practices used by the target company, including audit history, use of GAAP and non-GAAP pro forma numbers, and audit committee (composition and communication between audit committee, auditor and management).

A. RECOMMENDED SEC ANALYSIS

The subcommittees also recommend that the SEC "prepare and publish an analysis of the players in the various SPAC stages, their compensation, and their incentives." The subcommittees state that once the analysis is complete they may follow up with additional discussion or further recommendations to the SEC based on the findings; however, the IAC suggests that such an analysis would be beneficial to the public regardless of whether it takes further action.

B. RATIONALE

The subcommittees also offer further discussion of the rationale for the draft recommendations and the particular set of concerns they are meant to address.

1. Concerns that the sponsors and targets of SPACs may effectively be conducting regulatory arbitrage by seeking a deal structure with a staggered disclosure approach which amounts to a less restrictive path to the public markets.

Addressing disclosure liability frameworks, the subcommittees state their view that there is "no logical reason" for allowing for a safe harbor for financial projections and that the public communications of SPAC promoters should be treated the same way as public communications in IPOs. The subcommittees suggest it may be appropriate for underwriter liability under the Securities Act to extend to de-SPAC transactions and observe that, unlike IPOs, de-SPAC target accounting disclosures are not the subject of comfort letters.

The subcommittees also recommend that the SEC, when reviewing registration and proxy statements in connection with a de-SPAC transaction, makes inquiries concerning the level of diligence completed by the transaction participants.

2. Concerns about inherent conflicts of interest between the sponsors/insiders of SPACs and retail investors.

The subcommittees further state their belief that inherent conflicts of interest between the sponsors/insiders of SPACs and retail investors may not be understood or disclosed to investors at the time of IPO. The subcommittees propose standardized disclosure of the sponsor's total investment in the transaction; the value of the sponsor's interest if the proposed merger closes, including all management and promoter fees; and the break-even post-merger price for the sponsor. The subcommittees argue that disclosure should expressly state and make clear to investors that the sponsor has an interest in completing a transaction, even if this might not benefit investors who maintain their investment following the de-SPAC transaction.

3. Concerns relating to the effectiveness of disclosure about the risks, economics and mechanics of SPACs as a result of the complexity of these transactions and the staggered nature of the disclosure process.

The final set of concerns identified by the subcommittees relate to a perceived lack of understanding by retail investors of the economics of SPAC investments. The subcommittees cite a recent market study (conducted by professors at Stanford Law School and NYU School of Law) that suggests that the actual value of a SPAC's shares to the retail investor could be up to three dollars per share lower once the 20% sponsor "promote" fee, warrants, redemption rights, and underwriting fees are paid. The subcommittees note that, if the retail investor "understood that by remaining a shareholder through the SPAC transaction, they were likely to lose $3/share in value while the sponsor and redeeming shareholders benefit, it is unlikely a reasonable retail investor would want to take on that risk (unless awed by a celebrity promoter)." The subcommittees suggest one method of enhancing disclosure would be to require issuers to provide a table of the cash-per-share contingent on specified levels of redemption.

C. CONCLUSIONS

The draft recommendations underscore the increasing focus on disclosures in SPAC and de-SPAC transactions, especially those involving the interests of promoters and conflicts of interest, and we expect that this area will continue to be the subject of SEC scrutiny and potential rulemaking against a wider backdrop of broader pressure on SPACs and their disclosure, reduced availability of PIPE financing for SPAC business combinations and a growing focus from plaintiffs' lawyers on SPACs.

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