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SEC PROPOSES TO ENHANCE PROTECTIONS FOR SPAC INVESTORS

The Securities and Exchange Commission (SEC) proposed new rules and amendments, available here, that would enhance protections for investors in special purpose acquisition companies (SPACs) and subsequent business combination transactions between SPACs and private operating companies (de-SPAC transactions). In short, the proposed rules are designed to close perceived gaps between the regulatory requirements applicable to de-SPAC transactions and those for traditional initial public offerings (IPOs). The SEC will accept public comments on this proposal until the later of May 31, 2022 and 30 days following the publication of the proposing release in the Federal Register.

The SEC's release for these proposals includes a number of requests for comments, and it is likely the SEC will receive extensive comments given the material potential impact on SPAC structures. SEC Commissioner Peirce voted not to approve this proposal and expressed concern in her dissenting statement, available here, that a typical SPAC would not meet the proposal's parameters without significant changes to its operations, economics, and timeline. Below we discuss selected aspects of this proposal likely to be of greatest interest to market participants and their potential impacts.

Potential Impacts

- The proposed rules and amendments, if adopted, would provide enhanced investor protections and create new liability risks.
- Underwriters of a SPAC IPO who engage in any activities related to the de-SPAC transaction would likely seek to engage in IPO-style due diligence of the target company.
- Enhanced disclosure requirements and liability allocation would likely increase transaction costs and expand the timeline for de-SPAC transactions.

PROPOSED EXPANSION OF WHO WOULD BE LIABLE FOR DISCLOSURES IN REGISTRATION STATEMENTS FOR DE-SPAC TRANSACTIONS

The SEC is proposing to enhance investor protections in connection with de-SPAC transactions by expanding who would be liable for disclosure deficiencies in a related registration statement. If adopted, this would expand liability under Section 11 of the Securities Act of 1933, as amended (Securities

Act), which provides that issuers, directors, officers, and underwriters may be held liable for any material misstatement in, or material omission from, an effective registration statement.

A Target Company Would be Liable as a "Co-Registrant." The SEC is proposing to amend Form S-4 and Form F-4 to require the private operating company in a de-SPAC transaction to be a co-registrant. This would mean that the private operating company would be an "issuer" for purposes of Section 11 liability and its directors and officers who sign the registration statement would also be liable to investors for the accuracy of the disclosures in the registration statement, including any disclosed projections. Such an increase in potential liability could impact the decision of a private company to go public via a de-SPAC transaction. Some may reconsider and choose an IPO instead. Others may determine that the increased risk and costs of related insurance coverage would be too high and elect not to go public at all.

Deemed "Underwriters" for the De-SPAC Transaction. Proposed Rule 140a under the Securities Act would provide a new definition for the term "distribution" (for purposes of the statutory definition of "underwriter" provided in Section 2(a)(11) of the Securities Act) that would significantly expand underwriter liability in connection with de-SPAC transactions. Any underwriter of securities offered by a SPAC would be deemed to participate in the "distribution" of securities of the surviving public entity in a de-SPAC transaction if it "takes steps to facilitate" the de-SPAC transaction, or any related financing transaction (including, in the SEC's view, as a placement agent for a PIPE transaction meant to facilitate a de-SPAC transaction), or "otherwise participates (directly or indirectly)" in the de-SPAC transaction. If SPAC IPO underwriters are deemed to be underwriters for a de-SPAC transaction, they would become subject to liability under Section 11 of the Securities Act for any material misstatements or omissions in the registration statement for the de-SPAC transaction, unless they are able to establish a due diligence defense.

As proposed, receipt of compensation in connection with the de-SPAC transaction could be sufficient to constitute participation in the de-SPAC transaction. This would mean that a SPAC IPO underwriter who undertakes no further activities in connection with the de-SPAC, but whose fee is deferred and conditioned on the consummation of a subsequent de-SPAC transaction, could be deemed a statutory underwriter for the de-SPAC transaction. These deferred compensation arrangements are currently the market standard. If the SEC adopts this expanded liability regime, some SPAC IPO underwriters may refuse to participate in the subsequent de-SPAC transaction and insist on receiving their full underwriting fees at the SPAC IPO stage, rather than deferring a portion.

To the extent that SPAC IPO underwriters participate in some capacity in the subsequent de-SPAC transaction, they will likely only do so if they are able to engage in due diligence activities consistent with a typical IPO process to ensure they would be able to establish a due diligence defense to any Securities Act liability. These due diligence activities are likely to increase transaction fees and expenses and lengthen the timeline for completing a de-SPAC transaction, which could further reduce the attractiveness of a de-SPAC transaction for potential target companies.

PROPOSALS REGARDING PROJECTIONS

The SEC is proposing to address investor concerns related to potentially unreasonable or misleading projections by strengthening incentives for participants in a de-SPAC transaction to expend more care in preparing and reviewing projections that are disclosed to investors.

Increased Liability Risk for Projections Used in Connection with De-SPAC Transactions. Participants in SPAC offerings have generally sought to rely on the safe harbor provided by the Private Securities Litigation Reform Act of 1995 (PSLRA) when presenting projections in connection with de-SPAC transactions. The PSLRA does not extend its safe harbor protections to forward-looking statements made in connection with an IPO or any security offering by a blank check company. SPACs have customarily been structured to avoid "blank check company" status for these purposes by offering their shares at prices much higher than those that would trigger penny stock status.

The SEC is proposing to remove the “penny stock” condition from its definition of blank check company for purposes of the PSLRA safe harbor. Accordingly, the proposed amendment would eliminate the availability of the PSLRA safe harbor for projections and other forward-looking statements provided to investors in connection with de-SPAC transactions. This definitional change is consistent with a statement published in April 2021 by John Coates while he served as the Acting Director of the SEC's Division of Corporation Finance, available here. Coates argues that the PSLRA safe harbor was intended for established, publicly traded, reporting companies and should not be available when an unknown private company introduces itself to the public markets.

Despite the proposed rules, we expect that financial projections will continue to be prepared and publicly disclosed in connection with de-SPAC transactions. Many de-SPAC targets have been early-stage companies.[1] For these types of companies, projections prepared by the management of the target company have typically been considered important to an understanding of the economics of the transaction and are often used to negotiate the terms and conditions of the de-SPAC transaction. In addition, Delaware corporate law generally imposes a duty to disclose projections that have been used by a board or its advisors in the process of obtaining shareholder approval of a de-SPAC transaction.[2] Further, SPACs typically disclose projections to satisfy certain requirements under Regulation M-A and avoid claims that the omission of such information violates federal anti-fraud provisions. To assess and manage related liability risks, transaction participants will want to consider at the earliest stages of a de-SPAC transaction the extent to which financial projections will be prepared and publicly disclosed. They will want to consider using detailed financial modeling and rigorous testing of assumptions for achievability in connection with the preparation of projections.

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1 For a majority of de-SPAC transactions announced in the twelve months ending in the first quarter of 2021, the private operating companies were pre-revenue or pre-EBITDA companies. *See* Stuart Gleichenhaus and Bill Stotzer, Why Have SPAC Valuations Skyrocketed? FTI Consulting, Aug. 3, 2021, available here.

2 *See*, *e.g.*, In re Netsmart Techs., Inc., 924 A.2d 171 (Del. Ch. 2007).

If the SEC limits the availability the PSLRA safe harbor as proposed, participants in de-SPAC transactions will want to consider whether they have included sufficient cautionary disclosures to claim a defense under the judicially created "bespeaks caution" doctrine. Pursuant to this doctrine, projections that are accompanied by sufficient cautionary language would not give rise to liability because a reasonable investor could not have found the statement materially misleading.

In reaction to any perceived increase in liability risk, providers of D&O insurance could re-evaluate their appetite for insuring the directors and officers of SPACs or the resulting combined public company. They may seek to increase the cost of any D&O coverage they offer in connection with transactions involving SPACs. In addition, directors of a SPAC will want to consider whether the exculpatory and indemnification provisions included in the SPAC's governing documents could be revised to maximize legally permissible protections from liability. There is a possibility, however, that such approach to increase liability protections may be viewed unfavorably by investors.

Enhanced Presentation Requirements for Projections. Proposed amendments to Item 10(b) of Regulation S-K would provide expanded guidelines for presenting projections in SEC filings and would require management to have a reasonable basis for these projections. Presentation of any projections that are not based on historical financial results or operational history would need to be clearly distinguished from projections that are based on historical financial results or operational history. This proposed Item would require projections that are based on historical measures and operating history to be accompanied by the actual historical measures and operating history, presented in the filing with equal or greater prominence.

If a registrant does not have a history of operations that could serve as a basis for projections, the SEC would accept an outside review of projections as support for having a reasonable basis. If a report of such a review is included in a filing with the SEC, the registrant would also be required to provide specified disclosures about the reviewer and the process by which the review was obtained. The reviewer would be considered an expert for purposes of Section 7 of the Securities Act, and their consent to being named as an expert in a registration statement for a de-SPAC transaction would need to be filed as an exhibit.

The directors and senior management of a SPAC will want to consider whether to arrange for any projections presented in the proxy statement or registration statement for a de-SPAC transaction to be subject to a robust outside review process. While the additional transaction costs from this and the other rule changes may put additional pressure on the economics of SPAC transactions, including the size of the sponsor's promote shares (e.g., it may put pressure on SPAC sponsors to forfeit and/or subject more of their founder shares to earnout in connection with the de-SPAC transaction), an outside review could mitigate the increased liability risk that would arise if the PSLRA safe harbor is no longer available.

Enhanced Disclosure Requirements for Projections. Proposed Item 1609 of Regulation S-K would impose additional disclosure requirements relating to financial projections used in de-SPAC transactions. It would require the registration statements or other filings used for de-SPAC transactions to include disclosures relating to:

- the purpose of any projections disclosed by the registrant and the party that prepared such projections;
- all material bases of the disclosed projections and all material assumptions underlying the projections, and any factors that may materially impact the assumptions; and
- whether the disclosed projections still reflect the views of the board or management of the SPAC or target company, as applicable, as of the date of the filing; if not, the purpose of disclosing the projections and the reasons for any continued reliance by the management or board on the projections.

STATEMENT AS TO FAIRNESS

Proposed Item 1604(b) of Regulation S-K would require specified disclosures in plain English on the cover page of the prospectus for a de-SPAC transaction, including a statement of whether:

- the SPAC reasonably believes that the de-SPAC transaction is fair or unfair to unaffiliated security holders; and
- the SPAC or its sponsor has received a report, opinion, or appraisal from an outside party regarding the fairness of the transaction.

Similarly, proposed Item 1606(a) of Regulation S-K would require the registration statement for a de-SPAC transaction to include a statement on whether the SPAC reasonably believes that the de-SPAC transaction and any related financing transaction are fair or unfair to unaffiliated security holders of the SPAC. A proposed instruction clarifies that a statement that the SPAC has no reasonable belief as to the fairness or unfairness of the de-SPAC transaction or any related financing transaction would not be considered sufficient disclosure in response to this requirement.

This Item would also require SPACs to discuss in reasonable detail the material factors relied upon in making the fairness determination, such as:

- the valuation of the private operating company;
- the consideration of any financial projections;
- any report, opinion, or appraisal obtained from a third party; and
- the dilutive effects of the de-SPAC transaction and any related financing transaction on non-redeeming shareholders.

While the SEC's proposals do not require a SPAC or its sponsor to obtain a fairness opinion in connection with a de-SPAC transaction, it is conceivable that SPACs will choose to obtain fairness opinions from a financial advisor or an independent valuation firm to support their reasonable belief of fairness. This is not currently a routine practice in de-SPAC transactions and would further increase transaction costs.

If a SPAC or its sponsor receives a fairness opinion in connection with a de-SPAC transaction, proposed Item 1607 of Regulation S-K would require a summary of the fairness opinion be provided to SPAC shareholders as well as specified disclosures about the preparer of the fairness opinion, their qualifications, how they were selected, and certain material relationships. In addition, a copy of the fairness opinion would need to be filed as an exhibit to the registration statement.

To the extent that there are significant misaligned incentives or conflicts of interest, SPACs may face pressure to engage a special committee of directors that are not equity holders in the sponsor to approve the de-SPAC transaction. While allocating discretion to approve the transaction to such a committee may be advisable from a corporate law perspective, it may be inconsistent with the general intent of the SPAC structure – SPACs are marketed as investments in the experience and network of SPAC sponsors.

MINIMUM DISSEMINATION PERIOD

There is currently no federally mandated minimum period during which security holders are given time to consider proxy statement or prospectus disclosures in connection with de-SPAC transactions. The SEC is proposing a minimum dissemination period for any proxy statement or prospectus that is provided to SPAC shareholders in connection with a de-SPAC transaction. Proposed instructions to Forms S-4 and F-4 and proposed amendments to Rules 14a-6 and 14c-2 under the Securities Exchange Act of 1934 would require these disclosure documents to be distributed to SPAC shareholders at least:

- 20 calendar days in advance of a shareholder meeting or the earliest date of action by consent; or
- the maximum period for disseminating such disclosure documents permitted under the applicable laws of the SPAC's jurisdiction of incorporation or organization, if less than 20 calendar days.

INVESTMENT COMPANY ACT SAFE HARBOR FOR SPACS

The SEC has proposed a safe harbor for SPACs under the Investment Company Act of 1940, as amended (Investment Company Act). A SPAC that satisfies the conditions of proposed Rule 3a-10 would not be an "investment company"[3] and therefore would not be subject to regulation under the Investment Company Act. To qualify, a SPAC would need to meet conditions that limit its duration, asset composition, business purpose and activities. Specifically, these conditions would require a SPAC to:

- maintain assets comprising only cash items, government securities, and certain money market funds;
- seek to complete a de-SPAC transaction after which the surviving entity will be primarily engaged in the business of the target company; and

[3] Section 3(a)(1) of the Investment Company Act defines an "investment company" in three different ways, two of which are relevant in the context of SPACs, specifically: Section 3(a)(1)(A) defines an investment company to be any issuer of securities which is or holds itself out as being engaged primarily in the business of investing, reinvesting or trading in securities and Section 3(a)(1)(C) defines an investment company as any issuer that holds (among other actions) more than 40 percent of its assets (other than cash items and US government securities) in investment securities.

- enter into an agreement with a target company to engage in a de-SPAC transaction within 18 months after its IPO and complete its de-SPAC transaction within 24 months of such offering.

We anticipate that the third condition, related to the timing of a de-SPAC transaction, could be perceived by at least some market participants as overly restrictive. While the vast majority of SPACs only provide for an 18-month or 24-month investment period, sponsors typically have the ability to extend that period under certain conditions (such as investing more funds into the SPAC). In times of turbulent market conditions, such extensions are not uncommon. To the extent this safe harbor discourages any such extensions, sponsors could face increased pressure to enter into de-SPAC transactions on terms that are less than optimal for the SPAC's unaffiliated shareholders.

As the proposed rule is only a safe harbor, strict compliance with the conditions of the rule should not be mandatory for a SPAC to avoid being an investment company under the Investment Company Act. We have joined more than 55 leading US law firms in responding to Investment Company Act lawsuits targeting the SPAC industry (a copy of the response statement is available here). We and the other signatories to the response statement view the assertion that SPACs are investment companies to be without factual or legal basis and believe that a SPAC is not an investment company under the Investment Company Act if it:

- follows its stated business plan of seeking to identify and engage in a business combination with one or more operating companies within a specified period of time; and
- holds short-term treasuries and qualifying money market funds in its trust account pending completion of its initial business combination.

Existing SPACs and their sponsors will nevertheless want to carefully consider whether they are able to satisfy the conditions of the safe harbor provided by the proposed rule, as it provides a clear framework for determining investment company status – potentially providing protection from related lawsuits. In fact, the proposed safe harbor has already been invoked as supporting evidence that a given SPAC is not an investment company. Specifically, one of the SPACs alleged to be an investment company, Go Acquisition, has communicated to a federal judge that this SEC proposal supports its assertion that Go Acquisition is not an investment company.[4]

FINAL THOUGHTS

The rate of SPACs going public has dramatically decreased since the peak in early 2021.[5] These proposed rules and amendments, if adopted, could have a further dampening effect as some of the perceived advantages of SPAC structures are eliminated or diminished. Notably, the SEC's proposals contemplate imposing significant new liability risks on a range of participants in de-SPAC transactions. Such participants will likely seek to manage those risks by performing IPO-style due diligence on the target company and engaging outside

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4 Bob van Voris and Chris Dolmetsch, *SPAC Seizes on SEC's Proposed Rules to Fight Investor Suit*, BLOOMBERG, March 31, 2022, available here. The case is *Assad v. Go Acquisition Corp*., 21-cv-7076, U.S. District Court, Southern District of New York (Manhattan).

5 *See, e.g.,* Deal Point Data, *Special Purpose Acquisition Company (SPAC) Market Study: 2021 Year-End Update & Review*, Jan. 2022, available here.

experts to review financial projections or provide fairness opinions. These practices are likely to result in higher quality disclosures for SPAC shareholders electing whether to exercise their redemption right, but are also likely to contribute to a longer timeline and increased costs for completing a de-SPAC transaction.

As noted above, the SEC will likely receive extensive comments before finalizing the rules. While the SEC may respond to comments it receives by making adjustments to its proposals, we expect that the general impact of any finalized rules would be to regulate de-SPAC transactions more like IPOs. Market participants will want to consider how to effectively adjust to these rules, once finalized, and monitor whether any novel structures and risk mitigation strategies develop in response.

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CONTACTS

AMERICAS

G. David Brinton
Partner

T +1 212 878 8276
E david.brinton
@cliffordchance.com

Cliff Cone
Partner

T +1 212 878 3180
E clifford.cone
@cliffordchance.com

Andrew Epstein
Partner

T +1 212 878 8332
E andrew.epstein
@cliffordchance.com

Jefferey LeMaster
Partner

T +1 212 878 3206
E jefferey.lemaster
@cliffordchance.com

Jonathan Zonis
Partner

T +1 212 878 3250
E jonathan.zonis
@cliffordchance.com

Patrick Jackson
Counsel

T +55 11 3019 6017
E patrick.jackson
@cliffordchance.com

Jason Parsont
Counsel

T +1 212 878 8213
E jason.parsont
@cliffordchance.com

Matthew Warner
Counsel

T +1 212 878 3249
E matthew.warner
@cliffordchance.com

Hanah Kim
Associate

T +1 212 878 8154
E hanah.kim
@cliffordchance.com

Rebecca Hoskins
Professional Support Lawyer

T +1 212 878 3118
E rebecca.hoskins
@cliffordchance.com

ASIA

Liu Fang
Partner

T +852 2825 8919
E fang.liu
@cliffordchance.com

Johannes Juette
Partner

T +65 6410 2293
E johannes.juette
@cliffordchance.com

Jean Thio
Partner

T +65 6506 1956
E jean.thio
@cliffordchance.com

Terrence Moloney
Counsel

T +61 2 8922 8559
E terrence.moloney
@cliffordchance.com

EUROPE

Alex Bafi
Partner

T +33 1 4405 5267
E alex.bafi@cliffordchance.com

John Connolly
Partner

T +44 207006 2096
E john.connolly@cliffordchance.com

Michael Dakin
Partner

T +44 207006 2856
E michael.dakin@cliffordchance.com

Dr. George Hacket
Partner

T +49 69 7199 3103
E george.hacket@cliffordchance.com

Andrew Kelly
Partner

T +44 207006 8552
E andrew.kelly@cliffordchance.com

Olivier Plessis
Counsel

T +33 1 4405 5487
E olivier.plessis@cliffordchance.com

Laura Scaglioni
Counsel

T +39 02 8063 4254
E laura.scaglioni@cliffordchance.com

Dr. Axel Wittmann
Counsel

T +49 89 21632 8014
E axel.wittmann@cliffordchance.com