Baker McKenzie.

Legal Update

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United States: Rules on SPACs Arrive

Final Rules are adopted by the US Securities and Exchange Commission regulating initial public offerings and business combinations of special purpose acquisition companies

In brief

Almost two long years following the announcement of proposed rules revising the framework for regulating initial public offerings (IPOs) and business combinations of special purpose acquisition companies (SPACs), the US Securities and Exchange Commission (SEC) adopted in a three-two vote final rules on the topic.

While much has changed in the SPAC market since the SEC's proposed rules were announced - notably a cooling in the face of regulatory and economic headwinds - the final rules largely enact the SEC's proposals from March 2022. A detailed discussion of that proposal can be found here.

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Notable deviations from the SEC's original proposal include:

- Declining to create a new Rule 140a under the Securities Act of 1933, as amended ("**Securities Act**"), that would have deemed underwriters in a SPAC IPO to be underwriters in a subsequent business combination where such underwriters also take steps to facilitate such subsequent transaction.
- Determining not to adopt a safe harbor under the Investment Company Act of 1940, as amended ("**Investment Company Act**"), for certain SPACs.
- Removing a requirement that a SPAC state whether it reasonably believes that its business combination and any related financing transactions are fair or unfair to the SPAC's unaffiliated security holders.

The final rules will become effective 125 days following their publication in the Federal Register.

In depth

Clocking in at over 581 pages, the SEC's final rules are a dense read, adding many new disclosure items. The rules add a new Subpart 1600 to Regulation S-K to address disclosure for SPAC IPOs and business combinations as well as a new Article 15 to Regulation S-X that is intended to align the financial reporting requirements in a SPAC's business combination with those in a traditional IPO. Much of the substance of these disclosure requirements had been anticipated, and, as a result, the final disclosure rules are not expected to create a market large disruption.

We expect that more meaningful dialogue will evolve around the SEC's positions with respect to items impacting liability exposures.

- **Liability of SPAC IPO Underwriters**: One of the most controversial aspects of the SEC's 2022 proposal was a rule that would have deemed underwriters in a SPAC IPO to be underwriters in a subsequent business combination where such underwriters also took steps to facilitate such transaction. At the time of the proposal, the SEC pointed out that, even though it was proposing this new rule, the definition of "underwriter" under Section 2(a)(11) of the Securities Act was already broad enough in its view to pick up financial advisors and other participants in SPAC business combinations. The effect of these statements was immediate and profound, with a number of investment banks removing themselves from the SPAC market and/or requesting 10b-5 and comfort letters typical in a traditional IPO.

  While declining to create a new rule establishing deemed underwriter liability in a SPAC's business combination, the SEC reiterated its guidance that a SPAC's business combination is a distribution of securities and that a party involved in a business combination may be deemed a statutory underwriter - with associated Section 11 liability exposure under the Securities Act for material misstatements and omissions in disclosure along with associated due diligence defenses - even if such party did not buy and resell the securities subject to the distribution.

The guidance from the SEC is not particularly clear - relying on a facts and circumstances approach that has yet to be effectively tested in the context of SPAC business combinations. As such, we expect a continued filtering of financial and other advisor involvement in the SPAC market based on risk tolerance and quality of potential transactions.

> "We acknowledge that in a de-SPAC transaction, there is generally no single party accepting securities from the issuer with a view to resell such securities to the public in a distribution in the same manner as a traditional underwriter in traditional capital raising. Nevertheless, in a de-SPAC distribution, there would be an underwriter present where someone is selling for the issuer or participating in the distribution of securities in the combined company to the SPAC's investors and the broader public. Depending on the facts and circumstances, such an entity could be deemed a "statutory underwriter" even though it may not be named as an underwriter in any given offering or may not be engaged in activities typical of a named underwriter in traditional capital raising".

- **SPAC Status Under the Investment Company Act**: A point of intellectual and litigation interest during the recent SPAC boom was whether SPACs who fail to acquire a target in a business combination within one year of their IPO were subject to registration as investment companies under the Investment Company Act by virtue of the fact that a SPAC's trust account funds were invested in securities (typically in Treasuries, money market funds, or other cash-like securities).

  The SEC declined to adopt a safe harbor for SPACs "given the fact-based, individualized nature of this determination and because, depending on the facts and circumstances, a SPAC could be an investment company at any stage of its operation". Instead, the SEC enumerated certain activities that a SPAC might engage in that would weigh heavily towards a finding that such a SPAC should be registered as an investment company, including:

  - Investing in corporate bonds, or not engaging in a de-SPAC transaction but instead acquiring a minority interest in a company with the intention of being a passive investor.
  - A SPAC's officers, directors, and employees not actively seeking a de-SPAC transaction or spending a considerable amount of their time actively managing the SPAC's portfolio for the primary purpose of achieving investment returns.
  - SPAC durations of more than 18 months without completing a business combination (a practice which has become more common over the last challenging year for SPACs), which the SEC noted would raise more questions as to whether a SPAC's officers, directors, and employees are more engaged in achieving investment returns from the securities held by the SPAC rather than in achieving the SPAC's stated business purpose.
  - Marketing of the SPAC as a fixed-income investment, an alternative to an investment in a mutual fund, or as an opportunity to invest in Treasury securities or money market funds.
  - Merging with another company that met the definition of an investment company under the Investment Company Act.

  Republican Commissioner Mark T. Uyeda's dissent focused heavily on the failure to adopt a safe harbor under the Investment Company Act. However, to date, the lack of such a safe harbor has not been an oft-cited factor by participants in the cooling of the SPAC market.

- **Target Companies as Co-Registrants**: As foreshadowed in the proposed rules, the target compan(ies) (or, in the case of an asset sale, the seller of such assets) in a SPAC's business combination will be considered an issuer and its principal financial officer, controller, or principal accounting officer, and a majority of its board of directors will be required to sign any Securities Act registration statement filed in connection with the business combination.

  This requirement will subject such signing individuals to Securities Act Section 11 liability to affiliated and unaffiliated shareholders of a SPAC for material misstatements or omissions under the Securities Act - with the SEC noting that providing the public with a cause of action for strict liability for such statements was a central tenet of the Securities Act. It will also make target companies subject to periodic reporting requirements under the Exchange Act of 1934, as amended ("**Exchange Act**"), until the target company terminates and/or suspends its Exchange Act reporting obligations.

  In our view, the market has already internalized liability exposure - much of which was already implicitly borne via the target company's acquisition of control of the post-closing listed company. However:

  - Target companies will need to consider the additional financial and process burdens associated with Exchange Act reporting requirements during the pendency of the business combination.
  - The SEC should clarify what the expectations are for Exchange Act reporting when the subject of the SPAC's business combination is a business that is being carved out from other operations.

- The market for D&O insurance will likely evolve further to address this new Securities Act Section 11 exposure and mechanics necessary for running off coverage in the event that the subject business combination is not ultimately consummated.

- **Projections and the PSLRA Safe Harbor**: The final rules rendered Private Securities Litigation Reform Act of 1995's (PSLRA's) safe harbor for forward-looking statements unavailable to SPACs. This was achieved by including new definitions of "blank check company" in Rule 405 of the Securities Act and Rule 12b-2 of the Exchange Act. The final rules also added enhanced disclosure requirements related to the provision of projections in SPAC business combinations, including information regarding the material bases of and material assumptions underlying the projections.

  This change was expected and we believe that target companies, and their financial advisors, had been factoring such considerations into their approach to the provision of projections.

- **Substantive Fairness Determinations**: The proposed rules would have required a SPAC to state whether it reasonably believed that its business combination and any related financing transactions are fair or unfair to the SPAC's unaffiliated security holders. Market practice had evolved in light of this proposal to frequently include such disclosure notwithstanding the fact that the final rules had not yet been promulgated.

  In a departure from the proposal, the SEC has instead opted to require that if the law of the jurisdiction of the SPAC's organization requires the SPAC's board of directors (or similar governing body) to make a determination whether the de-SPAC transaction is advisable and in the best interests of the SPAC and its shareholders, or otherwise make any comparable determination, then the SPAC will be required to disclose that determination.

  This approach reflects the fact that a board's fiduciary duties with respect to assessing the fairness of a transaction is typically the province of the law of an entity's jurisdiction of organization. Previously, SPAC boards found themselves between a rock and a hard place with respect to the SEC's clear scrutiny of inclusion of a target company's projections in SPAC disclosure while effectively requiring their consideration and disclosure via a board determination of the fairness of a transaction to SPAC shareholders. The final rules make the SPAC board's position better.

  Realistically, we may see a further push towards the formation of offshore SPACs, with their jurisdiction's substantive rules on board determinations, as a by-product of the excise tax on SPAC redemptions enacted under the Inflation Reduction Act of 2022 and recent Delaware jurisprudence seen by many sponsors as unfavorable to SPACs.

Finally, it is worth highlighting that the SEC is adopting rules that require the re-determination of smaller reporting company (SRC) status following the consummation of a SPAC's business combination. SRCs are eligible for scaled-down disclosure requirements in Regulation S-K and Regulation S-X and in various forms under the Securities Act and Exchange Act. SRC status, which most SPACs qualify for, is determined at the time of filing an initial registration statement under the Securities Act or Exchange Act for shares of common equity and is re-determined on an annual basis.

Following a SPAC's business combination, the listed company must re-determine its SRC status prior to the time it makes its first SEC filing, other than the Form 8-K filed with Form 10 information (i.e., a super 8-K), with (i) public float measured as of a date within four business days after the consummation of the business combination and (ii) annual revenues measured using the annual revenues of the target company as of the most recently completed fiscal year reported in such Form 8-K. However, the listed company is given a grace period of 45 days following the business combination during which, even if the listed company does not have SRC status, it will not need to reflect non-SRC status in its SEC filings.

For further information and to discuss what this development might mean for you, please get in touch with your Baker McKenzie contact.

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