

MAYER | BROWN

# Discussion of SEC's Proposed Rules on SPACs, Shell Companies, and Projections

Meeting of SEC Small Business Capital Formation Advisory Committee

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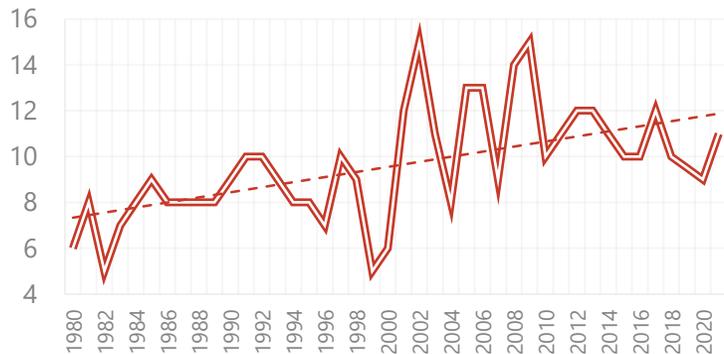
June 6, 2022

# Context: changes in the capital raising landscape

# Companies are staying private longer

- In recent years, companies have been electing to remain private longer, raising capital through successive private rounds, with more money being raised in private placements than in public offerings

**MEDIAN COMPANY AGE AT IPO**



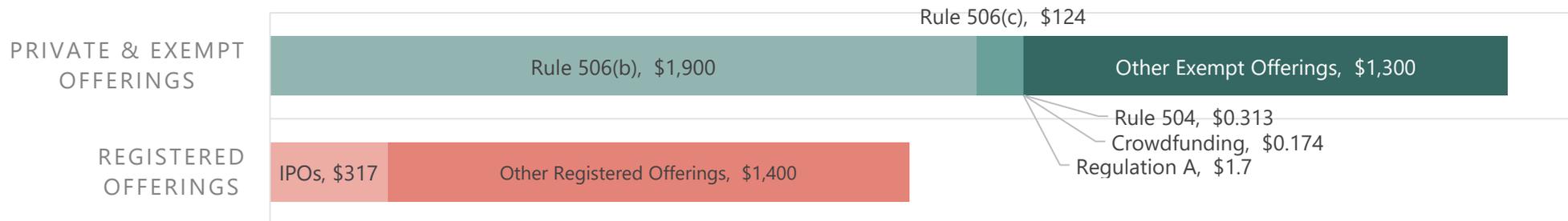
Source: University of Florida, J. Ritter

**LATE STAGE VC ACTIVITY**



Source: PitchBook & NVCA

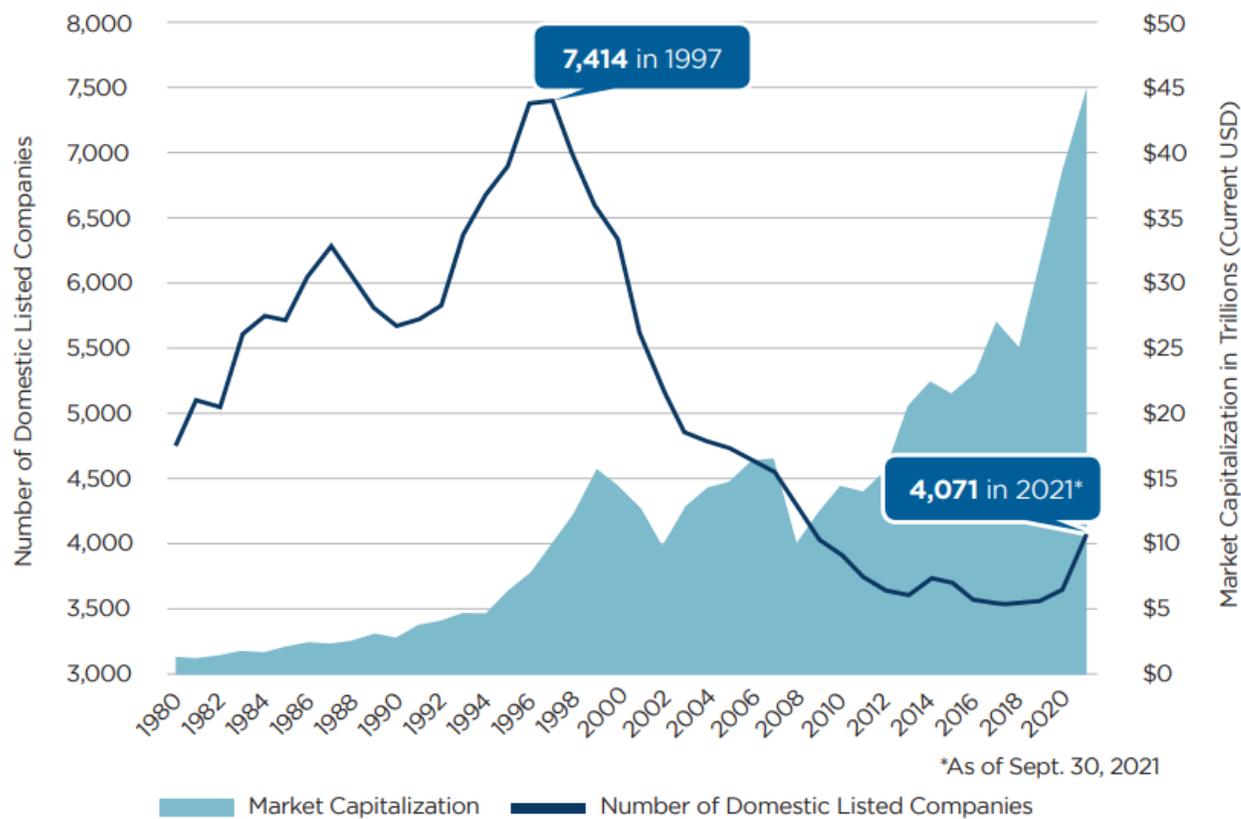
**CAPITAL FORMATION: PRIVATE VS. REGISTERED OFFERINGS\***



\*Between July 1, 2020 and June 30, 2021. In USD billions.  
Source: SEC's Division of Economic and Risk Analysis (DERA)

# Fewer public companies; companies going public at higher valuations

- There are fewer public companies in the United States compared to the early 1990s. Companies going public have higher valuations when they go public.



**TOTAL NUMBER OF UNICORNS WORLDWIDE:**

**1,057**

**TOTAL CUMULATIVE VALUATION:**

**~\$3,502 billion**



*Source: CB Insights*

Source: SEC's Office of the Advocate for Small Business Capital Formation

# The new three-track (or four-track) approach to the public markets

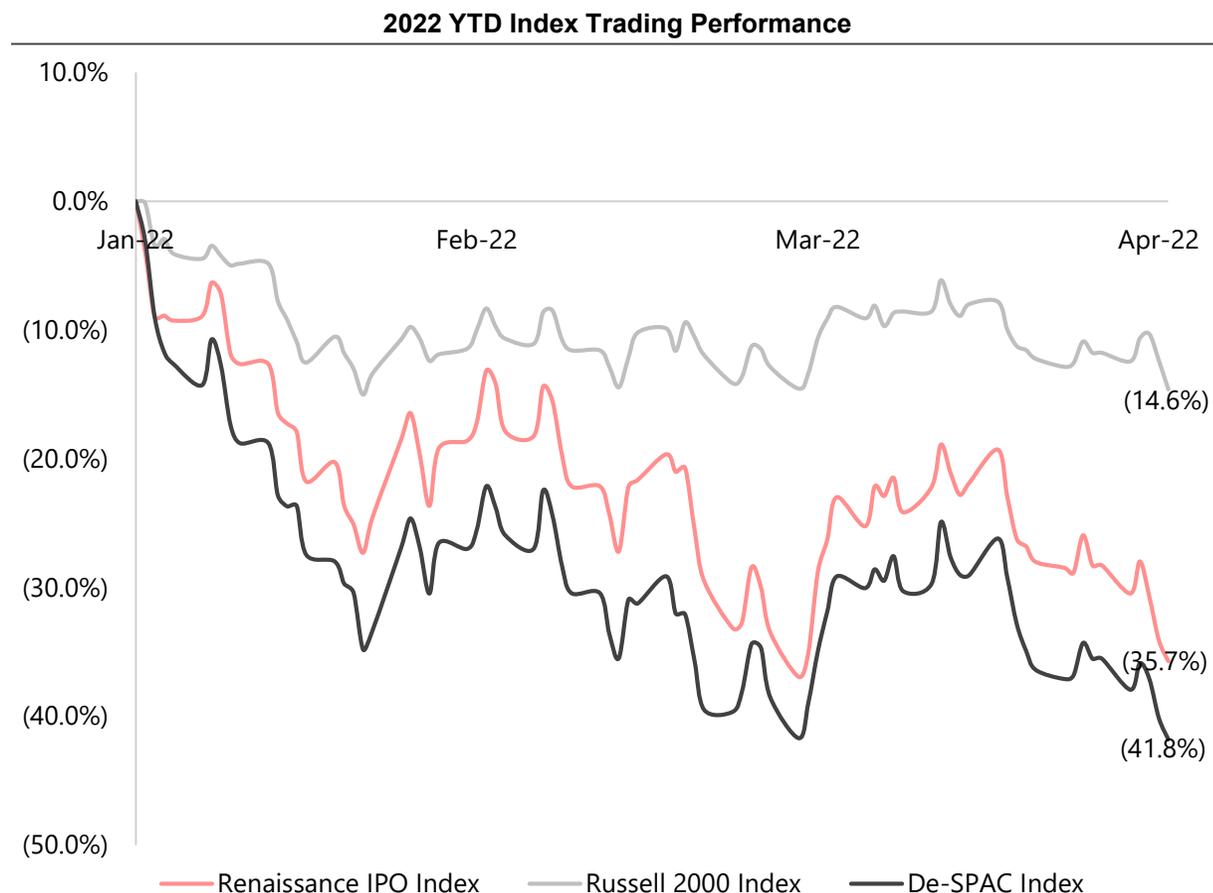
- The public markets have undergone significant changes in recent years
- At least prior to the SEC's recent proposed amendments, almost every client thinking about a liquidity opportunity considered:
  - An IPO
  - A combination with a SPAC
  - A direct listing
  - An outright sale/merger
- Each alternative has its place depending on the market cycles and IPO windows opening and closing and market volatility, as well as on the particular characteristics of the private company; however, it may be that not all of the alternatives have been particularly well understood

# Concerns about the traditional IPO model, and concerns about smaller public companies

- Plentiful private capital available at attractive valuations, so an IPO is no longer the principal capital raising alternative. The need for liquidity often is the principal underlying reason for an IPO or a direct listing
- Institutional investors prefer larger IPOs, and the direct listings that have fared best are those in which there has been a sustained, liquid secondary market. A lot has been written about the IPO spread for smaller and middle market companies, and “IPO underpricing,” but that has little to do with the decision to go public. The lack of market interest for IPOs of smaller and middle market companies and the lack of a robust liquid secondary market and the inability to raise capital in follow-on offerings makes it difficult for such companies to thrive as public companies

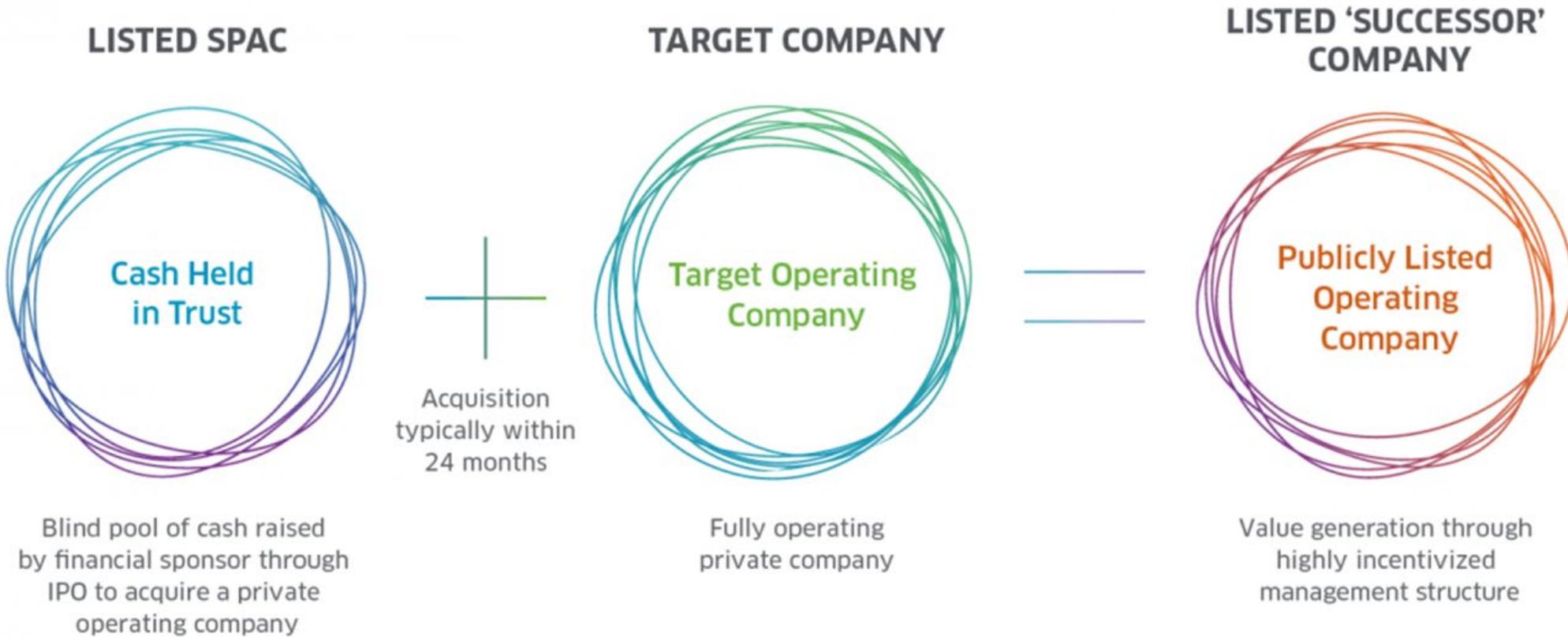
# Concerns about the traditional IPO model, and concerns about smaller public companies *(cont'd)*

- A lot of focus has been placed on the use of projections in de-SPAC transactions, and relatively little on many of the other factors associated with SPACs and common to smaller and middle market public offerings—lack of research coverage, complex capital structures, lack of liquidity, insufficient capital, inability to access the public markets through follow-on public offerings—all of which may contribute to after-market performance following the de-SPACs
- Similarly, there has been little focus on addressing the attractiveness of the public markets, the ease of capital formation for smaller public companies, communications safe harbors that have not been looked at since Securities Offering Reform in 2005, and the rules relating to research



# Overview of SPACs

# How does a SPAC work?



**Source:** Nasdaq, "SPACs: Special Purpose Acquisition Companies Listing a SPAC on Nasdaq" (June 2020)

# SPAC overview

- A special purpose acquisition company (“SPAC”) is a shell company that completes an IPO with no business operations of its own.
- A SPAC’s sole purpose is to identify a target operating company and consummate a business combination (commonly referred to as a “de-SPAC transaction”). A SPAC has a limited time period in which to complete a de-SPAC transaction.
- Upon completion of the initial business combination, the target company effectively becomes a publicly traded company.
- Because a SPAC has no operations, the disclosure in a SPAC IPO typically focuses on the prior experience of the SPAC’s organizers/founders (referred to as “sponsors”), who are expected to successfully find a target company and complete the de-SPAC transaction.

# Key SPAC IPO terms

- Sale of **Units** ordinarily priced at \$10.00 per unit, comprised of one share of Class A common stock and a fraction of a redeemable warrant to purchase one share of Class A common stock with a strike price of \$11.50
- The gross proceeds from a SPAC IPO are placed in a **trust account** and may be removed only in limited circumstances (*e.g.*, the SPAC completes a business combination or it fails to complete a business combination in the allotted time and dissolves, in which case the funds in the trust account are returned to Class A stockholders).
- Investment banks receive an **underwriting commission** (1/3 payable upon SPAC IPO closing, the balance deferred to, and payable only upon, the consummation of the business combination).
- Class A stockholders have **redemption rights** in connection with the consummation of the business combination. Redemption price is \$10.00, plus pro rata share of any interest earned in the trust account).
- “**Sponsor promote**” consisting of founder shares (typically represent 20% of the SPAC’s total outstanding common stock after IPO closing) and private placement warrants (issued simultaneously with the IPO, typically for a purchase price of \$1.00 to \$1.50 per warrant).

# De-SPAC transaction features

- Once a target company is identified, the SPAC will often raise additional capital through a private investment in public equity (“**PIPE**”) **transaction** (typically: one share of Class A common stock for a price of \$10.00, but as investor interest has waned, PIPE transactions have included additional securities).
- Announce all transactions to the market in a **press release** filed with the SEC on a Current Report on Form 8-K. The SPAC will usually also publicly release the projected financial information for the target company, which was shared with PIPE investors.
- SPAC then uses a proxy statement (often combined with a prospectus on a Form S-4 or Form F-4 registration statement) to **solicit stockholder approval** of the terms of the business combination and related transactions.
- If approved by stockholders and other **closing conditions** satisfied, (1) de-SPAC closes, (2) trust account funds (net) released to the target company, and (3) any financing transactions are simultaneously consummated.

# The SEC's SPAC Proposal

# Overview and additional disclosure requirements

- On March 30, 2022, the SEC proposed amendments and new proposed rules relating to SPACs, shell companies and projections
- Among other things, the proposed amendments would require additional disclosure
  - New Item 1603(a) of Reg S-K about a SPAC's sponsor, its affiliates, and any promoters relating to their experience, roles, responsibilities, agreements, compensation, etc.
  - New Item 1603(b) of Reg S-K(b) about actual or potential conflicts of interest between sponsors, directors and officers, on the one hand, and SPAC unaffiliated stockholders, on the other hand
  - New Item 1603(c) about the fiduciary duties of each officer and director to other companies
  - New Item 1602(c) regarding future dilution
  - New Item 1602(a)(4) presenting a tabular dilution disclosure of pro forma net tangible book value per share under a range of potential redemption levels
  - New Item 1604(c) disclosing each material potential source of additional dilution that non-redeeming shareholders may experience in de-SPACs
  - New Item 1604(c)(1) presenting a sensitivity analysis

# Overview and additional disclosure requirements *(cont'd)*

- New Item 1605 discussing the background of the transaction
- New Item 1606 requires significant new disclosures regarding the fairness from a financial point of view to the SPAC's unaffiliated securityholders of the de-SPAC and the related financing transaction
  - Substantially similar to the requirements in Item 1014 of Regulation M-A applicable to “going private” transactions under Rule 13e-3 of the Exchange Act
- New Item 1607 would require disclosure of any fairness opinion
- Non-financial statement disclosure requirements would be aligned with IPOs
  - If alignment is the objective, then, should the SEC consider removing impediments for “shell” and former “shell companies,” such as those in Rule 144, Form S-8, etc.
- The amendments also address:
  - A minimum dissemination period for de-SPAC proxy materials
  - Status of target company as co-registrant
  - Re-determination of smaller reporting company status
  - Inapplicability of PSLRA to projections
  - Investment Company Act safe harbor

# Discussion of Selected Proposed Amendments

# Disclosure and procedural requirements for de-SPAC transactions

## Background of the de-SPAC transaction

- New Item 1605 would require disclosure of de-SPAC transaction background, material terms and effects, including, among other things:
  - a summary of the background of the de-SPAC transaction, including, but not limited to, a description of any contacts, negotiations, or transactions that have occurred concerning the de-SPAC transaction;
  - a brief description of any related financing transaction, including any payments from the sponsor to investors in connection with the financing transaction; and
  - the reasons for engaging in the particular de-SPAC transaction and for the structure and timing of the de-SPAC transaction and any related financing transaction.
- New Item 1605(d) would require disclosure of material (including non-pecuniary) interests that the sponsor and the SPAC's officers and directors have in a de-SPAC transaction or any related financing transaction.
- New Item 1605(e) would require disclosure of whether security holders are entitled to any redemption or appraisal rights, and if so, a summary of the redemption or appraisal rights.

# Disclosure and procedural requirements for de-SPAC transactions

*(cont'd)*

## **Fairness of the de-SPAC transaction**

- New Item 1606(a) would require disclosure of whether the SPAC reasonably believes that the de-SPAC transaction and any related financing transaction are fair to the SPAC's unaffiliated security holders, as well as a discussion of the basis for this statement.
- New Item 1606(b) would require disclosure of the material factors upon which this reasonable belief is based and, to the extent practicable, the weight assigned to each factor.
- These requirements are substantially similar to the requirements in Item 1014 of Regulation M-A applicable to “going private” transactions under Rule 13e-3 under the Securities Exchange Act of 1934.
- New Item 1607(a), similar to Item 1015 of Regulation M-A: would require disclosure of any report, opinion, or appraisal obtained from an outside party relating to the consideration or the fairness of the de-SPAC transaction or any related financing transaction.

# Disclosure and procedural requirements for de-SPAC transactions *(cont'd)*

## **Fairness of the de-SPAC transaction *(cont'd)***

- If any outside party rendered any such report, opinion or appraisal, new Item 1607(b) requires disclosure of, among other things:
  - any material relationship between (1) the outside party, its affiliates, and/or unaffiliated representative; and (2) the SPAC, its sponsor and/or their affiliates, that existed during the past two years or is mutually understood to be contemplated and any compensation received or to be received as a result of the relationship;
  - whether the SPAC or the sponsor determined the amount of consideration to be paid to the private operating company or its security holders, or the valuation of the private operating company, or whether the outside party recommended the amount of consideration to be paid or the valuation of the private operating company; and
  - a summary concerning the negotiation, report, opinion or appraisal, which would be required to include a description of the procedures followed; the findings and recommendations; the bases for and methods of arriving at such findings and recommendations; instructions received from the SPAC or its sponsor; and any limitation imposed by the SPAC or its sponsor on the scope of the investigation.

# Disclosure and procedural requirements for de-SPAC transactions (cont'd)

## Fairness of the de-SPAC transaction (cont'd)

- Any such report, opinion or appraisal would be required to be included as an exhibit to a registration statement on Form S-4 or F-4 or a Schedule TO for a de-SPAC transaction and included directly in any proxy or information statement for a de-SPAC transaction.
- Following on the recent Delaware Court of Chancery decision in *In re MultiPlan Corp. Stockholders Litigation* applying the “entire fairness” standard to a breach of fiduciary duty claim in a de-SPAC transaction, the SEC seems to be codifying a judicial determination that de-SPAC transactions and related financings are inherently “conflicted transactions” in need of special procedures to ensure that they are entirely fair to unaffiliated stockholders. The proposing release states that disclosures required in going-private transactions “provide an appropriate model” for de-SPAC transactions “in that the conflicts of interests and misaligned incentives inherent in going-private transactions are similar to those often present in de-SPAC transactions.”

# Target company as co-registrant

- When a SPAC proposes to register the issuance of shares in connection with a de-SPAC transaction on a registration statement on Form S-4 or F-4, the Proposed Rules would require the target company be deemed a co-registrant.
- In addition to subjecting the target company to potential liability under Section 11 of the Securities Act, each of a target company's (i) principal executive officer; (ii) principal financial officer; and (iii) controller/principal accounting officer, as well as at least a majority of the target company's board of directors, would be required to sign the registration statement. By signing the registration statement, each of these individuals will be subject to Securities Act liability.
- Since no securities of the target company are being sold, and since the target company is not a "promoter" or a "control person," this is an unusual extension of the co-registrant theory and raises many novel securities law issues, creating a potential slippery slope in other merger contexts, as well as giving rise to a number of practical issues.

# Underwriting liability in de-SPAC transactions

- Under new proposed Securities Act Rule 140a, a person who has acted as an underwriter in a SPAC’s IPO and who “takes steps to facilitate the de-SPAC transaction, any related financing transaction, or otherwise participates (directly or indirectly) in the de-SPAC transaction” will be deemed to be engaged in the distribution of the securities of the surviving public entity in a de-SPAC transaction within the meaning of Section 2(a)(11) of the Securities Act.
- The proposing release states that this “clarification” of underwriter status in de-SPAC transactions should “motivate” SPAC IPO underwriters to exercise the care necessary to help ensure the accuracy of the disclosures in de-SPAC transactions by affirming that they are subject to Section 11 liability for registered de-SPAC transactions. This has already had a chilling effect on the market.
- Even if a SPAC IPO underwriter is not formally retained to act as an underwriter in a de-SPAC transaction, the release describes ways in which a SPAC IPO underwriter may be deemed to be “participating” in activities that are necessary for the de-SPAC transaction’s distribution of the combined company’s securities:
  - acting as a financial advisor to the SPAC;
  - assisting in identifying potential target companies or negotiating merger terms;
  - finding investors for, and negotiating, PIPE instruments; or
  - receiving compensation in connection with the de-SPAC transaction (including any deferred underwriting compensation that is delivered upon completion of the de-SPAC transaction).
- This aspect of the Proposed Rules has very significant consequences.

# Inapplicability of PSLRA

- Upon satisfaction of specified conditions, the Private Securities Litigation Reform Act of 1995 (the “PSLRA”) provides a safe harbor, which protects a company from liability in any private right of action brought under the Securities Act or Exchange Act based on material misstatements or omissions in forward-looking statements.
- The PSLRA safe harbor is also not available for offerings made by a “blank check company,” which is defined as a development stage company that has no specific business plan or purpose or that has indicated that its business plan is to engage in a merger or acquisition with an unidentified company or companies, and that is issuing “penny stock” (as defined in Exchange Act Rule 3a51-1). By raising greater than \$5 million in their IPOs, SPACs avoid being deemed “blank check companies” thus enabling them to rely on the PSLRA safe harbor in connection with disclosing projected financial information as part of the de-SPAC transaction.
- The Proposed Rules would amend the definition of “blank check company” by removing the element that a company issue “penny stock” thereby making the PSLRA’s safe harbor not available for forward-looking statements, including projections.
- However, projections will need to be included in any fairness opinion – how will these be handled?

# Who will pay the additional costs associated with the process?

## SPAC IPO

Possibly paying all of the underwriters' compensation upfront  
(no deferred compensation)

Higher D&O insurance costs

Different compensation arrangements for SPAC directors  
(to address issues potential conflicts of interest issues)

## De-SPAC Process

(Assuming that there are financial advisors interested in proceeding)

Fairness opinion fee

Costs associated with a comfort letter  
(assuming one can be obtained)

Legal opinion of SPAC counsel

Negative assurance letter from SPAC counsel

Legal opinion of Target counsel

Negative assurance letter from Target counsel

Additional costs associated with more extensive due diligence efforts

Target D&O insurance  
(If Target directors and officers need additional D&O insurance if Target is a co-registrant)

Higher financial advisory fees all around