Simpson
Thacher

Memorandum

Structure for SPACs: SEC Publishes Final Rules

February 16, 2024

Overview

On January 24, 2024, the U.S. Securities and Exchange Commission (SEC) published its much anticipated rules to regulate initial public offerings (IPOs) by special purpose acquisition companies (SPACs) and subsequent business combination transactions between SPACs and target companies (de-SPAC transactions). The SEC issued the nearly 600-page release just prior to the second anniversary of their issuance of the related proposed rules, which we discussed in our prior memo. In that interim period, the volume of SPAC IPOs and de-SPAC transactions have declined meaningfully for a variety of reasons. Market practice related to SPACs also continued to evolve in response to financial market developments, SEC Staff comments on SPAC SEC filings, Staff statements on accounting and disclosure matters, new Staff guidance in the form of Compliance and Disclosure Interpretations (C&DIs), judicial jurisprudence and, significantly, regulatory uncertainty surrounding the matters covered in the proposed rule. The SEC adopted most of the rules proposed in 2022 with some modification, but decided not to adopt its proposed rules regarding underwriter liability or a safe harbor from the definition of "investment company" under Section 3(a)(1)(A) of the Investment Company Act of 1940, as amended (1940 Act), opting instead to issue informal guidance on these topics in the text of the adopting release.

In the SEC's announcement of the new rules, SEC Chair Gary Gensler underscored the objective of enhanced investor protection and articulated a three-prong approach covering disclosure, the use of projections by issuers and issuer obligations. Beyond a new formal definition of a "Special Purpose Acquisition Company (SPAC),[1]" the final rules, which go into effect 125 days after publication in the Federal Register,[2] focus on the following topics:

- better alignment of the SEC's treatment of projections in de-SPAC transactions with those issued in traditional IPOs under the Private Securities Litigation Reform Act of 1995 (PSLRA);

[1] A SPAC is defined as "a company that has: (1) indicated that its business plan is to: (i) conduct a primary offering of securities that is not subject to the requirements of § 230.419 (Rule 419 under the Securities Act); (ii) complete a business combination, such as a merger, consolidation, exchange of securities, acquisition of assets, reorganization, or similar transaction, with one or more target companies within a specified time frame; and (iii) return proceeds from the offering and any concurrent offering (if such offering or concurrent offering intends to raise proceeds) to its security holders if the company does not complete a business combination, such as a merger, consolidation, exchange of securities, acquisition of assets, reorganization, or similar transaction, with one or more target companies within the specified time frame; or (2) represented that it pursues or will pursue a special purpose acquisition company strategy." Additionally, among other new definitions included in the final rules, the term "target company" means "an operating company, business or assets."

[2] Compliance with the structured data requirements (which require tagging of projection information disclosed pursuant to new subpart 1600 of Regulation S-K in Inline XBRL) will be required 490 days after publication of the final rules in the Federal Register.

- additional disclosures about SPAC sponsor compensation, conflicts of interest, shareholder dilution, the target company and other information that the SEC believes is material to investors in SPAC IPOs and de-SPAC transactions;
- target company status as a co-registrant on any registration statement filed in connection with a de-SPAC transaction (and the related assumption of potential liability under federal securities laws for the disclosures in that registration statement); and
- a deemed sale of securities by the target company to the reporting shell company's shareholders in any business combination transaction involving a reporting shell company and a minimum 20-calendar day dissemination period for a SPAC to solicit proxies from its shareholders.

Set forth below is a summary of each of these key aspects of the proposal, along with considerations and potential implications.

BETTER ALIGNMENT OF THE REGULATORY TREATMENT OF PROJECTIONS IN DE-SPAC TRANSACTIONS WITH THOSE ISSUED IN TRADITIONAL IPOS UNDER THE PSLRA

Update: The new rules increased disclosure requirements for projections for all issuers, whether or not they are SPACs, with special requirements for SPAC issuers.

- Item 10(b) of Regulation S-K will be amended to require that any projections used by any issuer that are not based on historical financial results or operational history must be "clearly distinguished" from projections that are based on historical financial results or operational history. Additionally, projections based on historical financial results or operational history must give equal or greater prominence to the historical measures or operational history. Presentation of projections that include a non-GAAP financial measure should include a clear definition or explanation of the measure, a description of the GAAP financial measure to which it is most closely related and an explanation of why the non-GAAP financial measure was used instead of a GAAP measure.

Furthermore, in connection with de-SPAC transactions, the rules:

- require enhanced disclosure related to projections, including disclosure of:
  - all material bases for the projections and all material assumptions underlying the projections;
  - the identity of the preparer of the projections; and
  - whether the projections still reflect the views of the board or management of the SPAC or target company as of the date of each filing relating to the de-SPAC transaction.
- clarify that the Item 10(b) guidelines also apply to projections of future economic performance of persons other than the registrant, such as the target company in a business combination transaction, that are included in the registrant's filings; and

- adopt a definition of “blank check company” under the PSLRA that makes the safe harbor for forward-looking statements under the PSLRA unavailable for blank check companies, including SPACs.

Implications: The SEC’s distinction between rules for SPACs and those for all other issuers in this area highlights the SEC’s continued heightened concern about the use of projections in de-SPAC transactions, although it is notable that the SEC used the SPAC rulemaking process as an opportunity to clarify projection disclosure requirements for non-SPAC issuers as well. The new rules impose guardrails on the use of projections but are unlikely to be particularly onerous to transaction participants. Currently, parties already have incentives to rigorously validate and evaluate projections, and they can be a critical factor in supporting a board’s evaluation of a transaction, establishing a valuation for the combined business, marketing a PIPE transaction, encouraging SPAC shareholders not to redeem and providing the basis for a fairness opinion (if applicable) and recommendation to shareholders that they approve the transaction. The process of preparing projections for a de-SPAC transaction has some similarities to the preparation of a financial model for a traditional IPO but also has features that are unique to the M&A context that would support the continued use of projections notwithstanding elimination of the statutory safe harbor. Since the SEC’s proposed release in 2022, many SPACs and target companies have increased the rigor of their processes for preparing projections, and current market practices may already satisfy the new SEC criteria.

In addition, an affirmative disclosure requirement regarding a change in management’s view will provide investors with updates on a target’s business prospects in connection with their evaluation of the business combination and is especially relevant for de-SPAC deals with a protracted timeline between deal announcement and the shareholder meeting held to approve the de-SPAC transaction.

ADDITIONAL DISCLOSURES ABOUT SPAC SPONSOR COMPENSATION, CONFLICTS OF INTEREST, DILUTION, THE TARGET COMPANY AND OTHER INFORMATION THAT IS IMPORTANT TO INVESTORS IN SPAC IPOS AND DE-SPAC TRANSACTIONS

Update: The new rules, which will be primarily codified in new Subpart 1600 of Regulation S-K, include various discrete disclosure obligations that are tailored to address concerns that have developed in SPAC IPOs and de-SPAC transactions, including the following:

- details on SPAC sponsors, SPAC sponsor compensation, conflicts of interest and shareholder dilution in both SPAC IPOs filings and subsequent de-SPAC filings;
- in de-SPAC transactions:
    - increased disclosure on the background and material terms of a de-SPAC transaction, as well as information about any determination by a board of directors or similar body as to whether the de-SPAC transaction is advisable and in the best interests of the SPAC and its shareholders, if required by law, and about any outside report, opinion or appraisal received that materially relates to the de-SPAC transaction;

- accelerated disclosures regarding the operating company target so that these disclosures are contained in the registration statement prior to approval of a business combination rather than in the so-called "Super 8-K" containing Form 10 information on the target that typically has been filed following consummation of the de-SPAC transaction; and
- financial statement requirements applicable to transactions involving shell companies and private operating companies that will be better aligned with those in traditional IPOs, which will be contained in a new Article 15 of Regulation S-X.

Implications: Although these items seek to address SEC concerns about perceived SPAC abuses, market practice has already largely evolved to provide much of the newly-required disclosure, in part in response to the issuance of the SEC's proposed rules in 2022. Additionally, market participants have often already structured commercial terms in respect of, and included disclosure on, many of these topics to avoid comments from the SEC Staff or to decrease liability exposure.

TARGET COMPANY STATUS AS A CO-REGISTRANT ON ANY REGISTRATION STATEMENT FILED IN CONNECTION WITH A DE-SPAC TRANSACTION (AND THE RELATED ASSUMPTION OF POTENTIAL LIABILITY UNDER FEDERAL SECURITIES LAWS FOR THE DISCLOSURES IN THAT REGISTRATION STATEMENT)

Update: In de-SPAC transactions, a target company will now be deemed a co-registrant on any Securities Act registration statement filed by a SPAC (or other shell company) in connection with a de-SPAC transaction. In addition, a post-de-SPAC public company will be required to re-determine its status as a smaller reporting company (SRC) prior to the time it makes its first SEC filing, other than the "Super 8-K." In that determination, public float will be measured as of a date within four business days after the consummation of the de-SPAC transaction, and annual revenues will be measured using the target company's annual revenues for the most recently completed fiscal year reported in the Super 8-K. If the company is determined not to be an SRC, it must include the more extensive disclosure applicable to a non-SRC in any filing beginning 45 days after the consummation of the de-SPAC transaction.

Implications: By co-signing the de-SPAC registration statement, a target company, as well as its directors and certain executive officers, will share liability under Sections 11 and 12 of the Securities Act for any material misstatements or omissions that it contains. The new rules reflect the reality that the target company is actively involved in preparing disclosure and otherwise coordinating the de-SPAC process. The possibility of Securities Act liability will require target company directors and officers to demonstrate that they have made a reasonable inquiry into statements made in the registration statement in order to establish their due diligence defense, including potentially requesting to be named as additional addressees for any comfort letters, legal opinions and negative assurance letters delivered in connection with the de-SPAC transaction. In addition, target companies and their directors and officers will need to consider whether their existing D&O insurance and indemnification policies are adequate for the additional exposure that they could face in the event of a material misstatement or omission in connection with the de-SPAC transaction.

DEEMED SALE OF SECURITIES FROM TARGET COMPANY TO THE REPORTING SHELL COMPANY'S SHAREHOLDERS IN ANY BUSINESS COMBINATION TRANSACTION INVOLVING A REPORTING SHELL COMPANY AND MINIMUM 20-CALENDAR DAY DISSEMINATION PERIOD

Update: Consistent with the adoption of co-registrant status for de-SPAC target companies, new Securities Act Rule 145a provides that any direct or indirect business combination between a reporting shell company (such as a SPAC) and an entity that is not a shell company (such as a SPAC target company) is deemed to involve an offer, offer to sell, offer for sale or sale, and the transaction will require Securities Act registration unless an exemption from registration is available. The rules also mandate a 20-calendar day minimum dissemination period in advance of a shareholder meeting or consent for approval of a business combination for prospectuses and proxy and information statements filed for de-SPAC transactions where consistent with local law.

Implications: Extension of Securities Act protections and potential liability in business combinations involving shell companies (including de-SPAC transactions) synchronizes the solicitation of shareholder approval in de-SPAC deals with other comparable transactions. This treatment also equalizes the treatment of SPAC transactions under federal securities laws regardless of structure. Previously, in a traditional de-SPAC transaction involving a U.S. SPAC as the legal acquirer of a U.S. target company, registration statements typically did not contemplate any issuance of securities to former SPAC shareholders, who did not receive a new security but simply had the right to vote on the deal and redeem their shares.

The 20-calendar day minimum dissemination period will likely have a limited effect. Even without a mandate, a 20-calendar day procedural guardrail has often been observed, as transaction participants and proxy solicitors typically recommend allocating sufficient time for delivery of disclosure documents to beneficial owners of shares and for shareholder outreach.

Further Guidance

Two significant and controversial topics contained in the proposed rule, underwriter liability and investment company status, were not included in the final rules. Instead, as discussed below, the SEC provided additional guidance in the text of the adopting release.

UNDERWRITER LIABILITY

Update: Consistent with the new "deemed sale" rule discussed above, the guidance characterizes de-SPAC transactions (distinguished from traditional M&A deals) as a distribution of securities and, even without a formal designation of "underwriter," a participant that "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" would be considered by the SEC to be acting as an underwriter for purposes of this distribution of securities. While emphasizing that "nothing in this release is intended to limit or alter the definition of underwriter for purposes of Section 2(a)(11) of the

Securities Act," the guidance seems to have that effect by expanding this definition as it relates to SPAC transactions.

Implications: In the absence of an explicit limitation of their risk, we anticipate that financial institutions participating in de-SPAC transactions will likely continue to observe certain due diligence procedures, such as conducting due diligence calls with the SPAC and target company, requesting additional representations and indemnities in their engagement documentation and requiring deliverables that are customarily requested in IPOs, such as negative assurance letters and comfort letters. Observing these procedures typically requires additional time, expense and certain representations to be made by requesting banks. In response to the guidance, financial institutions may also be reluctant to participate in both the initial formation of the SPAC and the subsequent de-SPAC transaction due to potential incremental liability concerns.

STATUS OF SPACS UNDER THE 1940 ACT

Update: Rather than adopt a safe harbor from the definition of "investment company" under Section 3(a)(1)(A) of the 1940 Act as proposed, the SEC provided interpretive guidance on the activities that SPACs could undertake that would cause a SPAC to become an investment company. Emphasizing the fact-based, individualized nature of this determination, the SEC stated that the analysis of an issuer's primary engagement under Section 3(a)(1)(A) has historically been based on the five "Tonopah factors" based on *In the Matter of Tonopah Mining Co.*, 26 S.E.C. 426 (July 21, 1947). As described by the SEC, below are the *Tonopah* factors as applied to SPACs (in parentheses).

- The Company's Historical Development (in terms of duration, the SEC explained that a SPAC's activities may become more difficult to distinguish from those of an investment company as the time it takes to achieve its stated business purpose increases);
- The Company's Public Representations of Policy (a SPAC that (i) holds itself out in a manner suggesting that investors should invest in its securities primarily to gain exposure to a portfolio of securities prior to a de-SPAC transaction or (ii) discloses that it intends to merge with an investment company would likely cause the SPAC to meet the definition of investment company);
- The Activities of the Company's Officers and Directors (consideration should be given to whether the SPAC's officers, directors and employees are focused on investing activities as opposed to a business combination);
- The Nature of the Company's Present Assets (whether the SPAC holds corporate bonds or other investment securities and/or intends to acquire a minority interest in a company as a passive investor instead of a de-SPAC transaction); and
- Sources of the Company's Present Income (a SPAC that derives a substantial portion of its income from corporate bonds or other minority interests would suggest the SPAC meets the definition of investment company).

Similar to the application of portions of the new rule on projections to both SPAC and non-SPAC issuers, as noted above, the 1940 Act guidance appears to apply not just to SPACs, but rather to all issuers—in particular, the duration of an operating company's primary (but temporary) engagement in securities-related activities. Commissioner Uyeda, in his dissenting statement, noted this broad applicability: "All types of issuers – not just SPACs – should pay heed to this guidance because the framework for investment company status determinations could have implications for an operating company that temporarily derives income from investment securities . . . While targeted at SPACs, the knock-on effects of this guidance could raise serious legal and compliance issues across a wide array of issuers."

Implications: The SEC's decision to not adopt a safe harbor from the definition of investment company under Section 3(a)(1)(A) has generally been viewed as a good outcome since many commentators thought that the safe harbor was unnecessary and could have called into question the 1940 Act status of SPACs that did not comply with the prescriptive terms of the proposed safe harbor, including (i) a limitation on the types of investment securities that could be held by a SPAC and (ii) a requirement that a SPAC enter into an agreement with a target company within 18 months after its initial public offering and complete its de-SPAC transaction within 24 months of such offering. Going forward, managing SEC guidance related to the duration of a SPAC's pre-business combination stage likely poses the greatest challenge, and the SEC's guidance declines to provide certainty on this factor, leaving SPACs to analyze the facts and circumstances in light of the considerations that the SEC highlights. Nevertheless, there are numerous commercial and other non-1940 Act reasons for limiting the period between a SPAC IPO and consummation of business combination.

Outlook for SPACs

Private ordering, in part due to the SEC's earlier proposed rulemaking, has largely driven the evolution of the SPAC and de-SPAC markets. The foreshadowing effect of the original proposed SPAC rules and other actions taken by the SEC in the nearly two years since the rules were proposed, together with developments in the financial markets during that period, have already dampened the SPAC market, and we think it is unlikely that the new rules will spur any significant market shift. Although the rules have the stated objective of securing investor protection by creating parity for a public reporting debut, whether through an IPO or a merger with a SPAC, the de-SPAC pathway must now navigate additional regulatory obstacles, and we anticipate a continued retrenchment in the SPAC market as an alternative to the traditional IPO market.

For further information regarding this memorandum, please contact one of the following authors:

NEW YORK CITY

Mark A. Brod
+1-212-455-2163
mbrod@stblaw.com

John C. Ericson
+1-212-455-3520
jericson@stblaw.com

Joseph H. Kaufman
+1-212-455-2948
jkaufman@stblaw.com

Karen Hsu Kelley
+1-212-455-2408
kkelley@stblaw.com

Lesley Peng
+1-212-455-2202
lpeng@stblaw.com

Arielle L. Katzman
+1-212-455-7106
arielle.katzman@stblaw.com

WASHINGTON, D.C.

David W. Blass
+1-202-636-5863
david.blass@stblaw.com

Rajib Chanda
+1-202-636-5543
rajib.chanda@stblaw.com

James W. Hahn
+1-202-636-5574
james.hahn@stblaw.com

PALO ALTO

William B. Brentani
+1-650-251-5110
wbrentani@stblaw.com