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SPAC Enforcement Risks Increase with Enhanced SEC Scrutiny

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What happened

In a recent client alert, we discussed the dramatic rise in offerings of special purpose acquisition companies (SPACs) and some of the attendant litigation and enforcement risks. A raft of recent public statements and actions by Securities and Exchange Commission (SEC) staff reflect the agency's enhanced scrutiny of these transactions and suggest that enforcement investigations (and ultimately actions) cannot be far behind.

In late March 2021, it was reported that the SEC's Division of Enforcement had requested information from Wall Street banks regarding SPAC transactions. According to the reports, Enforcement staff requested information on topics including SPAC deal fees, compliance, reporting and internal controls. Enforcement's areas of focus may include potential deficiencies in the due diligence SPACs perform before acquiring assets, and whether payouts to sponsors are sufficiently disclosed to investors.

Then, on March 31, 2021, Paul Munter, the SEC's acting chief accountant in the Office of the Chief Accountant (OCA), issued a public statement titled, "Financial Reporting and Auditing Considerations of Companies Merging with SPACs." In the statement, Munter observed that the "merger of a SPAC and target company often raises complex financial reporting and governance issues" and identified several areas of potential risk. Among other things, the statement highlighted the risk that "private companies that were not contemplating an IPO or were otherwise earlier in their preparations" may be unprepared for the rigorous financial reporting and internal control requirements expected of public companies and asked stakeholders to give "careful consideration [to] whether the target company has a clear, comprehensive plan to be prepared to be a public company."

Next, on April 8, 2021, John Coates, the acting director of the SEC's Division of Corporation Finance (Corp Fin), issued a public statement titled, "SPACs, IPOs and Liability Risk under the Securities Laws." According to the statement, the SEC staff "are continuing to look carefully at filings and disclosures by SPACs and their private targets." The statement specifically identified a range of potential federal securities law violations that may arise in the context of SPAC transactions. Notably, Coates questioned whether de-SPAC transactions are covered by the protections of the Private Securities Litigation Reform Act (PSLRA) and observed that, in any event, the PSLRA does not apply to actions brought by the SEC. Correspondingly, he cautioned on the risks of using forward-looking information, which he noted can be "untested, speculative, misleading or even fraudulent." This was the second time in five months that Corp Fin had addressed the issue.

Most recently, on April 12, 2021, Munter and Coates issued a joint statement on accounting and reporting considerations for SPAC warrants. Walking through two "fact patterns" related to SPAC warrants, the Corp Fin and OCA staff indicated that under the circumstances presented, the warrants should have been classified as liabilities. In the first fact pattern, the staff opined that warrant provisions providing for potential changes to the settlement amounts based on the characteristics of the holder would preclude the warrants from being indexed to the entity's stock, and thus the warrants should be classified as a liability. In the second fact pattern, the staff stated that warrants should be classified as liabilities if, in the event of a tender offer, all warrant holders would be entitled to cash, while only certain of the holders of the underlying shares of common stock would be entitled to cash. The staff concluded by advising SPAC registrants to consider the impact of the guidance on previously issued financial statements and to assess

potential restatements.

Why it matters

These statements (along with two recent investor alerts) make clear that the SEC is heavily focused on the burgeoning SPAC market, that it is seeing issues that concern it, and that it is warning SPAC participants to attend to these issues. While statements from the SEC staff may come from different divisions and offices, they are clearly and carefully coordinated to meet certain goals. As a primary matter, these statements are designed to put parties, as well as their attorneys, accountants, and other advisers, on notice that the SEC is watching. As a secondary matter, such statements by staff in other divisions and offices should be viewed as harbingers of future Enforcement activity. Particularly in recent years, the SEC staff has become adept at issuing statements by the likes of Corp Fin and the Office of Compliance Inspections and Examinations and then following up with Enforcement activity on the same issues. The staff statements make it more difficult for parties to say to Enforcement that they did not realize they were engaged in violations.

Enforcement's focus on SPACs is likely to be bolstered by the arrival of its new chair. Gary Gensler, who took an aggressive enforcement approach as head of the Commodity Futures Trading Commission, was sworn in on April 17, 2021. Gensler is expected to bring a more aggressive approach to enforcement than his predecessor, Jay Clayton, and he has already stated that at the top of his enforcement agenda, he intends to bring a heightened scrutiny to SPACs.

The recent public statements provide some insight into potential subjects of SPAC-related enforcement activity. Based on the statements by Corp Fin and OCA, one can expect Enforcement will initiate more investigations into SPAC disclosures in SEC filings. Ominously, in his **April 8 statement**, Munter made a point of reminding SPAC participants that material misstatements or omissions in de-SPAC proxy solicitations are subject to negligence-based liability under Exchange Act Section 14(a) and Rule 14a-9 thereunder, suggesting that the SEC may be willing to pursue a wider scope of conduct beyond outright fraud.

The most significant SPAC enforcement risks arise from disclosures during the IPO and in proxy and registration statements. The sponsor is expected to provide full and fair disclosures around potential risks, conflicts of interest, and other material facts related to each proposed transaction, including:

- Sponsors' obligations and allegiance to parties other than the SPAC, i.e. relationships between the SPAC and target company and relationships between SPAC management and target management or any private investors;
- The control that the SPAC's sponsors, directors, officers and their affiliates have over approval of a merger and their economic interest therein;
- The degree to which additional funding may dilute shareholders' interest in the combined company; and
- The economic terms of the securities held by a SPAC's sponsors, directors, officers and affiliates.

Enforcement (with the help of Corp Fin and OCA) will closely scrutinize disclosures around these issues.

SPAC transactions and targets are primarily valued by the sponsor through the use of fairness opinions, due diligence, valuation assessments, financial projections and statements about the target's future prospects (*i.e.* projections), rather than the market-based valuation that accompanies a traditional IPO process. (The valuation tends to be validated by the PIPE investors who often accompany transactions.) Enforcement will examine these forward-looking statements, particularly where **high valuations** have been assigned to early stage companies based on projected future performance. Enforcement will also scrutinize whether risks of nonperformance have been adequately identified. Where a target's expected future performance turns on assumptions such as business pipelines, for example, the SEC staff will likely pay particular attention to whether those assumptions have been vetted and whether the risks have been adequately described. And, as the SEC staff has recently reminded market participants, whatever the applicability of the PSLRA safe harbor to private litigation over SPACs, it provides no protection against government

enforcement actions.

We expect that the SEC staff will also focus on the post-merger combined public company. Post-merger public companies must abide by a myriad of financial reporting rules and regulations. Accordingly, like other public companies, they must maintain sufficient personnel, processes and controls to meet disclosure obligations and comply with financial reporting standards. A failure to scale these functions adequately creates a high risk of unwanted SEC scrutiny. In light of its recent inquiries to Wall Street, the SEC appears to be examining the role of gatekeepers—particularly underwriters and auditors—in the SPAC market with a critical eye. Finally, SPACs present multiple insider trading and selective disclosure concerns, particularly given the number of participants who may not be familiar with these issues and how they apply to SPACs. While the SEC has yet to issue any statements on this topic, we fully expect that Enforcement will be looking at these issues as well.

Conclusion

For questions about the litigation and enforcement risks related to SPACs or more information on SEC enforcement matters, please contact a member of Cooley's white collar defense and investigations and securities litigation groups. For more content on SPACs and the public securities arena generally, please visit Cooley's **SPACtivity page** and Cooley's **PubCo blog**.

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