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The Redditors' Amicus Brief

After a meteoric rise in the first half of 2021, the super-SPAC Pershing Square Tontine Holdings ("PSTH") has come crashing down to earth. In the wake of PSTH's failed bid to acquire a stake in Universal Music Group, disgruntled PSTH investor George Assad filed suit asserting, among other things, violations of the Investment Company Act of 1940 (the "ICA"). Litigation over SPACs that fail to live up to their hype may not be uncommon, but PSTH has an unusual ally in this case: a group of individual investors, purportedly recruited from the website Reddit, who filed an amicus brief arguing that Assad's suit is nothing more than an attempt to supplant the SEC's regulatory authority and that no reasonable investor would have viewed PSTH as an investment company. Setting aside the legal merits of the claims of Assad and the amici, the individual investor amicus brief highlights an important question relating to the regulation of SPACs: Are retail investors systematically disadvantaged in SPAC transactions, and will the SEC pursue closer regulation of SPACs as a result?

Background

PSTH was once the darling of the SPAC world. Led by Bill Ackman, the billionaire founder and CEO of hedge fund Pershing Square Capital Management, PSTH was the biggest SPAC in the world, valued at over $4 billion. PSTH pitched itself as different from other SPACs: it would collect no fees, ostensibly allowing retail investors to participate on relatively equal footing with the deep-pocketed players (such as institutional investors) that SPACS traditionally attract. But it all went south in the summer of 2021 when Ackman announced that PSTH would depart from the SPAC playbook and, rather than engage in a merger, would instead acquire a 10% stake in Universal Music Group. The SEC, however, quickly raised serious concerns about the structure of the proposed acquisition, and PSTH dropped the proposal, announcing that it would look for another target. The value of PSTH has since cratered, falling below the

SPACS, Mind the GAAP

The Securities and Exchange Commission continues to scrutinize special purpose acquisition companies, or SPACs. In late March, the SEC proposed new rules and amendments to enhance disclosure and investor protection in initial public offerings ("IPOs") by SPACs and in business combination transactions involving shell companies, such as SPACs, and private operating companies. If adopted, the proposed rules will more closely align the required financial statements issued by SPACs with those required in IPO registration statements.

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SPACs Get Their Passports and Go Global

Although much of the focus of the SPAC world is on the United States and the United Kingdom, the traditional finance hubs of Wall St. and the London Stock Exchange are not the only places to start a SPAC. Seeking to take advantage of the boom in SPAC activity, countries across the globe are opening up to SPAC markets and putting in place new rules to do so. With such a world-wide boom, regulatory scrutiny and litigation are sure to follow.

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$20 redemption price. Retail investors were particularly hard hit by the failed bid, with a number losing hundreds of thousands or even millions of dollars on call options. Even with the security of the $20 floor, many retail investors who did not get in at the $20 IPO price realized losses that were significantly higher than those experienced by institutional investors who got into the deal at the ground floor.

The Lawsuit

PSTH now faces a legal challenge brought by investor George Assad, a Massachusetts stockbroker in an action brought in the United States District Court for the Southern District of New York before Judge Analisa Torres. Assad, a serial plaintiff in federal securities complaints, has filed similar lawsuits against two other SPACs – GO Acquisition Corp. and E.Merge Technology – and is represented in all three cases by a team that includes well-known securities law professors John Morley of Yale and former SEC Commissioner Robert Jackson, now a law professor at NYU. In the PSTH suit, Assad alleges that PSTH is an investment company and should have registered as such under the ICA and that PSTH's directors received compensation in violation of the ICA and the Investment Advisor's Act. The suit contends that PSTH's practice (widespread among SPACs) of placing proceeds reaped after going public into a trust which in turn holds government securities (and money market funds that invest in government securities) breached the ICA, as did the lucrative sponsor shares available to directors and sponsors.

While the merits of the claim are being adjudicated, some big players have come out in support of PSTH, with 49 law firms signing a memo issued by law firm White & Case entitled "SPACs are Not Investment Companies." PSTH has also garnered the support of a group of 62 individual investors, who filed an amicus brief in support of Pershing Square's motion to dismiss, characterizing Assad's suit as a misguided attempt to usurp the SEC's authority to regulate SPACs and arguing that reasonable investors (such as themselves) do not view or treat PSTH as an investment company. The amicus brief – and Assad's response to it – offers insight into a fundamental critique of SPACs that animates Assad's claims: that SPACs disadvantage retail investors while lining the pockets of sophisticated investors and directors.

The Individual Investor Amicus Brief and its Implications

The individual investor amicus brief was signed by 62 individual PSTH shareholders, purporting to offer the court the perspective of ordinary, individual PSTH shareholders, a perspective that carries some weight with the court given that, when evaluating whether a company is subject to the ICA, courts give great weight to the beliefs the company is likely to induce in its investors. Whatever the value of the amici's legal arguments, the brief sparked controversy because of its unusual origins. Specifically, Assad alleges that the signatories were recruited to the cause from the internet forum Reddit by the investor relations department of PSTH's investment advisor, and that the brief was written by an attorney handpicked by PSTH. Attaching pages of conversations from Reddit in which purported signatories say things such as "[d]on't even really understand what I'm doing here," Assad contends that the individual investor amicus (and its signatories) fundamentally misunderstand the issues in the case, reflecting the general lack of sophistication of retail investors, particularly in comparison with institutional investors.

That Reddit is taking a star turn in this complex securities case is perhaps not terribly surprising: Redditors (as users of the forum are known) dominated the financial news a year ago when the site was instrumental in the GameStop short squeeze. The connections between PSTH and the Reddit-led GameStop frenzy don't stop there: Many retail investors who profited from the GameStop affair poured their earnings into PSTH, which was being talked up by Redditors as the next big thing. The Reddit connection to both the GameStop phenomenon and the rise and fall of PSTH raises questions about an issue that has troubled SEC Chairman Gary Gensler for some time: the gamification of investing and the negative impact of the phenomenon on retail investors. For example, in a report issued on October 18, 2021, the SEC noted that the gamification of certain online trading platforms encourages retail investors to engage in more frequent trades, often to their detriment (but to the benefit of the platform), and suggests that further consideration is warranted of the gamification of such platforms. It is conceivable, therefore, that the amici's efforts to support PSTH in this case may have the (unintended) consequence of suggesting to the SEC parallels between the GameStop phenomenon and SPACs that might invite rather than discourage closer regulation. And indeed the SEC has already taken some steps toward tightening regulation on SPACs in a manner that could bear directly on the litigation under discussion. On March 30, 2022, as discussed elsewhere in this Issue, the SEC issued proposed rules for SPACs that would permit SPACs to continue to enjoy exemption from the ICA, but only under certain conditions. While the notice-and-comment period for the proposed rules is still open (and is scheduled to run until at least May 31, 2022), and while the impact, if any, of a rule change on the PSTH ligation is unclear, SEC action is coming, and soon.

SPACs, Mind the GAAP (cont'd)

This development should come as no surprise in light of the SEC's recent actions. Over the course of 2021, the SEC pushed back on industry accounting practices on multiple occasions. For example, last April, the SEC released a staff statement reminding SPACs that Generally Accepted Accounting Principles ("GAAP") includes guidance regarding factors that must be considered in determining whether warrants and other contracts that may be settled in an entity's own stock should be classified as equity, an asset, or a liability.

Recently, some SPACs have broadly cautioned investors that "accepted accounting" for SPACs may change, which might necessitate a restatement of the entity's financial statements. In letters released earlier this year, the SEC admonished two SPACs for attempting to use such broad disclosures to protect themselves from the consequences of issuing financial statements that did not comply with GAAP. In one letter issued to McLaren Technology Acquisition Corp., the SEC pointed to a disclosure that the SPAC expects its warrants to be accounted for as equity, but that "if auditors of a potential target disagree or the SEC issues a statement in the future, it could result in different accounting treatment" requiring a restatement. The SEC questioned the appropriateness of this disclosure given management's responsibility for financial statements and the auditor's opinion that the financial statements were prepared in conformity with GAAP. In other words, having disclosed that it anticipated treating its warrants as equity, McLaren could not disclaim responsibility if an auditor subsequently disagrees with that treatment.

Another letter issued to Anthemis Digital Acquisitions I Corp. focused on a disclosure of how "changes to the 'accepted accounting for [SPACs]'. . . could result in the recognition of accounting errors in previously issued financial statements." The SEC disputed the notion that there could be "accepted accounting" for SPACs that deviated from GAAP. It further sought clarification of the relationship between such "accepted accounting" for SPACs and both Regulation S-X, which requires that financial statements must be prepared in accordance with GAAP, and representations in the entity's financials statements and the related audit opinion that the financials were prepared in accordance with GAAP.

In December, while speaking at the American Institute of CPAs conference in Washington, D.C., Melissa Rocha, the Deputy Chief Accountant of the SEC's Division of Corporation Finance, noted the SEC staff's concern about the use of "boilerplate risk factors" to disclaim accounting errors that might result from either changes to "accepted accounting" practices or the possibility that a target company's auditors might disagree with an accounting treatment reflected in the SPAC's financial statements. The SEC's rebuke of the use of disclaimers took many by surprise as the accounting practices in question were both long-standing and had not previously drawn scrutiny.

Although the broad disclaimers apparently seek to protect against litigation brought by unhappy investors, it is unclear whether they will successfully serve their intended purpose. In May of 2021, a shareholder filed a class action lawsuit against Virgin Galactic Holdings asserting that it (and certain of its officers) had made false or misleading statements related to the treatment of warrants. Plaintiffs subsequently amended their complaint to focus on other issues, thereby obviating the need for judicial analysis of the validity of such disclaimers. In light of the SEC's recent commentary, however, it appears that SPACs using such disclaimers may be opening themselves up to enforcement actions based on the failure to prepare financial statements in accordance with GAAP, or for misrepresenting that the entity's financial statements had, in fact, complied with GAAP.

In light of the extensive scrutiny that SPACs are facing from the SEC, it is not surprising that their accounting practices and risk factor disclosures are receiving exacting treatment. The recent crackdown appears to be dampening Wall Street's appetite for participating in the SPAC market, with Goldman Sachs announcing that it is scaling back its SPAC business "in response to the changed regulatory environment." All the while, the SEC continues to contemplate increased disclosure requirements for SPACs as it reviews recommendations issued by its Investor Advisory Committee last year.

SPACs Get Their Passports and Go Global (cont'd)

Perhaps the most concrete actions to welcome the SPAC market have come from the United Arab Emirates Securities and Commodities Authority, which recently paved the way for the country's first SPAC listing. Formally entitled the "UAE Federal Law By Decree No. 32 of 2021" (the Commercial Companies Law), the new law recognized SPACs under UAE law for the first time. The UAE government exempted SPACs from the majority of the rules of the Commercial Companies Law. In early 2022, the UAE's Securities and Commodities Authority issued SCA Chairman of the Board Resolution No. 1 of 2022 on the Regulations for Special Purpose Acquisition Companies. The new regulations allow SPACs to be listed on regulated securities markets in the UAE, making the Abu Dhabi Securities Exchange the first UAE exchange to promulgate rules for the listing of SPACs. The new SPAC rules pave the way for companies based in the UAE to undergo business combinations with domestic SPACs rather than SPACs based in the United States. Allowing homegrown SPACs to take companies public could lead to significant operational and cost savings.

The UAE is not the only country getting in on the SPAC boom. Saudi Arabia's bourse is considering whether to allow them, its chief executive said last year. Egypt is also gearing up for blank-check firms as an alternative investment model for upstart companies, having issued new rules for listing on the Egyptian stock exchange and with officials expecting SPAC listings and mergers to follow. Indonesia's financial authority has completed a study about the necessary legal framework for SPACs and intends to introduce new rules soon.

Although countries are at varying stages of the development of rules and norms for SPAC transactions, what is clear is that SPACs are likely to be a popular financing model in markets all over the world. With regulations—and opportunities—arising in emerging markets plenty of new frontiers exist for SPAC activity in 2022. The fallout in terms of enforcement and litigation will inevitably follow.

Delaware Issues First Major Decision on SPAC Corporate Governance Issues

While the investing public waits for the adoption of new SPAC guidelines from the SEC, private litigation may prompt changes to SPACs' structure and conduct. Although not as splashy as new regulations from the Government, courts' treatment of SPACs in civil litigation will impact the liability regimes applicable to SPACs.

Perhaps the most influential court in the country for corporate governance has offered the first indication of how judges will try to fit SPACs into existing corporate legal doctrine. On January 3, 2022, Vice Chancellor Lori Will of the Delaware Court of Chancery denied, in large part, the defendants' motion to dismiss a challenge to alleged conflicts of interest and disclosure violations involving a SPAC in *In re Multiplan Corp. Stockholders Litigation*. The Chancery Court's decision suggests that courts will seriously consider claims that a SPAC's sponsors are conflicted and violated disclosure obligations, and opens the door to more aggressive litigation based on such conduct. Should other courts follow suit, SPACs would be under pressure not only from regulators, but from their own investors.

Just Your Everyday SPAC

During its IPO, Churchill Capital Corporation III, the SPAC at the heart of the *In re Multiplan* litigation, issued units consisting of one Class A share and a fractional warrant for $10 apiece. As is common, at the IPO, the SPAC's sponsors received "founder" or Class B shares, which often are referred to as a "promote," consisting of 20% of the outstanding shares of the company for a nominal price. The sponsor also purchased 23 million warrants at $1.00 per warrant with an exercise price of $11.50. Like other SPACs, if Churchill did not complete a merger within 24 months, the company would liquidate its Class A shares for $10 per share plus interest. While the investors who purchase Class A shares would be redeemed, Churchill's sponsors would lose all of their investment. If the SPAC did complete a merger within the sunset period, shareholders had the right to vote to approve the transaction and redeem their shares at a fixed price of $10 plus interest.

At first, things went according to plan. Churchill identified Multi-Plan Corp., a health care data analytics company, as its target. In July 2020, the SPAC's management approved the merger with Multi-Plan and solicited proxies from the Class A shareholders to give the final approval to the merger. The proxy statement that went out to shareholders described Multi-Plan's business, financial conditions, and potential risks. In characterizing the events leading up to the merger, the proxy statement touted Churchill's "extensive due diligence." Relatively few shareholders objected and redeemed their shares, and the de-SPAC transaction closed in October 2020.

The rosy period did not last long. After the merger, Multi-Plan performed poorly. In Spring 2021, several Class A shareholders filed suit alleging that Churchill failed to disclose a crucial piece of information in the proxy materials: Multi-Plan's largest customer (United Health Group) was developing an in-house platform that would deprive the Company of a large revenue source and create a direct competitor. Although the proxy statement mentioned that UnitedHealth Group Inc. represented roughly 35% of Multi-Plan's revenue, it did not disclose that it would soon become a direct competitor. The Class A shareholders sued in Delaware Chancery Court, alleging that the directors, officers, and other fiduciaries of the SPAC violated their duties to the shareholders and that the SPAC's failure to disclose this fact hindered the shareholders' ability to exercise their redemption rights. At the heart of the lawsuit was the alleged conflict between the sponsors—who would lose their entire investment without a merger—and the company's common shareholders.

Importantly, the plaintiffs argued that the Chancery Court had to analyze all aspects of the transaction for fairness, rather than merely asking whether the Company acted reasonably and in good faith. This argument set up a central question for how SPACs' insiders' decisions will be judged in the future: whether the conflicts that often accompany SPACs' preferential structure for sponsors would subject them to increased judicial scrutiny.

Don't Rush to (Business) Judgment

The Chancery Court summarized the legal question before it as whether "the defendants breached their fiduciary duties by prioritizing their personal interests above the interests of Class A stockholders in pursuing the merger and by issuing a false and misleading proxy, harming stockholders who could not exercise their redemption rights on an informed basis." Central to the dispute was whether the "business judgment rule" applied. Under the business judgment rule, a corporation's board is presumed to have been informed, acted in good faith, and with the honest belief that the action

was taken in the best interest of the corporation. Under the business judgment rule, courts are hesitant to substitute their own judgment for that of the corporation's board of directors. If reason to doubt the independence of a corporation's board exists, however, Delaware courts look more carefully at the details of the transaction and apply the "entire fairness standard." Under this "entire fairness standard," the burden is flipped—the corporation must show that the transaction was fair.

The plaintiffs in *In re Multi-Plan* argued that the more rigorous entire fairness standard applied because the merger, including the Class B redemption rights, constituted a conflicted transaction. For the sponsors who held the Class B shares, even a deal that negatively impacted the Company's stock price was preferable to no deal at all. In a feature that is characteristic of many SPACs, the failure to enter into a merger before the sunset period meant dissolution of the SPAC and huge losses for the sponsors. Defendants, meanwhile, argued that the sponsors' economic incentives—*i.e.*, their redemption rights—were disclosed in the IPO prospectus, such that the shareholders could not cry foul when the sponsors acted on those incentives. In essence, the defendants asserted that because they disclosed the structure of the SPAC, the fact that the sponsors later took advantage of that structure was not a conflict of interest.

The Chancery Court rejected the defendants' argument. What mattered to the shareholders, the court reasoned, was not just that the sponsors disclose the SPACs' structure, but that shareholders knew the relevant information about the transaction when it came time to decide whether to exercise their redemption rights:

> In this case, the structure of the SPAC . . . [was] disclosed in the [IPO] prospectus but the transaction at issue was not. Public stockholders who invested in Churchill agreed to give the Sponsor an opportunity to look for a target company with the understanding that they retained an option to make a redemption decision. They did not, however, agree that they did not require all material information when the time came to make that choice.

Furthermore, the court concluded that the Class B shareholders received a "unique benefit" not afforded to the investing public. By virtue of the merger, the court observed, the Class B shareholders avoided the worst outcome for their financial interest—the failure to enter a business combination and the dissolution of the SPAC.

Next, the Chancery Court determined that the SPAC's board itself was conflicted. The court determined that Churchill's board either was self-interested in the merger with Multi-Plan or had prior connections with one of Churchill's founders and the SPAC's largest shareholder.

As a result, the Chancery Court held that it would analyze the plaintiffs' claims under the entire fairness standard, leaving it to the SPAC to show that the deal was fair as a matter of law.

All Isn't Fair in Love and SPACs

Having decided that the entire fairness standard, not the business judgment rule, provided the appropriate analytical framework, the Chancery Court then applied it. Taking as true the plaintiffs' claims—as is required on a motion to dismiss—the Chancery Court had little trouble finding that the plaintiffs had stated a claim for breach of fiduciary duty

against the SPAC. Of central importance was the plaintiffs' allegation that the SPAC withheld material information about the merger that would have allowed the shareholders to exercise their redemption rights. Thus, the plaintiffs survived the motion to dismiss not merely because the SPAC's sponsors allegedly had conflicts of interest or would stand to benefit from the merger, but because of the combination of the conflicts in the SPAC's structure, in the transaction itself, and the failure of the sponsors to disclose material information.

The Chancery Court was careful to limit its ruling to the facts before it, where there were conflicted SPAC insiders who also failed to fully inform other investors. Indeed, the court clarified that

> [t]he core, direct harm presented in this case concerns the impairment of stockholder redemption rights. If public stockholders, in possession of all material information about the target, had chosen to invest rather than redeem, one can imagine a different outcome.

SPACs After *In re Multi-Plan*

Although *In re Multi-Plan* addressed only the sufficiency of plaintiffs' pleading, the decision signals an important development for the liability regime that SPACs will have to navigate going forward. It also echoes positions that have been raised by regulators at the SEC regarding the importance of transparency from SPACs' sponsors and directors, suggesting that SPACs will face pressure from both the Government and private litigants along the same lines.

The Chancery Court's opinion offers several takeaways. First, the application of the entire fairness standard shows that SPACs that are haled into court will have to show that their boards were either not conflicted or that they disclosed those conflicts to investors. Another important legal outcome of *In re Multi-Plan* is the Chancery Court's holding that the plaintiffs' claims were direct claims rather than so-called derivative claims because the plaintiffs' claimed injury concerned the redemption rights in their shares—*i.e.*, the plaintiffs' alleged harm to themselves, not merely harm to the Company. Derivative claims face a number of procedural hurdles before they can be brought to court. Because the kinds of redemption rights at issue in *In re Multi-Plan* are common in SPACs, the decision suggests that many SPAC investors will be able to assert direct claims, easing the path to litigation.

Additionally, the decision offers practical lessons for SPACs that could help them avoid litigation if the business combination goes south. Most obviously, SPAC sponsors should carefully consider whether their boards have existing financial or personal interests in the SPAC or other connections to the sponsor. Any relationship that could compromise the independence of the board should clearly be disclosed in connection with the business combination. SPACs that do have conflicted board members might preemptively seek out a fairness opinion from a qualified financial advisor to rebut claims from the public shareholders that the deal is not beneficial to the company. Lastly, "due diligence" and "disclosure" are likely to be key for courts addressing similar claims in the future. The Chancery Court made clear that Churchill's failure to disclose material information about Multi-Plan's prospects was central to its ruling. Thus, even SPACs that have some conflicted board members might avoid costly litigation if they perform the necessary leg work to inform their shareholders of the risks of the merger.

The SEC Makes its Move on SPACs with Proposed Rule

After months of keeping the investing public on the edge of its seat, on March 30, 2022 the SEC issued its long-awaited proposed rules for SPACs. Broadly, the proposed rules target two issues that have long been on the SEC's radar: (1) preferential treatment for SPAC sponsors, and (2) the disclosure obligations of a SPAC for IPOs and mergers. The agency's formal justification for the proposed rules is to "to improve the usefulness and clarity of the information provided to investors" and "to enhance investor protections" at every stage of a SPAC. Behind those bromides, however, is a more concrete goal: to make SPACs behave more like companies undergoing a traditional IPO. Some of these proposed rules reflect recently articulated SEC priorities such as reducing and exposing conflicts of interests, increasing transparency in SPAC IPOs and mergers, and ensuring that SPACs are not immune from liability for false or misleading statements.

Seeking (Dis)closure

The SEC has been consistent in its messaging around SPACs that a truncated IPO is not an excuse to hide information, nor does it relieve the SPAC's sponsors of their duties to conduct adequate due diligence and make appropriate disclosures. In the proposed rulemaking, the SEC attempts to leverage disclosure obligations to address some of the informational problems that are unique to SPACs, such as the roles of SPAC insiders. For instance, SPACs would be required to disclose their sponsors,' affiliates,' and promoters' experience, background, and responsibilities in addition to any conflicts of interest those insiders might have with normal shareholders of the SPAC and fiduciary duties that the SPAC's officers or directors owe to other companies.

Other disclosure requirements would make the SPAC clearly and prominently set forth the details and potential consequences of a business combination for shareholders. For example, the SEC is proposing that on the cover page of any prospectus, the SPAC would need to disclose its timeframe for completing a merger, the compensation of sponsors, and any potential dilution of the stock of existing shareholders. When the SPAC issues a registration statement for a proposed business combination, the SPAC would be required to include a statement about the fairness of the merger, whether any related financing transactions are fair for public investors, and make clear whether the SPAC has received an outside opinion about the fairness of the transaction.

The SEC's proposed disclosure enhancements did not stop there, however. The agency also proposed rules that would align the requirements of SPACs with those of companies going through a traditional IPO. Some of these changes are already commonplace. For example, the SPAC would have to disclose information about the target company before closing the de-SPAC transaction, such as a description of its business, relevant legal proceedings, securities owned by some beneficial owners and management, and recent transactions of unregistered securities. SPACs often disclose this information already in the registration statements that accompany de-SPAC transactions, making the proposed rule a formalization of existing practice.

A more radical feature of the proposed rule, however, would close a loophole that SPACs had used to relieve themselves of certain disclosure requirements associated with a traditional IPO, regardless of the size of the company after the de-SPAC transaction. Currently, nearly all SPACs are able to take advantage of relaxed reporting requirements imposed on entities that qualify as "Smaller Reporting Companies" under Regulation S-K, regardless of how big the target company is. SPACs are able to do this because, unlike companies that undergo a traditional IPO, SPACs currently are permitted to utilize the revenue (or lack thereof) of the SPAC (which is, by design, often nothing) for a year after the de-SPAC transaction for purposes of determining how much and what information the company has to disclose to regulators and the public. The proposed rule eliminates this delayed revenue reporting. Under the proposed rule, SPACs would have to re-test their revenue immediately after completing the de-SPAC transaction and update their status on the next periodic reporting statement. Accordingly, the SPAC could not delay the rigorous reporting obligations that would normally be imposed on a company of similar size.

Better Safe (Harbor) Than Sorry

Other efforts in the proposed rule to make SPACs look like traditional IPOs are also significant. Notably, the proposed rule expands the potential liability for a host of actors involved in SPACs. For instance, the SEC proposes a new Rule 140a under the Securities Act of 1934, which would expand the scope of liability for those who participate in the de-SPAC transaction. To begin with, the proposed rule takes a broad view of who can be deemed and underwriter of a SPAC, defining an underwriter as any entity that "takes steps to facilitate the de-SPAC transaction, or any related financing transaction, or otherwise participates (directly or indirectly) in the de-SPAC transaction." More specifically, the SEC noted that "financial advisors, PIPE investors, or other advisors, depending on the circumstances, may be deemed statutory underwriters in connection with a de-SPAC transaction." Likewise, the SEC proposes to include target companies and their officers and directors as co-registrants in Form S-4 and Form F-4 filings, meaning that these actors could be swept up in litigation over the material facts or omissions in those filings.

Bringing liability to the doorstep of new actors, along with the SEC's recent and well-publicized aggressive approach to enforcement, appears to broaden the regulatory risk to a greater number of participants in a de-SPAC transaction. Indeed, a major consequence of the proposed rule is that investment banks, which typically are able to perform less thorough due diligence when underwriting a de-SPAC transaction (as compared to a traditional IPO), might require the implementation of substantial additional due diligence processes by third parties, undermining one of the perceived benefits of the SPAC process

Perhaps most importantly, the proposed rule would remove forward-looking statements about the de-SPAC transaction from the PSLRA's safe-harbor provision. Previously, SPACs could credibly claim that they fell under the exceptions to liability for misstatements in their marketing materials because they were not a "blank-check company" issuing penny stocks. The proposed rule clarifies that SPACs cannot evade private securities actions for misrepresentations in their marketing materials simply by not offering penny stocks. If enacted, the proposed rule would revise the PSLRA safe harbor such that SPACs were no longer safe from liability for the things they say about a target company. Although it remains unclear how the specter of liability could affect—or even eliminate—projections used in SPAC marketing materials, it is evident that the SEC would like to rein in the freewheeling nature of SPACs hitting the market.

Time Flies When You're a SPAC

SPACs have faced criticism in private litigation that they are not SPACs at all, but are simply investment companies in SPAC clothing. Investors in various SPACs have alleged that the companies' structure makes them investment companies, whose business and structure bring them under the ambit of the Investment Companies Act of 1940 ("ICA"). Companies governed by the ICA must comply with a bevy of regulations and disclosure requirements regarding their businesses and operations. For instance, the ICA regulates how advisers can be compensated, prevents certain transactions between advisers and the issuer, and dictates board compensation and the contents of the fund's portfolio. Many of the regulations to which investment companies are subject would run counter to the structure and compensation arrangements of SPACs, which often pay a premium price for premium leadership.

Although the idea that SPACs are merely serving as investment companies in disguise previously was limited to private plaintiffs, the proposed rules, however, would narrow SPACs ability to enjoy ICA exemption. The proposed rules contemplate requirements enabling SPACs to avoid having to comply with the ICA, but many of those may undermine the benefits SPACs are perceived to provide. For example, SPACs that are not investment companies would have to keep their money in certain kinds of assets—namely, U.S. Government securities and money market funds invested in U.S. Government securities. The SEC's proposed rule also prompts SPACs to accelerate the business combination timeline. Moreover, the rule would also require that after the SPAC merged with the target company, its would have to be "primarily engaged in the business of the target company or companies."

The SEC also indicated that the behavior of the SPAC's management and board would be important in determining whether it was an investment company. The more a SPAC's management and employees are focused on managing a securities portfolio and less on finding a target company, the less likely it could avoid the requirements of the ICA.

SPACs' Chance to Weigh In

The proposed rule is just that—a proposal. In the next phase, members of the public, including those involved with SPACs will have an opportunity to comment on the proposal. Because of the complexity of the issues involved, it could be months or longer before SPACs will know the final form of the SEC's new legal regime. What is clear now, however, is that the agency is determined to wield its regulatory powers to curtail what it believes to be are deficiencies in the way that SPACs operate currently, thereby undermining some of the very benefits for those who support SPACs.

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