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SPACs experience slowdown after increased SEC attention, but will it last?

Special purpose acquisition companies, or SPACs, exploded in popularity in 2021. Although SPAC activity spiked in the first quarter of 2021, with the issuance of 298 SPACs raising approximately $88 billion in capital,[1] the market slowed significantly, but remained robust, in the second quarter with 60 SPACs raising $12.8 billion.[2] According to SPACTrack, as of July 27, 2021, there were 570 active SPACs looking for target companies to acquire, with approximately $170 billion in capital at the ready. Although the SPAC frenzy has cooled significantly in recent months as the Securities and Exchange Commission ("SEC") has issued multiple alerts, statements and guidance, including guidance regarding the accounting treatment of warrants, it is not clear that a similar cooling of SPAC-related litigation will result.

Though around for decades, demand for SPACs, also known as blank check companies, has re-emerged over the last few years. A SPAC is a public shell company that has no operations with the sole purpose to acquire a private company, typically within an 18 to 24-month window. A business combination with a SPAC presents private companies an alternative path to going public rather than through a traditional Initial Public Offering ("IPO"). SPACs have been touted as a way for private companies to go public in a shorter amount of time with more certainty than a traditional IPO, while allowing retail investors increased access to newly public companies.

However, SPACs have also faced criticism based on the lack of an identified target company at the time of the SPAC IPO, as well as the payment structure for the SPAC sponsors, which typically consists of 20% of the total offering, acquired for a nominal fee. Because the SPAC (the parent shell company) is typically required to be liquidated if a business combination is not completed within the specified time period, the structure of SPACs has come under criticism as presenting an inherent conflict of interest between the founders/sponsors and the public shareholders due to the financial incentives to complete a deal.

From December 2020 to April 2021, the SEC has issued a number of alerts, bulletins and guidance with respect to SPACs. On December 10, 2020, the SEC issued an Investor Bulletin entitled "What You Need to Know About SPACs." This bulletin represented an opening salvo in the SEC's response to the increasing popularity and surge in SPAC registrations in 2020. This bulletin contains a general description of SPACs and is intended to inform investors of certain key features of a SPAC, including the "equity interests held by the sponsor, which may have been obtained for nominal consideration[,]" and the importance of reviewing the "business background of the SPAC management and its sponsors" because the SPAC does not have an operating history to evaluate.

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[1] https://www.businesswire.com/news/home/20210407005635/en/ICR-the-Leading-SPAC-Advisor-Publishes-Q1-2021-SPAC-Market-Update

[2] https://www.businesswire.com/news/home/20210714005638/en/ICR-the-Leading-SPAC-Communications-and-Advisory-Firm-Publishes-Q2-2021-SPAC-Market-Update

The bulletin further explains other central features of SPACs, including a description of the trust account, the trading price, warrants[3], and the typical two-year period to consummate the initial business combination, and states that **"[w]ith an increasing number of SPACs seeking to acquire operating businesses, it is important to consider whether attractive initial business combinations will become scarcer."** (emphasis in original).

Shortly after the issuance of the investor bulletin, the SEC's Division of Corporation Finance issued guidance on SPAC disclosures on December 22, 2020. This SEC guidance is essentially a road map for plaintiff's counsel in examining SPAC disclosures for deficiencies.

The December 22 Guidance focuses primarily on the potential conflicts of interest between the entity or management team that forms the SPAC, as well as its directors, officers and affiliates and the economic interests of public shareholders. The guidance states that "[c]lear disclosure regarding these potential conflicts of interest and the nature of the sponsors', directors', officers' and affiliates' economic interests in the SPAC is particularly important because these parties are generally responsible for negotiating the SPAC's business combination."

In particular, the guidance also references disclosures necessary to clearly describe the financial incentives of SPAC sponsors, directors and officers in completing a business transaction, as well as information about the losses of sponsors, directors and officers that could occur if the SPAC does not complete a business transaction. The guidance discusses the terms of securities held by the sponsors, directors, officers and their affiliates and how the rights of those classes of securities compare to and differ from the rights and terms of securities offered in the IPO, as well as the resulting risks to public shareholders.

On March 10, 2021, the SEC issued an investor alert and bulletin, entitled "Celebrity Involvement with SPACs," cautioning investors not to make investment decisions related to SPACs based solely on celebrity involvement. The Wall Street Journal has reported that celebrities such as Shaq, Alex Rodriguez and Serena Williams are involved in SPACs.[4]

In particular, the SEC alert stated that "celebrity involvement in a SPAC does not mean that the investment in a particular SPAC or SPACs generally is appropriate for all investors. Celebrities, like anyone else, can be lured into participating in a risky investment or may be better able to sustain the risk of loss. ***It is never a good idea to invest in a SPAC just because someone famous sponsors or invests in it or says it is a good investment.***" (emphasis in original).

A March 31, 2020 public statement from Paul Munter, Acting Chief Accountant of the SEC, entitled "Financial Reporting and Auditing Considerations of Companies Merging with SPACs," identified "key considerations related to the unique risks and challenges of a private company entering the public markets through a merger with a SPAC," including market and timing considerations, financial reporting considerations, internal control considerations, corporate governance and audit

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[3] https://www.investopedia.com/terms/w/warrant.asp

[4] https://www.wsj.com/articles/the-celebrities-from-serena-williams-to-a-rod-fueling-the-spac-boom-11615973578?page=2; https://www.wsj.com/articles/sports-stars-think-they-got-game-in-spac-arena-11617622201?page=1.

committee considerations and auditor considerations. Given the typical 18-24 month timeframe to complete a business combination with a private company, the statement indicates that throughout the de-SPAC process (the stage after the execution of a definitive agreement and before the actual combination of the SPAC) [5], there are a number of complex issues that target companies encounter. Accordingly, it is "essential that target companies have a comprehensive plan in place to address the resulting demands of becoming a public company on an accelerated timeline" and that the combined public company "have a capable, experienced management team that understands" the reporting and internal control requirements and expectations for a public company.

On April 8, 2021, John Coates, Acting Director, Division of Corporation Finance, issued a Public Statement entitled "SPACs, IPOs and Liability Risk under the Securities Laws." The statement makes significant points regarding the safe-harbor provision of the Private Securities Litigation Reform Act ("PSLRA"), including that the safe-harbor: 1) only applies to private litigation and does not prevent the SEC from taking appropriate action to enforce securities laws; 2) does not apply to false or misleading statements made with actual knowledge that the statements were false or misleading; and, perhaps most significantly, 3) that it is "uncertain at best" that the PSLRA offers something for SPACs unavailable for traditional IPOs. Mr. Coates states that the PSLRA excludes from its safe-harbor "initial public offerings" and "**that phrase may include de-SPAC transactions.**" (emphasis added).

The Statement also notes that greater clarity on the scope of the PSLRA safe-harbor may be advantageous and that given the current wave of SPACs, it may be time to revisit these issues. For example, the Commission could use the rulemaking process to reconsider and recalibrate the applicable definitions, or the staff could provide guidance explaining its views on how the PSLRA safe-harbor should apply to de-SPACs.

Significantly, the Statement further notes that the de-SPAC transaction should be the focus of protection, explaining that: "**[i]f we do not treat the de-SPAC transaction as the "real IPO," our attention may be focused on the wrong place, and potentially problematic forward-looking information may be disseminated without appropriate safeguards**." (emphasis added).

On April 12, 2021, Mr. Coates and Paul Munter, Acting Chief Accountant, issued a Staff Statement on Accounting and Reporting Considerations for Warrants Issued by Special Purpose Acquisition Companies ("SPACs"). The statement indicated that in many circumstances, the SPAC warrants should be classified as liabilities. The statement further suggested the possibility of restating previously issued financial statements and assessing whether prior disclosures on the evaluation of internal controls over financial reporting and disclosure controls and procedures needs to be revised in the amended filings.

The SEC's guidance on the accounting treatment of warrants appears to have put the brakes on a "frothy" SPAC marketplace. At the end of April, CNBC reported that new SPAC IPOs slowed

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[5] https://www.gigcapitalglobal.com/de-spac-process-shareholder-approval-founder-vote-requirements-and-redemption-offer/

significantly. After 109 new SPAC IPOs issued in March 2021, there were only 10 new SPAC IPOs in April 2021[6]. In addition, as of June 22, 2021, 497 SPACs have restated their warrant reporting, with the majority correcting previously issued financial statements.[7] Of the SPACs that have issued restatements of their financials, almost all have reported that "weaknesses existed in their internal controls." In addition, there has already been at least one lawsuit filed regarding the restatement of financials due to the accounting treatment of warrants.[8]

Additional Indications of Regulatory/Legislative Action

In March 2021, the SEC issued letters to Wall Street banks asking them to voluntarily disclose information regarding their SPAC dealings.[9] On July 13, 2021, Reuters further reported that the SEC was focusing on the potential for conflicts of interest when banks act as underwriters and advisors on the same deal.[10]

In April 2021, Republican Senator John Kennedy from Louisiana introduced a bill aimed at boosting transparency for investors in SPACs. According to a press release issued on April 29, 2021 by Senator Kennedy's office, "[w]ithin 120 days of its enactment, the SPAC Act would require the SEC to issue rules on enhanced disclosures for SPACs during the initial public offering stage and the pre-merger stage to make those disclosures more transparent to investors, especially main street investors."[11]

In prepared remarks before the House Committee on Appropriations on May 26, 2021, SEC Chair Gensler indicated that issues related to SPACs was one of the five key capital market trends affecting the SEC's needs going forward, explaining that "[w]e are in the midst of a once-in-a-generation wave of traditional initial public offerings" and "an unprecedent[ed] surge in non-traditional IPOs by special purpose acquisition companies (SPACs)."[12] Chair Gensler noted that

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[6] https://www.cnbc.com/2021/04/21/spac-transactions-come-to-a-halt-amid-sec-crackdown-cooling-retail-investor-interest.html

[7] https://www.law360.com/securities/articles/1395957/will-spac-restatement-wave-trigger-shareholder-litigation- See also https://www.dandodiary.com/2021/06/articles/securities-litigation/will-spac-warrant-accounting-restatements-result-in-further-securities-class-action-litigation/. On July 2, 2021, the Wall Street Journal reported that 540 companies had restated their financial accounts in the past three months based on the SEC Guidance. https://www.wsj.com/articles/a-wave-of-earnings-restatements-slams-a-hot-market-11625218380?st=qygs0j6jpkf7i0q&reflink=article_email_share

[8] https://www.dandodiary.com/2021/05/articles/securities-litigation/virgin-galactic-hit-with-securities-suit-over-spac-warrant-accounting-issue/

[9] https://www.cnbc.com/2021/03/25/sec-opens-inquiry-into-wall-streets-blank-check-ipo-frenzy-reuters.html

[10] https://www.reuters.com/business/exclusive-us-sec-focuses-bank-fee-conflicts-it-steps-up-spac-inquiry-sources-2021-07-13/

[11] https://www.kennedy.senate.gov/public/2021/4/kennedy-introduces-spac-act-to-increase-transparency-surrounding-blank-check-companies

[12] https://www.sec.gov/news/testimony/gensler-2021-05-26

the SEC received 700 S-1 filings year-to-date seeking to go public, 300 having been completed so far in 2021, compared to 13 in all of 2016.

Chair Gensler further referenced a number of policy concerns raised by the surge of SPACs, including whether investors are appropriately protected and whether retail investors are getting appropriate and accurate information at each stage. He also questioned how SPACs fit into the SEC's mission to maintain fair, orderly and efficient markets, referencing a recent study purportedly showing that SPAC sponsors generate significant dilution and costs, that PIPE investors are able to buy at a discount to a post-target IPO price, with the retail public bearing the costs.

On July 13, 2021, the SEC brought its first enforcement action against a SPAC (at least during this latest period of SPAC activity) signifying that the SEC is willing to take a more active enforcement role.[13] Even though SPAC offerings have pulled back from their peak in Q1 2021, and increased regulatory enforcement should be anticipated, SPACs have remained robust and are likely to continue to normalize. Although potential Congressional action[14] and/or expected SEC rule-making may temporarily slow initial SPAC offerings and acquisitions, SPACs will continue to present another option for companies, especially earlier-stage growth companies, to access public capital markets other than through a traditional IPO or direct listing. The competition for bankers specializing in SPACs further indicates that SPACs are not going away and that an increase in initial offerings and deals may be on the horizon, although perhaps not on the levels previously seen in Q1 2021.[15]

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[13] https://www.sec.gov/news/press-release/2021-124. Chair Gensler was quoted as stating that the case "illustrates risks inherent to SPAC transactions, as those who stand to earn significant profits from a SPAC merger may conduct inadequate due diligence and mislead investors[.]"

[14] The U.S. House Committee on Financial Services has released draft legislation amending the Securities Act of 1933 and the Securities Exchange Act of 1934 to exclude SPACs from the safe-harbor provision for forward-looking statements.

[15] A July 6, 2021 Wall Street Journal article indicated that the head of Credit Suisse's team specializing in blank-check companies was being "courted by several firms," but decided to stay at Credit Suisse. It was not known what Credit Suisse offered to keep him. https://www.wsj.com/articles/more-credit-suisse-senior-bankers-depart-in-wake-of-archegos-loss-11625587510?page=1