

# Key Enforcement Risks For SPAC Parties Amid SEC Scrutiny

By **Nicole Rabner, Elizabeth Mitchell and Lorraine Echavarria** (April 2, 2021)

In the face of volatile markets and a global pandemic, an old capital markets vehicle has been taking the markets by storm: special purpose acquisition companies, or SPACs.

Although SPACs have been around for many years, the volume and profile of these deals have exploded in the past 12 months,[1] and regulator interest is expected to increase proportionately.

Indeed, the U.S. Securities and Exchange Commission has signaled that it intends to enhance its scrutiny of SPAC transactions and resulting public operating companies.

In late March, the SEC's Division of Enforcement reportedly sent requests to various financial institutions focused on their SPAC dealings.[2] According to press reports, these requests seek information about those firms' deal fees, deal volumes and internal controls related to SPACs.

On March 31, the SEC's Division of Corporation Finance and the Office of the Chief Accountant each issued statements underscoring the need for SPACs and the companies that enter the public markets by merging with a SPAC to meet their accounting, financial reporting and governance obligations as public companies.[3]

These developments likely foreshadow a wave of Enforcement Division inquiries assessing potential violations of the federal securities laws involving SPACs.

A SPAC is a company with no operations that offers securities for cash via an initial public offering and places substantially all of the offering proceeds into a trust account to fund the future acquisition of one or more private operating companies.

In connection with the SPAC's IPO, its securities are listed on an exchange and publicly traded on the secondary market while the SPAC looks for its acquisition target. SPACs have a specified time frame in which they must acquire a private company, typically two years.

SPAC shareholders have the choice either to remain a shareholder of the company after the SPAC's business combination with the private company — referred to as the de-SPACing transaction — or instead to redeem their shares and receive a pro rata share of the funds held in the trust.

Upon the completion of the de-SPACing transaction, the acquired company becomes public through its business combination with the public SPAC entity; at that time, the previously private operating company must meet all SEC requirements for public companies, including for robust financial reporting and disclosure.

If an acquisition does not occur within the applicable period, the trust is liquidated and the net offering proceeds plus interest are returned to shareholders.

SPACs offer important benefits to the capital markets, but they also present unique risks for investors that we expect the staff of the Enforcement Division to scrutinize. In this article,



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we discuss areas of expected enforcement focus as the Enforcement Division dials up its attention on SPACs.

### **Enforcement Risks for SPAC Sponsors**

The most significant enforcement risk arises from allegations of inadequate disclosures, with SPAC sponsors on the front line. The SPAC sponsor is the entity establishing a management team and forming the SPAC, a role played by hedge fund managers, investment banks, private equity firms, venture capital firms and institutional asset managers, among others.

Sponsors contribute their investment and operational expertise and typically provide a portion of the capital that is used to pay IPO and ongoing expenses while the SPAC seeks an acquisition. In return, sponsors have significant control over their SPACs and seek to gain significant upside from an eventual business combination transaction.

The sponsor is expected to provide full and fair disclosure regarding potential risks, conflicts of interest, and other material facts related to each proposed transaction. This includes disclosures made during the IPO and in the proxy statements and registration statements describing the initial business combination.

The Division of Corporation Finance staff has indicated that it will be closely scrutinizing sponsor disclosures regarding conflicts of interest, given that the economic interests of SPAC sponsors, directors and officers are not the same as, and can be at odds with, those of SPAC investors.[4]

We expect the Enforcement Division staff likewise will scrutinize the adequacy of disclosure in offering documents, including on the following topics:

- The SPAC sponsors' obligations and allegiances to parties other than the SPAC and how those allegiances may affect their evaluation of a business combination, for example, relationships between the SPAC and target company and relationships between SPAC management and target management or any private investors;
- The economic interests of SPAC sponsors, especially their incentives to complete an acquisition within the specified time period, and their potential losses if one is not completed;
- The control that the SPAC's sponsors, directors, officers and their affiliates have over approval of a business combination transaction;
- The material economic terms of the securities held by a SPAC's sponsors, directors, officers and affiliates, which can differ from — and potentially dilute the value of — the securities held by public shareholders; and
- The degree to which additional funding, including from the sponsors or their affiliates — such as other funds managed by the SPAC sponsors or their principals — may dilute shareholders' interest in the combined company or may be provided in the form of a loan or security that has different rights from those of common shareholders.[5]

We anticipate the Division of Enforcement also will scrutinize generally whether the merger proxy or registration statement contains adequate disclosure about the contemplated business combination for SPAC shareholders to make informed decisions, both on whether to approve the transaction and on whether to redeem their shares.

Unlike in a traditional IPO, where the market values the private company, in a de-SPACing transaction, the sponsor plays a significant role in determining the value of the target private company and deciding how much the SPAC will pay for it.

The SEC likely will examine the basis for recommending the particular business combination, including valuation assessments, financial projections and statements about a target's expected future prospects, and descriptions of the due diligence performed on the target company.

The Enforcement Division staff also will likely 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 likely will pay particular attention to whether those assumptions have been vetted and whether the risks have been adequately described.

It is worth noting that it is uncommon for SPACs to receive fairness opinions on the valuations of the targets. In terms of prioritization, we expect the Enforcement Division staff will focus on instances where the acquired company subsequently suffered material performance losses, both where the target company was relatively immature and thus had little history of financial performance and operation, and where the target was well established and backed by well-known private equity companies.

In addition, certain SPACs are associated with high-profile figures, including former politicians and athletes, either as part of the management team or as investors offering their endorsements.

The SEC has made it clear that these arrangements, including payment for promotional activities or testimonials, must be adequately disclosed. The SEC's Office of Investor Education and Advocacy issued an investor alert earlier this month cautioning investors regarding the risks of investing in SPACs due to celebrity backing.[6]

This alert was similar to a November 2017 SEC release about risks associated with celebrity-backed initial coin offerings, which was a precursor to multiple enforcement actions related to celebrities touting ICOs.[7]

We expect Enforcement Division staff to scrutinize SPACs associated with celebrities to assure that any arrangements to compensate them for their role and endorsements are fully and fairly disclosed. We also anticipate the Enforcement Division staff will focus on the risk disclosures relating to the role, background and experience of celebrities identified as principals or otherwise associated with SPACs.

### **Enforcement Risks for the Combined Public Company**

The SEC staff statements issued March 31 foreshadow that Enforcement Division staff also will scrutinize whether the post-merger public operating company is abiding by the myriad rules and regulations governing public companies and intended to offer investor protection.[8]

These statements emphasized that, as of the merger, the combined public company must have the necessary personnel, processes and controls in place to produce high-quality financial reporting, comply with disclosure requirements and operate with effective board oversight.[9]

We expect Enforcement Division staff to probe whether these combined public companies

have implemented reasonable systems of internal controls over financial reporting and disclosure, maintain adequate books and records, and have effective corporate board oversight, including by the audit committee.

The Enforcement Division staff will likely focus on situations where the de-SPAC company fails to meet reporting deadlines, adhere to SEC reporting rules and disclosure requirements, or adopt the accounting standards required of a public company.

We also anticipate Enforcement Division staff will scrutinize the strength of the external audit process and auditor independence in de-SPAC mergers.

### **Enforcement Risks for Underwriters and Broker-Dealer Distributors of SPACs**

Recent press reports on requests for information made by the Enforcement Division suggest that underwriters of SPAC IPOs, investment bankers to SPACs and targets, and private investment in public equity, or PIPE, placement agents will also be a focus of the SEC and the Financial Industry Regulatory Authority's scrutiny. The SEC and FINRA view these intermediaries as fulfilling important gatekeeping roles.

The SEC is likely to evaluate potential misrepresentations and omissions in offering documents, road show and investor presentation materials, and other disclosures on topics such as fees associated with SPAC transactions and control of funds raised in SPAC offerings.

We expect the Enforcement Division staff to evaluate whether broker-dealers have taken reasonable steps to monitor the materials used by firms to assure that they provide an accurate and balanced description of the offering.[10]

Relatedly, in February, FINRA identified risks related to SPACs among the emerging anti-money laundering and financial crime risks that it highlighted for the industry.[11]

FINRA noted that some firms have been engaging in the formation and IPO of SPACs without written supervisory procedures requiring member firms to "independently [conduct] due diligence" of SPAC sponsors and address other fraud risks, such as representations about the target company's financial condition and prospects.[12] We expect FINRA to make this area a priority in its own risk monitoring and enforcement program.

Further, we note that the SEC wields new authority for any recommendations made by broker-dealers to retail customers under the SEC's new Regulation Best Interest.[13]

Regulation Best Interest's care obligation requires broker-dealers and their associated persons, in making recommendations to retail customers, as defined, to exercise reasonable diligence, care and skill to, among other things, have a reasonable basis to believe that the recommendation is in the best interest of a particular retail customer based on that retail customer's investment profile and the potential risks, rewards and costs associated with the recommendation and does not place the financial or other interest of the broker, dealer or such natural person ahead of the interest of the retail customer.[14]

Regulation Best Interest also requires broker-dealers and their associated persons to disclose all material conflicts of interest associated with a transaction.[15] We expect the SEC's Division of Examinations and Enforcement Division staff to evaluate whether recommendations to retail customers to invest in SPACs satisfy the Regulation Best Interest requirement.

Finally, we expect broker-dealers in multiservice firms to face Enforcement Division inquiries

related to potential coinvestment in the different stages and levels of the capital structure involving affiliated invested investment companies and investment advisers.[16]

### **Potential Insider Trading Inquiries**

The Enforcement Division staff also can be expected to look for unusual trading patterns that could indicate leaks of material nonpublic information in the context of SPAC deals.

Directors, management and employees of the sponsor likely possess material nonpublic information at various stages of their search for an acquisition, and it is common for SPAC sponsors to be negotiating with the SPAC's business combination target and simultaneously marketing the SPAC's PIPE confidentially.

Likewise, directors, managers and employees of the target will often have material nonpublic information with respect to a potential business combination transaction with a SPAC in which they are involved, and underwriters may possess such information during diligence, underwriting and financial advisory activities. We expect these circumstances to give rise to potentially complicated insider trading probes.

The recent information requests made by the Enforcement Division to financial institutions and statements by the Division of Corporation Finance and Office of the Chief Accountant foreshadow that significant regulator attention will be devoted to SPAC transactions and the resulting public operating companies.

With the explosion in the profile and volume of SPACs, we expect the SEC will devote significant time to examining each stage of a SPAC transaction and every type of participant in these deals.

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[1] SPACs have been around since the early 1990s, but their popularity has grown in an extraordinary fashion recently. SPAC IPOs have surged globally, to a record \$80 billion of new issuance activity in the first 10 weeks of 2021, the vast majority in the United States. That volume has already eclipsed the record \$79 billion in gross proceeds raised by IPOs of such vehicles in 2020. See Ortenca Aliaj & Patrick Temple-West, "SEC questions bank over their work with SPACs," Financial Times (Mar. 25, 2021), available at <https://www.ft.com/content/3bb219a1-e56b-4c0b-990a-b5d2f9e92a03>.

[2] Jody Godoy, Chris Prentice, "U.S. Regulator opens inquiry into Wall Street's blank check IPO frenzy," Reuters (Mar. 24, 2021), available at <https://www.reuters.com/article/us-usa-sec-spacs-exclusive/exclusive-u-s-regulator-opens-inquiry-into-wall-streets-blank-check-ipo-frenzy-sources-idUSKBN2BH09F?il=0>.

[3] "Staff Statement on Select Issues Pertaining to Special Purpose Acquisition Companies," Division of Corporation Finance (Mar. 31, 2021) ("Corporation Finance March SPAC

Statement"), available at [https://www.sec.gov/news/public-statement/division-cf-spac-2021-03-31?utm\\_medium=email&utm\\_source=govdelivery](https://www.sec.gov/news/public-statement/division-cf-spac-2021-03-31?utm_medium=email&utm_source=govdelivery); "Financial Reporting and Auditing Considerations of Companies Merging with SPACs," Statement of Paul Munter, Acting Chief Accountant (Mar. 31, 2021) ("Munter Statement"), available at <https://www.sec.gov/news/public-statement/munter-spac-20200331>.

[4] "Special Purpose Acquisition Companies," Division of Corporation Finance (Dec. 22, 2020), available at <https://www.sec.gov/corpfin/disclosure-special-purpose-acquisition-companies>.

[5] Likewise, it is possible that investment management firms, such as hedge fund managers, that sponsor SPACs or that have ties to SPAC sponsors could be scrutinized to the extent that the funds they manage participate in SPAC investments that benefit affiliated SPAC sponsors. Participation can take the form of forward-purchase transactions, PIPE transactions, SPAC IPOs, acquisitions of SPAC shares in the secondary market, and other arrangements.

[6] "Celebrity Involvement with SPACs," Office of Investor Education and Advocacy (Mar. 10, 2021), available at <https://www.sec.gov/oiea/investor-alerts-and-bulletins/celebrity-involvement-spacs-investor-alert>.

[7] "Statement Urging Caution Around Celebrity Backed ICOs, Division of Enforcement and Office of Inspections and Examinations" (Nov. 1, 2017). See also *In the Matter of Floyd Mayweather Jr.*, Securities Act Rel. No. 10578 (Nov. 29, 2018); *In the Matter of Lhaled Khaled*, Securities Act Rel. No. 10579 (Nov. 29, 2018).

[8] Corporation Finance March SPAC Statement & Munter Statement, *supra* note 3.

[9] *Id.*

[10] See Regulatory Notice 08-54, FINRA (Oct. 2008) available at <https://www.finra.org/sites/default/files/NoticeDocument/p117208.pdf>.

[11] "2021 Report on FINRA's Examination and Risk Monitoring Program," FINRA (Feb. 2021), available at <https://www.finra.org/sites/default/files/2021-02/2021-report-finras-examination-risk-monitoring-program.pdf>.

[12] *Id.*

[13] See Exchange Act Rule 15I-1.

[14] Exchange Act Rule 15I-1 (a)(2)(ii).

[15] Exchange Act Rule 15I-1(a)(2)(i)(B).

[16] See e.g., Sections 17(a) and 17(d) of the Investment Company Act.