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Analysis of Recent SEC Disclosure Guidance Regarding Special Purpose Acquisition Companies

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The SEC recently promulgated guidance urging special purpose acquisition companies (“SPACs”) to provide increased and more robust disclosures, both at the time of a SPAC’s initial public offering (“IPO”) as well as when a SPAC enters into a business combination transaction.[1] In particular, the SEC has identified areas where the interests of SPAC sponsors, directors and officers may not directly align with SPAC shareholders meriting more fulsome disclosures.

The following provides a brief summary of the SEC’s recent guidance.

I. BACKGROUND

SPACs are formed by sponsors in order to raise funds through an IPO with the express purpose of using the funds to complete one or more business combination transactions. Once the SPAC completes such a business combination transaction, the combined entity continues as a public company, without the acquired company having conducted its own IPO.

The funds raised through the SPAC IPO are held in trust until the business combination transaction occurs. If the SPAC fails to complete a business combination transaction within a specified amount of time, typically 18–24 months, the trust proceeds are returned to the public shareholders. Public shareholders in the SPAC will also be offered the opportunity to redeem their common shares at the time of the business combination for their pro rata share of the money in the trust.

Sponsors are typically compensated through receipt of a percentage of SPAC shares (typically 20% of the post-IPO outstanding common shares giving effect to the issuance of the sponsor promote shares) in exchange for a nominal investment. The sponsor is not able to access the trust proceeds in exchange for the sponsor shares, meaning that the sponsor shares only have value if a business combination is consummated. In connection with a SPAC IPO, sponsors will also typically make a significant investment of capital (“at risk” capital), which investment will likewise only have value if a business combination is consummated, which may also influence the behavior of sponsors. The disparate effects of the failure to enter into a business combination transaction may lead to divergent interests between a SPAC’s sponsors and its public shareholders.

We have seen an explosion in SPAC activity in 2020 with approximately 250 IPOs raising nearly $83 billion (compared to approximately 60 IPOs and $13.6 billion for 2019). It is against this backdrop that the SEC issued its disclosure guidance, which closely folloed an investor bulletin educating public shareholders about SPACs.[2]

II. GUIDANCE REGARDING DISCLOSURES AT TIME OF IPO

In the guidance, the SEC encourages SPACs to include robust disclosures at the time of its IPO on a number of topics, particularly in areas where SPAC public shareholders’ interests may diverge from, or conflict with, the interests of SPAC sponsors, directors or officers.

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[1] SEC’s Division of Corporate Finance, CF Disclosure Guidance: Topic No. 11, Special Purpose Acquisition Companies (Dec. 22, 2020), available at: https://www.sec.gov/corpfin/disclosure-special-purpose-acquisition-companies#_ednref2.
[2] SEC’s Office of Inspector Education and Advocacy, What You Need to Know About SPACs – Investor Bulletin (Dec. 10, 2020), available at: https://www.sec.gov/oiea/investor-alerts-and-bulletins/what-you-need-know-about-spacs-investor-bulletin.

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Oftentimes, SPAC sponsors, directors and officers do not work exclusively on behalf of the SPAC and have fiduciary or contractual obligations to other entities. There may therefore be instances where these other entities compete with the SPAC or have conflicting interests. Accordingly, the SEC has encouraged SPACs to disclose:

- The sponsors', directors' and officers' potential conflicts of interest;
- Whether any conflicts relating to other business activities include fiduciary or contractual obligations; how these activities may affect the ability of sponsors, directors and officers to evaluate and present a potential business combination opportunity to the SPAC and its shareholders; and how any potential conflicts will be addressed; and
- Whether the SPAC may pursue a business combination with a target in which sponsors, directors, or officers have an interest, and if so, how the SPAC will consider potential conflicts of interest.

SPAC sponsors, directors and officers often have financial incentives that differ from public shareholders. Accordingly, the SEC has encouraged SPACs to disclose:

- The securities owned by sponsors, directors, and officers including the price paid for the securities and how that price compares to the public offering price in the IPO;
- A description of any concurrent offering of securities to the sponsors and their affiliates, the amount of those securities, the price to be paid and how that price compares to the public offering price in the IPO;
- A description of the conflicts of interest that result from sponsors', directors', and officers' securities ownership, compensation arrangements or relationships with affiliated entities that may create financial incentives to complete a business combination transaction even if the transaction may not be in the best interest of other shareholders; and
- Whether and how sponsors, directors, and officers may be compensated for services to the SPAC, including whether any payments will be contingent on the completion of a business combination transaction and the amount of any such contingent payments.

A SPAC typically must liquidate and distribute pro rata the net offering proceeds held in trust to its public shareholders if it does not complete a business combination transaction within the specified time frame. As the deadline approaches, sponsors, directors, and officers may face increased pressure to complete a business combination transaction to avoid losing their investment, providing acquisition targets with significant leverage. Accordingly, the SEC has encouraged SPACs to disclose:

- The financial incentives of SPAC sponsors, directors and officers to complete a business combination transaction, including how they differ from the interests of the public shareholders, and information about the losses the sponsors, directors and officers could incur if the SPAC does not complete a business combination transaction;
- The amount of control that SPAC sponsors, directors and officers and their affiliates will have over approval of a business combination transaction;
- Whether, and if so how, the SPAC may amend provisions in its governing instruments to facilitate the completion of a business combination transaction, including whether shareholder approval is required, and if so, the requisite voting standard for approval and whether the sponsors have sufficient voting power to approve it;

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- Whether, and if so how, the SPAC may extend the time it has to complete a business combination transaction, including whether shareholders may redeem their shares in connection with any proposal to extend the time period; and

- If applicable, a balanced disclosure about the SPAC sponsors', directors', and officers' prior SPAC experience, including the outcome of presented and completed business combination transactions and liquidations.

SPAC securities issued to sponsors often differ from the securities issued to public shareholders that give sponsors substantial control over the SPAC. SPACs may also raise capital by selling securities in private offerings with terms that differ from the shares sold in the IPO. Accordingly, the SEC has encouraged SPACs to disclose:

- The terms of securities held by sponsors, directors and officers, including 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;

- The material terms of any convertible debt held by the sponsors, directors and officers, including when the debt is convertible, the maximum number of securities they may acquire through conversion and any contingencies on conversion;

- Whether the SPAC plans to seek, or has obtained, additional funding, how the terms of securities issued or to be issued in private offerings compare to the terms of securities offered in the IPO, and whether the sponsors, directors and officers may participate in or have an interest with respect to such financing; and

- Whether the SPAC has entered into a forward purchase agreement allowing the purchaser to invest in the SPAC at the time of a business combination transaction, and if so, a clear description of the terms of the agreement, including whether the forward purchaser's commitment to purchase the securities is irrevocable, and any potential dilutive impact on other shareholders.

III. DISCLOSURES RELATING TO A BUSINESS COMBINATION TRANSACTION

In the guidance, the SEC also encourages SPACs to include robust disclosures regarding a business combination transaction. In particular, given that additional financing may be necessary to help finance the transaction, the SEC has encouraged SPACs to disclose:

- Any additional financing necessary to complete the business combination transaction and how the terms of such financing may impact public shareholders;

- If the terms of additional financing involve the issuance of securities, how the price and terms of those securities compare to and differ from the price and terms of the securities sold in the IPO;

- Whether sponsors, directors and officers are participating in any additional financing; and

- If convertible securities will be issued, the material terms for conversion and any material impact on the beneficial ownership of the combined company.

Because SPAC sponsors, directors and officers may have evaluated a number of potential acquisition candidates before presenting a business combination transaction to public shareholders, the SEC has encouraged SPACs to disclose:

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- Detailed information about how it evaluated and decided to propose the identified transaction, including why the target company was selected as opposed to alternative candidates and who initiated contact, including what material factors the board of directors considered in its determination to approve the transaction;
- How the nature and amount of consideration the SPAC will pay to acquire the target was determined, including a clear description of the negotiations regarding the amount of consideration and a clear explanation of all material terms of the transaction;
- A clear description of any conflicts of interest of the sponsors, directors and officers in presenting this opportunity to the SPAC, how the SPAC addressed these conflicts of interest, and how the board of directors evaluated the interests of sponsors, directors and officers;
- Whether the sponsors, directors and officers have an interest in the acquisition target, including, if material, the approximate dollar value of any such interest and when the interest was acquired and the price paid;
- Detailed information regarding how the sponsors, directors and officers will benefit from the transaction, including by quantifying any material payments they will receive as compensation, the return they will receive on their initial investment, and any continuing relationship they will have with the combined company;
- The total percentage ownership interest the SPAC sponsors, directors, officers and affiliates may hold in the combined company, including through the exercise of warrants and conversion of convertible debt; and
- Whether the SPAC has waived any provisions of any policy regarding conflicts of interest, and the reasons for any such waiver.

IV. UNDERWRITER DISCLOSURES

The underwriter for the SPAC IPO may agree to defer a portion of its compensation until the closing of the business combination transaction and may also provide additional services to the SPAC in connection with the business combination transaction. Accordingly, the SEC has encouraged SPACs to disclose:

- Whether the underwriter of the IPO may provide additional services such as identifying potential targets, providing financial advisory services, acting as a placement agent in a private offering or underwriting or arranging debt financing and what fees the SPAC may pay for such services;
- Whether payment for any such additional services will be conditioned on the completion of a business combination transaction; and
- Any conflict of interest the underwriter may have in providing such services if IPO underwriting compensation is to be deferred until the completion of a business combination transaction.

V. CONCLUSION

As the SPAC boom continues, the SEC remains focused on ensuring that SPACs provide clear and robust disclosures with respect to potential conflicts of interest, particularly those created by sponsor compensation and divergent economic incentives, in order to protect retail investors. Additionally, with respect to investment advisers, the SEC's guidance may also provide insight into what the SEC expects that advisers disclose to limited partners in connection with any fund or client investment in an adviser-sponsored SPAC.

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