

SEC Has Its Eye on SPACs

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SPACs — short for “special purpose acquisition companies” — recently have drawn significant interest by companies and executives as a more seamless method to conduct an initial public offering. Often referred to as “blank check” companies, SPACs provide a vehicle by which companies may raise funds from public markets through initial public offerings (IPOs) that take a company from private to publicly listed. Unlike traditional IPOs, which often involve private companies that have developed over time, SPACs are shell companies when they become public and have no underlying operating business and no assets apart from cash and other limited investments. SPACs also have, in the SEC’s words, “distinct risks associated with” investing in them.^[1] These risks include conflicts of interests that SPAC sponsors may have, meaning that the sponsors’ economic interests may diverge from shareholders.^[2] In addition, SPACs are not all similarly structured, making it incumbent upon every investor to understand every SPAC’s unique features.^[3]

It is because of these differences between traditional IPOs and SPACs that the SEC has begun to increase its focus on the latter. With the explosion in number of SPACs, these differences have become even more important as more investors consider investing in SPACs. By way of illustration, in 2016, there were only 13 SPAC IPOs; last year, that number expanded to 248, and as of March 2021, there were already at least 232 SPAC IPOs.^[4]

In fall 2020, then SEC Chairman Jay Clayton indicated that the SEC would begin reviewing SPAC filings more closely to ensure that investors are being protected from possible securities fraud or scams.^[5] The numerous statements that the SEC has made in recent months (discussed more fully below) show that the SEC is indeed looking more closely at SPACs. Thus, the SEC has advised that it reviews SPACs just as closely as it reviews IPOs, and it has warned investors that they should be aware of the risks of investing in SPACs, issuing an Investor Bulletin in December 2020 that provided information in a question-and-answer format.^[6] Under the new Biden administration, the SEC appears to take an even more cautious approach, stating as recently as March that investors should not be persuaded to invest in a SPAC just because a growing number of professional athletes have announced plans to create their own.^[7]

Future SEC regulation of SPACs may include several specific areas of concern, including predictions of financial performance, conflicts of interest among SPAC management teams, insider trading, and antitrust violations.^[8] The transactions are structured as follows: If the SPAC is at the IPO stage, an investor must rely on the sponsors or management team.^[9] While SPACs “may identify in [their] IPO prospectus a specific industry or business that it will target as it seeks to combine with an operating company,” “it is not obligated to pursue a target in the identified industry.”^[10] Then, after the SPAC “has identified an initial business combination opportunity, its management negotiates with the operating company and, if approved by SPAC shareholders (if a shareholder vote is required), executes the business combination.”^[11] Usually, this transaction is “structured as a reverse merger in which the operating company merges with and into the SPAC or a subsidiary of the SPAC.”^[12] This

process is what gives rise to the above concerns of conflicts of interests among the management teams, insider trading, and antitrust violations.

The SEC is poised to become more active in regulating these areas of concern, especially now that the U.S. Senate has confirmed Gary Gensler to lead the SEC. Gensler is widely seen as a more assertive regulator than his predecessor, and many in the industry believe that Gensler will focus even more attention on SPACs.^[13] In fact, on March 24, the SEC opened an inquiry into the SPAC phenomenon, sending letters to Wall Street banks requesting information on the banks' interaction with SPACs.^[14] While these letters are not formal investigative demands — and, as such, do not mandate the banks to provide the information requested by the SEC — such letters often suggest that the SEC may be gearing up for a formal investigation.^[15] Specifically, the SEC is seeking information regarding SPAC deal fees, volumes, internal controls, compliance, and reporting.^[16] And on March 31, two different divisions of the SEC — the Division of Corporation Finance and Acting Chief Accountant Paul Munter — issued statements concerning SPACs.^[17] These statements provided further indication that the SEC will increase its focus on SPACs, including the adequacy of their compliance with regulations, such as required financial disclosures and statements.

There has also been an increase in the number of investor lawsuits against companies that combined with SPACs, and while not initiated by the SEC, there remains the possibility that the SEC will continue to monitor litigation trends in this area.^[18] Litigation may also inform the SEC of any potential wrongdoing by SPACs, which may open the door to additional investigations, enforcement actions, or potential lawsuits.

We will continue to monitor updates in this area. Please contact a member of Troutman Pepper's Securities Practice Group if you have any questions about possible litigation and SEC enforcement trends related to SPACs.

[1] SEC, "What You Need to Know About SPACs — Investor Bulletin" (Dec. 10, 2020), <https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-alerts/celebrity>.

[2] *Id.*

[3] *Id.*

[4] Mark Schoeff Jr., "Booming SPAC Market Draws SEC Scrutiny" (Mar. 11, 2021), <https://www.investmentnews.com/booming-spac-market-draws-sec-scrutiny-203844>.

[5] Soyoung Ho, "SPACs Are Hot but SEC Is Watching," *Thomson Reuters* (Oct. 26, 2020), <https://tax.thomsonreuters.com/news/spacs-are-hot-but-sec-is-watching/>.

[6] See SEC, *supra*, note 1.

[7] SEC, "Celebrity Involvement with SPACs — Investor Alert" (Mar. 10, 2021), <https://www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-alerts/celebrity>.

alerts/celebrity.

[8] Tom Zanki, “4 Ways a Gensler-Led SEC Could Toughen SPAC Scrutiny,” *Law360* (Mar. 5, 2021), <https://www.law360.com/articles/1361701/4-ways-a-gensler-led-sec-could-toughen-spac-scrutiny>.

[9] SEC, *supra* note 1.

[10] *Id.* (italics omitted).

[11] *Id.* (italics omitted).

[12] *Id.*

[13] *Id.*

[14] Jody Godoy & Chris Prentice, “U.S. Regulatory Opens Inquiry into Wall Street’s Blank Check IPO Frenzy,” *Thomson Reuters* (Mar. 24, 2021), <https://www.reuters.com/article/usa-sec-spacs-idUSL1N2LM3CH>; CNBC, “SEC Opens Inquiry into Wall Street’s Blank Check IPO Frenzy: Reuters, Citing Sources” (Mar. 24, 2021), <https://www.cnbc.com/2021/03/25/sec-opens-inquiry-into-wall-streets-blank-check-ipo-frenzy-reuters.html>.

[15] *Id.*

[16] *Id.*

[17] SEC, “Staff Statement on Select Issues Pertaining to Special Purpose Acquisition Companies,” Division of Corporation Finance (Mar. 31, 2021), https://www.sec.gov/news/public-statement/division-cf-spac-2021-03-31?utm_medium=email&utm_source=govdelivery; SEC, “Financial Reporting and Auditing Considerations of Companies Merging with SPACs,” Statement of Paul Munter, Acting Chief Accountant (Mar. 31, 2021), <https://www.sec.gov/news/public-statement/munter-spac-20200331>.

[18] See Godoy & Prentice, *supra* note 14.

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