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Not So Special – Securities And Antitrust Regulators May Increase Attention To SPACs In The Coming Year

INTRODUCTION

In a remarkable year for the equity markets in 2020, the increased use of Special Purpose Acquisition Companies ("SPACs") to take companies public stands out as a defining trend. In 2020, well-known private businesses – like Virgin Galactic – became publicly-traded companies through an acquisition by a SPAC, rather than through a traditional initial public offering ("IPO").[1] And several prominent investors – including Bill Ackman of Pershing and former White House Economic Adviser, Gary Cohn[2] – lead SPACs currently looking for private targets to acquire. This trend shows no sign of slowing in 2021.

As SPAC creators and potential private targets continue to pursue this "going public" route, all parties involved in a SPAC acquisition – on both the SPAC and the target side – should be aware of the potential regulatory scrutiny under the federal securities and antitrust laws that will likely accompany the increasing popularity of these transactions.

I. SPAC BACKGROUND

At the time of its creation, a SPAC registers with the U.S. Securities and Exchange Commission ("SEC") and has its shares and warrants publicly-traded.[3] In 2020 alone, 248 SPACs registered with the SEC and raised over $83 billion, nearly double the amount raised in course of the prior decade.[4] Unlike most other public companies that register with the SEC, a SPAC is a "shell company" with no operating business at the time it becomes publicly-traded. Instead, the SPAC sponsors raise investor funds, and retain them in a trust, for the sole purpose of funding a later acquisition of a yet-to-be-determined private business. In exchange for their funds, investors often receive common stock as well as warrants to purchase additional stock at a specified price on a later date. The sponsors of the SPAC, meanwhile, typically receive 20% of the equity in the SPAC for a nominal fee.

Private companies that sought to go public have historically done so through an IPO utilizing a Form S-1 registration statement. In an IPO process, a private company engages a syndicate of underwriters to offer its shares to numerous prospective purchasers. An acquisition by, or merger with, a SPAC presents an attractive alternative way for a private business to become a public company for a few reasons. A SPAC acquisition often moves faster than an IPO process and provides greater valuation certainty as a target can lock in a negotiated price before the transaction is announced, as opposed to an initial offering price that may fluctuate based on IPO demand and market volatility.

II. FEATURES THAT HEIGHTEN SECURITIES LIABILITY ISSUES

As the primary regulator enforcing the federal securities laws, the SEC has a keen interest in the process by which private entities become publicly-traded companies. SPAC participants should be aware that certain features of the SPAC acquisition process can increase the risk of misstatements as well as prohibited trading on non-public information.

a. Streamlined Due Diligence Prior to Going Public

When a SPAC has reached an agreement-in-principle with a target, SEC rules require the filing of a proxy statement, which will contain detailed financial information regarding the target, to solicit approval of the acquisition from the SPAC's shareholders.[5] Both the SPAC and the private target face potential liability for misstatements in those proxy materials. The risk of misstatement may be heightened in a SPAC acquisition, relative to an IPO, based on key differences in the due diligence conducted prior to completion of the acquisition.

In a traditional IPO, external parties – besides the acquirer – evaluate the representations being made to investors, providing additional valuable checks in the process. First, the underwriters for an IPO face potential liability for misstatements in the offering materials distributed to prospective investors.[6] Under the Securities Act of 1933, underwriters can assert a defense based upon due diligence performed to establish a reasonable belief in the accuracy of the statements being made.[7] To best position themselves to assert a due diligence defense, underwriting firms, as a matter of practice, perform numerous procedures to test statements being made regarding a company about to go public via an IPO.

Additionally, the SEC's Division of Corporation Finance conducts an in-depth review a draft of the S-1 registration statement, the key SEC filing in connection with an IPO. An initial public offering cannot go forward until the SEC staff declares the corresponding registration statement to be effective.[8]

A SPAC acquisition, by contrast, relies largely upon the acquirer to perform due diligence because: 1) there is no role for an underwriter comparable to an IPO, and 2) whereas all initial registration statements are reviewed by the SEC's Division of Corporation Finance, that is not necessarily the case for all acquisition-related filings. Removing additional layers of review can heighten the risk of a private target business inadvertently providing misleading information regarding its business to investors. In September 2020, for example, the SEC brought an enforcement action against a private business named Akazoo S.A. for misrepresenting many of the basic details of the business to the acquiring SPAC and its investors – including the number of users, span of operations, and success of its business model.[9]

Additionally, limitations on the time that SPACs have to find a target to acquire can also hinder the pre-acquisition due diligence process. Most SPACs have a set timeframe of 18-24 months to complete an acquisition.[10] If a SPAC fails to complete an acquisition within that window, the pool of money collected by the SPAC and held in trust will be returned to investors, with interest. Failing to find a suitable target wastes time, effort, opportunity costs and likely harms the SPAC management team's reputation in the investing public's eyes. This feature – while created to provide investors certainty on how long their capital will be tied up – can create scenarios where SPAC management feels immense pressure to find a target quickly, which can conflict with the goal of having a robust due diligence process.

For example, in June 2019, the SEC brought a settled enforcement action against the CEO of Cambridge Capital Acquisition Corp. ("Cambridge"), a SPAC that acquired an intelligence company named Ability Computer & Software Industries, Ltd ("Ability").[11] The SEC's order highlighted that Cambridge needed to complete an acquisition by December 2015, which was the month that the SPAC shareholders approved the acquisition of Ability. The SEC found that the CEO of Cambridge failed to take reasonable steps and conduct appropriate due diligence to ensure that SPAC investors who voted on the acquisition had material and accurate information regarding the target's business prospects.

The risks of streamlined due diligence may only increase, as we anticipate further SEC scrutiny going forward on the disclosures made to SPAC investors regarding a proposed acquisition. Just last month, the SEC's Division of Corporation Finance issued guidance relating to disclosures made by SPACs, including with respect to disclosures regarding a target, its business prospects and the diligence undertaken as part of the SPACs process of evaluating the target.[12] The Division of Corporation Finance encouraged SPACs to provide detailed information regarding the selection of the target, rationale for choosing the target over alternatives, the negotiation process, and the material terms of the proposed acquisition.

b. Greater Reliance on Forward-Looking Projections

To combat the rise of frivolous private litigation, the Private Securities Litigation Reform Act ("PSLRA") provide issuers of securities a safe harbor for forward-looking statements. The safe-harbor protects issuers against a private plaintiff's claims that forward-looking statements were misleading if: 1) the issuer identifies a statement as forward-looking and provides meaningful cautionary language, or 2) the issuer lacked knowledge that the forward-looking statement was misleading.[13]

This valuable safe-harbor protection *does not* apply in all circumstances and, notably, does not extend to statements made in connection with an initial public offering.[14] At the time of adopting securities offering reform rules in 2005, the SEC considered, but declined, to extend safe harbor protections to IPOs due to the untested nature of the issuers.[15] Due in part to this lack of protection, many companies choose not to include financial projections in IPO registration documents.

In the SPAC context though, the IPO transaction occurred at the time the SPAC registered with the SEC. Accordingly, the safe harbor for forward-looking statements is available for SEC filings relating to the subsequent acquisition of the target by a SPAC.[16] While many SPACs choose to use forward-looking projections to market the acquisition to investors, the safe harbor is not an absolute protection and these types of statements will still draw significant scrutiny in private civil litigation as well as with the SEC. For example, in the SEC actions stemming from Cambridge's acquisition of Ability, the SEC alleged misstatements of future revenue projections.[17]

c. Insider Trading Risk

The mechanics of a SPAC process also raise significant concerns of potential trading on material non-public information. In a traditional IPO process, there is no publicly-traded company until the "going public" offering has been completed, which makes it functionally harder for insiders to trade on material non-public information in advance of an IPO in the public market. In the context of a SPAC acquisition, however, the SPAC entity is already a public company whose shares can be freely traded by non-affiliates while it is looking for a target to acquire. In the time before a SPAC acquisition target becomes known, insiders likely possess various types of material non-public information, including planned targets, industries of interest, potential offer pricing, and plans for conversions of existing ownership interests and related dilution.

Further, a SPAC may be less equipped to protect against misuse of material non-public information than a standard public company. SPACs, by design, have no ongoing business operations and have virtually all assets sitting in trust

waiting for use in a potential acquisition. As a result, prior to completing an acquisition, SPACs will typically not have invested capital to build out insider trading compliance programs that many public companies have in place.[18]

With the rapid rise in reliance on the SPAC route to going public, we anticipate that regulators – including, in particular, the SEC – will devote resources towards analyzing trading in the shares of SPACs in advance of the public announcement of acquisition targets, or other material events, for potential abnormal patterns.

III. ANTITRUST CONCERNS

Additionally, the growing trend towards SPACs raises potential risks with respect to antitrust laws that could prevent a transaction or otherwise frustrate the goals of SPAC participants.

a. Collusion or Bid Rigging Concerns

Due to the explosive growth of SPACs, the demand for attractive private targets exceeds the supply. One source that tracks the SPAC market reports that approximately 200 registered SPACs are currently looking for targets.[19] With so much competition for high-value targets, coupled with the inherent time pressure to complete acquisition, the SPAC heightens the risk "collusion" or "market allocation". For example, SPAC sponsors may be tempted to coordinate amongst each other to avoid having multiple bidders for the same targets, which could reduce price competition while also giving priority to the bids of the SPACs that need to find a target sooner.

This type of market coordination has been the subject of litigation and investigation in the past in a somewhat different context. In the years after the financial crisis, a number of large private equity firms allegedly colluded to avoid increasing the costs of corporate buyouts. A number of firms settled lawsuits brought by private investors alleging violations of Section 1 of the Sherman Antitrust Act by conspiring to suppress prices by avoiding bidding on the same buyout targets.[20] The U.S. Department of Justice ("DOJ") also reportedly investigated the private equity firms at the time, but did not move forward with criminal charges.[21]

b. Concentration Risk From Multiple Acquisitions

Under the Hart-Scott-Rodino Act, the DOJ and the Federal Trade Commission ("FTC") review proposed transactions above a certain financial threshold that affect commerce in the United States, and either agency can take legal action to block transactions that would "substantially lessen competition."[22]

The SPACs themselves are "blank check" companies and their acquisition of a single private company should not by itself reduce competition in any relevant market. Yet, the lucrative nature of this business has led to the rise of entities, and certain individuals, with business models with multiple SPACs and acquiring targets. For example, Chamath Palihapitiya, a large Silicon Valley investor, has created six SPACs, which have already identified three targets to take public.[23] As sponsors come to obtain interests in multiple targets in the same industry, concerns over mergers reducing competition, including increased opportunities for tacit collusion, will soon arise.

DOJ and FTC review of acquisitions by private entity firms should provide a warning for firms or individuals that take large positions in multiple SPACs. As part of their broad mission to protect competition, these agencies will apply scrutiny to situations where an entity owns even a partial interest in two competing firms. By way of illustration, in 2007, the FTC objected to a transaction whereby a petroleum and gas provider would be taken private and controlled by two private equity firms.[24] The FTC pointed to the fact that these two private equity firms already held a significant non-majority interest in a competing provider in the energy industry. The FTC imposed a series of conditions before allowing the transaction to proceed, including requiring the private equity firms to cede their board seats at the competing provider and not assert any other control or influence over its operations. Even though not an outright rejection of an acquisition, conditions requiring relinquishment of control of an entity could significantly hinder the business goals of SPAC sponsors.

IV. CONCLUSION

The emergence of SPAC acquisitions have been championed by many as a more efficient way for private business to become publicly-traded companies. The popularity of these transactions have attracted significant capital from a broad array of sophisticated investors, as well as secondary trading from traditional retail investors who may feel the SPAC model allows them to "get in the door early" by purchasing shares of the SPAC in the public market pre-acquisition. The prominence and prevalence of SPACs inevitably will be followed by increased regulatory scrutiny. Indeed, it is likely that SPACs will emerge as one of the areas of cooperation between the DOJ and SEC pursuant to the Memorandum of Understanding the agencies signed last Fall.[25] As such, it is critical that SPAC sponsors and investors evaluate whether to deploy additional resources to compliance and diligence and that they assess their activities through both a securities and antitrust lens in order to minimize liability risk.

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[3] An overview of SPACs can found on the SEC's website at https://www.sec.gov/oiea/investor-alerts-and-bulletins/what-you-need-know-about-spacs-investor-bulletin.
[4] Statistics on the SPAC market can be found at https://spacinsider.com/stats/. See also Michael J. de la Merced, The Year in Deals Can be Summed Up in 4 Letters (Dec. 19, 2020), DealBook, https://www.nytimes.com/2020/12/19/business/dealbook/deals-mergers-acquisitions-2020.html (discussing four-fold increase in the number of SPACs that registered with the SEC in 2020).
[5] Section 14A of the Exchange Act.
[6] Sections 11, 12(a)(2) of the Securities Act of 1933.
[7] Sections 11, 12(a)(2) of the Securities Act of 1933.
[8] https://www.sec.gov/smallbusiness/goingpublic
[9] Amended Complaint, In re Akazoo S.A. Sec. Litig., No. 1:20-cv-01900-BMC, 9, 19 (E.D.N.Y. Sept. 8, 2020), ECF No. 15.
[10] Speech of Commissioner Allison Herren Lee, Investing in the Public Option: Promoting Growth in Our Public Markets (Oct. 8, 2020), available at https://www.sec.gov/news/speech/lee-investing-public-option-sec-speaks-100820.

[11] In the Matter of Benjamin H. Gordon, Admin. Proc. File No. 3-19120 (June 20, 2019).
[12] CF Disclosure Guidance: Topic 11 (Dec, 22, 2020) ***available at*** https://www.sec.gov/corpfin/disclosure-special-purpose-acquisition-companies.
[13] 15 U.S.C. §§ 77z-2, 78u-5.
[14] 15 U.S.C. §§ 77z-2(b)(2)(D), 78u-5(b)(2)(D).
[15] Securities Offering Reform, Securities Act Rel. No. 33-8591 (July 19, 2015).
[16] *See, e.g*., Simon Moore, *Why SPACs Are Exploding, A CEO's Take* (Oct. 5, 2020), Forbes, https://www.forbes.com/sites/simonmoore/2020/10/05/why-spacs-are-exploding-a-ceos-take/?sh=58892ec63f87.
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[22] Merger Review, FTC.Gov, https://www.ftc.gov/news-events/media-resources/mergers-and-competition/merger-review
[23] Eric Newcomer, The Man with Six SPACs (Nov. 6, 2020), https://www.newcomer.co/p/the-man-with-six-spacs
[24] https://www.ftc.gov/news-events/press-releases/2007/01/ftc-challenges-acquisition-interests-kinder-morgan-inc-carlyle
[25] See DOJ Will Partner With SEC to "Lean In" on Aggressive Antitrust Policing of the Financial Services Sector (Oct. 26, 2020), available at https://www.kslaw.com/news-and-insights/doj-will-partner-with-sec-to-lean-in-on-aggressive-antitrust-policing-of-the-financial-services-sector.