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SPAC Sweeps: FINRA Releases Guidance After Announcing Its Latest Series of Targeted Exams

After a period of astounding growth in the special purpose acquisition company (SPAC) market, FINRA recently joined the SEC in announcing further scrutiny of broker-dealers and their affiliates involved in SPAC offerings, releasing a targeted exam letter earlier this month.¹ In this alert we provide an overview of SPACs, the evolution of regulatory review of this activity to date, and some key takeaways from FINRA's guidance.

REGULATORY HISTORY

SPACs (also known as "blank check companies") are shell-type entities formed with the purpose of raising capital through an initial public offering (IPO) to acquire an existing private company. SPACs are an attractive capital raising mechanism for investors because of their speed and efficiency in bringing a company to market, and they theoretically provide early investment access (with accompanying alpha, and risk) to a broader population. However, they require far fewer disclosures than a traditional IPO, including omitting much information about the target's business operations and finances. They also include what is viewed by some as inherent conflicts of interest and can tempt participants into cutting corners to accelerate the process, as SPAC sponsors stand to greatly profit if a transaction is completed before a two-year expiration period. Finally, as the SPAC market is currently saturated with sponsors seeking targets, there is some concern that those sponsors are settling for less-than-ideal investments to complete a deal. For these reasons, among others, as the SPAC market has grown, regulators have shown increasing interest in policing the market.

The SEC announced its SPAC sweep in March of this year when the Enforcement Division began reviewing selected SPAC



transactions and scrutinizing banks' internal policies and procedures related to SPACs.² Since then, SEC Chair Gary Gensler has made numerous public statements concerning the heightened risks that SPACs present for investors, and has instructed his staff to propose rules and guidance in light of the surge in SPAC activity.³ In July, the SEC announced its first settlement with a SPAC, its sponsor, and others for fraud charges based on the failure to disclose material information in the SPAC's proxy statement.⁴ A rising tide of civil litigation has followed the regulatory action, including suits in Delaware courts that challenge the business judgment rule,⁵ and a suit in August calling into question whether SPACs are truly 'blank check' companies, or whether they should be alternatively considered investment companies and regulated accordingly.⁶

Soon after the vocal SEC activity, in a Securities Industry and Financial Markets Association webcast on July 22, FINRA announced its intention to initiate its own SPAC sweep.⁷ FINRA President and CEO Robert Cook expressed interest in reviewing SPACs specifically because of the conflicts of interest that they present.⁸ Cook's statements are consistent with FINRA's earlier guidance concerning SPACs that warned that investors "should be aware of the potential for conflicts of interest between SPAC sponsors and SPAC shareholders" due to the risk of "potential misuse of funds and potential fraud through misrepresentation or omissions regarding the prospects of the target company."⁹

FINRA'S TARGETED EXAM LETTER

FINRA's targeted exam requires broker-dealers and their affiliates to provide information on SPAC activities over a three-year period, from July 1, 2018, through September 30, 2021. In particular, FINRA will examine, among other things, firms' policies and procedures and other internal guidance concerning twelve SPAC-related areas of interest:

- public offerings;
- qualified independent underwriters;
- due diligence;
- suitability;
- conflicts of interest;
- private securities transactions;
- employee trading;
- information barriers;
- watch and restricted lists;
- research reports;
- outside business activities; and
- communications with customers regarding corporate events or shareholder votes and research reports.

FINRA will also be reviewing firms' training in these same areas.



TRENDS AND TAKEAWAYS

Because SPACs have only two years to identify and acquire a target, the recent rise in SPACs will lead to many acquiring their targets in the midst of FINRA's sweep. There have been almost 500 SPACs in 2021 alone, following 248 in 2020, and 59 in 2019.¹⁰ Crucially, however, more than half of this year's SPACs—approximately 300—occurred in the first quarter, followed by a decline to around 60 SPACs in the second quarter, and roughly 90 SPACs in the third quarter, respectively.¹¹ With two changes to the SEC's accounting guidance on SPACs this year thus far, these numbers demonstrate the impact of increased regulatory scrutiny on the formation of new SPACs.¹² And while a relatively small amount of registered broker-dealers appear to have engaged in SPAC activities as of yet, FINRA's sweep indicates an enhanced interest in these activities and the likelihood of further inquiries ahead. If past is prologue, FINRA's SPAC sweep is likely to broaden by way of both target firms and topic areas.

Broker-dealers and their affiliates should do the following:

- anticipate investigations at a systems-and-processes level to ensure firms have the proper framework in place to conduct the activity, as well as on a deal-specific level to ensure prior and current transactions are conducted in accordance with regulatory expectations;
- consider the potential disclosure obligations and create a framework to ensure various stakeholders have an opportunity to weigh in on potentially material information that SPAC participants need to know; and
- closely monitor the changing enforcement and regulatory landscape, along with the civil litigation in this space, as significant changes necessitating modifications could come as a result of new precedent.

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¹ FINRA, *Special Purpose Acquisition Companies (“SPACs”)* (Oct. 2021), available at <https://www.finra.org/rules-guidance/guidance/targeted-examination-letters/special-purpose-acquisition-companies-spacs>.

² *SEC Opens Inquiry into Wall Street’s Blank Check IPO Frenzy: Reuters, Citing Sources*, CNBC (Mar. 24, 2021), available at <https://www.cnbc.com/2021/03/25/sec-opens-inquiry-into-wall-streets-blank-check-ipo-frenzy-reuters.html>.

³ Gary Gensler, Chair, U.S. Sec. & Exch. Comm’n, Testimony Before the Subcommittee on Financial Services and General Government, U.S. House Appropriations Committee (May 26, 2021), available at <https://www.sec.gov/news/testimony/gensler-2021-05-26>. The SEC’s semiannual regulatory agenda also noted that the SEC intends to propose SPAC-related rule amendments by April 2022. See Press Release, U.S. Sec. & Exch. Comm’n, SEC Announces Annual Regulatory Agenda (June 11, 2021), available at <https://www.sec.gov/news/press-release/2021-99>.

⁴ Press Release, U.S. Sec. & Exch. Comm’n, SEC Charges SPAC, Sponsor, Merger Target, and CEOs for Misleading Disclosures Ahead of Proposed Business Combination (July 13, 2021), available at <https://www.sec.gov/news/press-release/2021-124>.

⁵ See, e.g., Complaint, Kwame Amo v. MultiPlan Corp., No. 2021-0258 (Del. Ch. Mar. 25, 2021) (asserting that the defendants’ conduct should be judged under the heightened scrutiny of the entire fairness standard, rather than the business judgment rule). The business judgment rule provides that so long as a company’s director acted in good faith in conducting a transaction, the courts will not question his decisions, thus putting the burden of proof on the plaintiff. The entire fairness standard, in contrast, typically arises with board-wide issues of fair dealing and fair price, and the directors have the burden to prove the transaction at issue was entirely fair.

⁶ Complaint, Assad v. Pershing Square Tontine Holdings, No. 1:21-cv-06907 (S.D.N.Y. Aug. 17, 2021).

⁷ Al Barbarino, *FINRA Sweeps to Target SPACs, Social Media Influencers*, LAW360 (July 22, 2021), available at <https://www.law360.com/articles/1405500>.

⁸ *Id.*

⁹ FINRA, *Investing in a SPAC* (Mar. 29, 2021), available at <https://www.finra.org/investors/insights/spacs>.

¹⁰ *SPAC IPO Transactions: Summary by Year*, SPACINSIDER, available at <https://spacinsider.com/stats/> (last visited Oct. 20, 2021).

¹¹ Preston Brewer, *ANALYSIS: SPAC Frenzy Cools in Q2, Relinquishing IPO Lead*, BLOOMBERG LAW (July 12, 2021), available at <https://news.bloomberglaw.com/us-law-week/analysis-spac-frenzy-cools-in-q2-relinquishing-ipo-lead>.

¹² Anirban Sen, Chris Prentice & Krystal Hu, *U.S. SEC Cracks Down A Second Time on SPAC Equity Accounting Treatment*, REUTERS (Sept. 28, 2021), available at <https://www.reuters.com/business/finance/exclusive-us-sec-cracks-down-second-time-spac-equity-accounting-treatment-2021-09-28/>.