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SPACs

SEC Proposes Rules to Regulate SPACs

By Joel Rubinstein, Jonathan Rochwarger, Elliot Smith, and Daniel Nussen

On March 30, 2022, the US Securities and Exchange Commission (SEC), in a three-to-one vote of its commissioners divided along political lines, approved the issuance of proposed rules regarding special purpose acquisition companies (SPACs).[1] This proposal follows in the wake of increasing focus over the past two years by the SEC on SPACs, which in 2021 completed 610 initial public offerings (IPOs) and facilitated the public market debuts of 221 companies through de-SPAC transactions.[2]

In announcing the proposal, SEC Chairman Gary Gensler stated that the proposal

> would strengthen disclosure, marketing standards and gatekeeper and issuer obligations by market participants in SPACs, helping ensure that investors in these vehicles get protections similar to those when investing in traditional IPOs.[3]

The "overarching principle," Mr. Gensler said, is Aristotle's maxim: "Treat like cases alike." Even assuming SPACs and IPOs are "like" cases,[4] despite the SEC's stated intent to align the procedural and disclosure requirements for de-SPAC transactions with traditional IPOs, the proposed rules, if adopted in their current form, would impose significant asymmetrical obligations and liabilities on a wide range of market participants in de-SPAC transactions as compared to traditional IPOs. Accordingly, the proposed rules could have a chilling effect on the SPAC market and thereby undermine one of the SEC's core missions of facilitating capital formation.[5]

The proposed rules would mandate the following principal changes for SPACs:

1. New disclosure and financial statement requirements in certain SEC filings by SPACs, including with respect to financial projections and fairness determinations in de-SPAC transactions;
2. New registration requirements under the Securities Act of 1933, as amended (Securities Act), for de-SPAC transactions and the elimination of the safe harbor for forward-looking statements under the Private Securities Litigation Reform Act of 1995 (PSLRA) for disclosure in those registration statements;
3. Securities Act liability for "underwriters" in de-SPAC transactions; and
4. A 20-calendar day minimum dissemination period for disclosure documents in a de-SPAC transaction.

In addition, the SEC is proposing a new safe harbor under the Investment Company Act of 1940, as amended (Investment Company Act), for a SPAC to determine that it is not required to register as an investment company under the Investment Company Act, which could create uncertainty for SPACs that do not satisfy the conditions of the safe harbor.

The public comment period will remain open for 30 days following publication of the proposing release in the Federal Register or until May 31, 2022, whichever period is longer.

In this article, we provide our overall perspective on the SEC's proposal, and then summarize the principal aspects of the proposed rules.

Joel Rubinstein, Jonathan Rochwarger, Elliot Smith, *and* **Daniel Nussen** *are attorneys of White & Case LLP.*

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Our Perspective

In the proposing release, the SEC explained that its decision to propose the rules arose from concerns expressed by certain commentators, as well as the SEC's Investor Advisory Committee and Small Business Capital Formation Advisory Committee, regarding:

- The amount of sponsor compensation and other costs associated with a de-SPAC transaction and their dilutive effects on a SPAC's shareholders
- The fact that a SPAC sponsor's founder shares would be worthless if the SPAC does not complete a de-SPAC transaction, which represents a potential conflict of interest that could lead a sponsor to enter into a de-SPAC transaction that is unfavorable to the SPAC's unaffiliated shareholders
- Relatively poor returns for investors in companies following de-SPAC transactions
- The adequacy of the disclosures provided to investors in SPAC IPOs and de-SPAC transactions explaining the potential benefits, risks and effects for investors, the potential benefits for the sponsor and other affiliates of the SPAC and information about the target company
- The use of projections in de-SPAC transactions that, in the SEC's view, have appeared to be unreasonable, unfounded, or potentially misleading, particularly where the target company is an early-stage company with no or limited sales
- The lack of a named underwriter that in a regular-way IPO or direct listing would typically perform traditional gatekeeping functions, such as due diligence, and would be subject to liability under Section 11 of the Securities Act for untrue statements of material facts or omissions of material facts
- The proposed rules seek to address these concerns by mandating certain additional disclosures to investors, standards for marketing practices (particularly the use of and liability for projections) and gatekeeper and issuer obligations

Since the issuance of the proposing release, SPAC market participants of all types have scrambled to assess the potential consequences of the proposed rules on current and future SPAC transactions. Many participants do not agree that the concerns expressed above mandate the need for additional regulation, particularly in the current challenging market environment where the market seemingly has "self-corrected" and much of the disclosure requirements already have found their way into SPAC SEC filings.

We expect that many comment letters will be submitted on the proposal, which will highlight that de-SPAC transactions and IPOs are not like cases (for example, a de-SPAC transaction is structured as an M&A deal) and, in part due to their fundamental differences, the proposed rules do not treat them alike. Meanwhile, while the comment letter process unfolds, SPACs are left to contend with some of the statements made by the SEC in the proposal, which have created uncertainty even prior to any rules being adopted.

In particular, the SEC stated that the basis for imposing Securities Act liability for a de-SPAC registration statement on an "underwriter" is a "clarification" of existing law. In light of the SEC's position, SPAC underwriters, financial advisors and other participants in de-SPAC transactions are focused on determining what, if any, additional work may be advisable for them to undertake (such as additional due diligence, for example) in connection with pending and future SPAC IPOs, and de-SPAC transactions.

Underwriter Liability and Projections

One of the primary concerns with the proposed rules is expansive underwriter liability imposed by the operation of proposed Rules 145a and 140a on a potentially wide range of participants in SPAC transactions. Proposed Rule 145a would deem any business combination of a reporting shell company involving another entity that is not a shell company

to involve a sale of securities to the reporting shell company's shareholders, and, therefore, require the de-SPAC transaction to be registered.

As a basis for this rule, the SEC stated that its

> preliminary view is that such a transaction would be 'a disposition of a security or interest in a security… for value,' regardless of the form or structure deployed, and regardless of whether a shareholder vote or consent is solicited.

While the SEC has in the past raised this view in the context of SPACs, it has until now declined to adopt it to require registration of a de-SPAC transaction.[6]

In addition, proposed Rule 140a would deem anyone who has acted as an underwriter of the securities of a SPAC in its IPO and takes steps to facilitate a de-SPAC transaction or any related financing transaction or otherwise participates (directly or indirectly) in the de-SPAC transaction to be engaged in a distribution and to be an underwriter in the de-SPAC transaction, with the attendant civil liability under Sections 11 and 12 of the Securities Act (and no safe harbor protection under the PSLRA) for the disclosures in the de-SPAC registration statement, including any financial projections included therein.

Because de-SPAC transactions are structured as mergers or other forms of business combination transactions, applicable state or foreign corporate law, Regulation M-A and/or the anti-fraud provisions of the federal securities laws require financial projections provided to a SPAC's board of directors and/or the parties' fairness opinion providers to be included in the registration statement for a de-SPAC transaction.[7]

The expansive underwriter liability contemplated by the proposed rules would "collide" with such existing obligations of a SPAC and target company, and would result in underwriter liability for the financial projections included in a de-SPAC registration statement. This represents a significant expansion of the scope of information for which there is underwriter liability compared to an IPO or direct listing. In traditional IPOs and direct listings, issuers do not include financial projections in their registration statements. Thus, the institutions acting as underwriters or financial advisors in those transactions are not exposed to Securities Act liability for financial projections.

Yet, as the SEC undoubtedly is aware, issuers in IPOs still indirectly provide investors with financial projections by sharing their financial models, including projections, with research analysts, who then provide their models to their institutional investor clients. Similarly, in direct listings, financial projections are confidentially shared directly with investors during the marketing of the offering and later made public through a Current Report on Form 8-K that is filed after the registration statement becomes effective. Accordingly, underwriters in SPAC transactions are not being treated like underwriters or financial advisors in IPOs and direct listings. If proposed Rules 140a and 145a are adopted as proposed, financial institutions may decline to be involved with many SPAC transactions.

In addition, the SEC warns in the proposing release that although proposed Rule 140a addresses the underwriter status of only the SPAC IPO underwriter in the context of a de-SPAC transaction:

> Federal courts and the Commission may find that other parties involved in securities distributions, including other parties that perform activities necessary to the successful completion of de-SPAC transactions, are "statutory underwriters" within the definition of underwriter in Section 2(a)(11). For example, financial advisors, PIPE investors, or other advisors, depending on the circumstances, may be deemed statutory underwriters in connection with a de-SPAC transaction if they are purchasing from an issuer "with a view to" distribution, are selling "for an issuer," and/or are "participating" in a distribution.

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While it always is the case that courts and the SEC may deem certain participants in a distribution to be statutory underwriters, the inclusion of this explicit statement in the proposing release has left many SPAC market participants concerned that the SEC may be implying that it has reached this conclusion in the de-SPAC context. Such an expanded definition of "underwriter" would also result in disparate treatment participants and advisors in de-SPAC transactions compared to participants and advisors in traditional IPOs and direct listings, and also would create uncertainty for participants and advisors in other similar transactions such as transformative mergers or acquisitions by public companies.

SPACs and the Investment Company Act

Another aspect of the proposed rules that could create serious challenges for SPACs is the SEC's proposal to adopt a new safe harbor for a SPAC to determine that it is not an investment company under the Investment Company Act. As justification of the need for this safe harbor, the SEC states that

> as the SPAC market has grown dramatically in recent years, some SPACs have sought to operate in novel ways that suggest a need for SPACs and their sponsors to increase their focus on evaluating when a SPAC could be an investment company …

This appears to be referring to Pershing Square Holdings Tontine, Ltd., which proposed a de-SPAC transaction in which it would acquire and hold a minority interest in another company.

It is surprising that the SEC would conclude that this highly unusual proposed transaction, which was structured contrary to the manner in which SPACs universally state in their IPO prospectuses they will structure transactions (that is, that they will only structure a transaction so that they acquire a controlling interest in a target company such that they will not be required to be registered under the Investment Company Act) and which ultimately did not go forward, signaled a need for a safe harbor. Moreover, SPACs simply are not investment companies.[8]

While many of the conditions in the safe harbor simply mirror what SPACs are required to do already, the requirement that a SPAC must announce and close a de-SPAC transaction within 18 and 24 months, respectively, would put an arbitrary deadline on SPACs and, contrary to the stated intent of many of the other proposed rules, would put pressure on SPACs to prioritize speed over diligence and quality, to the detriment of shareholders and contrary to a board's fiduciary obligations.

In addition, in its discussion of these timelines, the SEC does not take into account that often the longest lead-time item to complete a de-SPAC transaction is the SEC Staff's review of de-SPAC proxy statements and registration statements, which can often take four or five months. The reason the SEC states for the need to impose these timeframes is that the SEC is "concerned that, the longer the SPAC operates with its assets invested in securities and its income derived from securities, the more likely investors will come to view the SPAC as a fund-like investment and the more likely the SPAC will appear to be deviating from its stated business purpose."

Given that SPACs invest only in short-term treasury securities and money market funds that invest only in short-term treasury securities it is hard to imagine that investors would ever view SPACs as a fund-like investment. Moreover, the SPAC's sponsor would gain nothing from deviating from its stated purpose of finding and consummating a de-SPAC transaction and instead only investing in treasuries. As the SEC notes in its proposing release, the NYSE and Nasdaq each require listed SPACs to complete their business combinations within 36 months, which the market has universally agreed is the appropriate outside date for ensuring that SPACs remain focused on identifying and completing a business combination during their lifespans.

The following is a more detailed summary of the proposed rules.

Enhanced Disclosure and Projections

Proposed Subpart 1600 of Regulation S-K would impose specialized disclosure requirements on SPACs in connection with both their IPOs and their de-SPAC transactions. Much of the proposed disclosure requirements would codify and standardize both long-standing and recently developed customary disclosure practice in SPAC IPOs and de-SPACs that have evolved from responses to SEC comments to individual registrants, compliance and disclosure interpretations and public statements, into line-item disclosure in Regulation S-K, and, in the de-SPAC context, include requirements that are already consistent with Forms S-4 and F-4, Schedule 14A and Regulation M-A.

Beyond standardizing existing disclosure practices, the proposal would impose new disclosure requirements that focus principally on conflicts of interest, SPAC sponsors, dilution and the economic impacts of a de-SPAC on unaffiliated public investors, fairness determinations regarding the de-SPAC and projections, and would seek to highlight the items the SEC believes are most important to public investors by requiring their disclosure on the prospectus cover page in an IPO and in a de-SPAC transaction.

Dilution

The proposal reflects the common reality of a de-SPAC in which public SPAC investors typically represent approximately 80 percent of the total shareholder base prior to the de-SPAC but are diluted to a collective minority position when securities are issued as consideration to target sellers and in private placements to private investment in public equity (PIPE) or other similar investors, including SPAC sponsors, in the de-SPAC, which dilution may be amplified by public shareholder redemptions.

In an IPO, the proposed rules would require a SPAC to include tabular disclosure in the prospectus demonstrating potential dilution at assumed redemption levels and, if known and quantifiable, financing levels for the de-SPAC.

In a de-SPAC, the proposed rules would include standardized tabular disclosure requirements to show dilution pursuant to a sensitivity analysis at reasonably likely redemption levels from sources including shareholder redemptions, SPAC sponsor compensation, underwriting fees, outstanding warrants and convertible securities and PIPE financings, which recent SEC comments have largely already required across individual de-SPACs.

The proposal extends beyond existing practice by requiring the inclusion of the company valuation at or above which non-redeeming shareholders' interest per share equals or exceeds the IPO price per common share and a description of the model, methods, assumptions, estimates and parameters necessary to understand such a sensitivity analysis. The proposal seeks to clearly highlight the potential economic impact to a SPAC shareholder that chooses not to redeem its shares in the de-SPAC and seeks to formally tie dilution and redemption variables to the post-transaction company's disclosed valuation.

Our perspective: Dilution disclosure has become customary in de-SPAC transactions and is the subject of frequent SEC comment in that context. However, it is less clear that providing such information at the IPO stage would be useful to investors. Prior to the closing of a SPAC IPO, a SPAC is prohibited from selecting a de-SPAC transaction. As a result, the proposed new disclosure requirements in the IPO context would comprise a potentially meaningless set of hypothetical data points given that no other details of the eventual de-SPAC transaction or related financing are known or quantifiable at that time.

SPAC Sponsors

The proposed rules codify the SEC's position, consistent with recent enforcement actions and public statements over the last two years, that a SPAC sponsor is to be viewed as a party possessing a functional and defined role separate and apart from its position as a significant SPAC shareholder. The proposed rules highlight the common identity of individuals who serve in SPAC management roles and

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who own or control a SPAC sponsor with the responsibility to organize, direct and manage the SPAC, formalizing the requirement to disclose conflicts of interest with unaffiliated security holders that may arise at the time of the IPO and de-SPAC.

SPAC sponsors may be required to disclose details about their own organization and ownership that go beyond the SEC's existing beneficial ownership rules and existing practice. For example, a SPAC would be required to disclose the details of the direct and indirect ownership of the SPAC sponsor, potentially bringing to the forefront disclosure of passive and other financial partners in SPAC sponsor vehicles, an area of sometimes inconsistent disclosure practice.

In an IPO, the proposed rules seek to standardize disclosure regarding, among other things, the role and responsibility of the SPAC sponsor and its affiliates, their compensation and related conflicts of interest. The proposal would place an emphasis on the SPAC sponsor as a defined party or group of parties, whereas existing practice has sometimes placed such focus on the SPAC's executive officers and directors as a conceptually distinct set of parties.

Our perspective: With a distinct focus on SPAC sponsors, the proposed rules codify much of what practitioners have considered to be good disclosure practice. For example, disclosure about significant interests in or an ability to control or influence a SPAC sponsor was previously not part of the SEC's line-item disclosure requirements, but often was included pursuant to a materiality analysis. It should be noted, however, that the expansion of such disclosure may provide further bases for liability for SPAC sponsors in IPOs and de-SPACs, a position the SEC already has taken in its Momentus Inc. enforcement action.[9]

Fairness Determinations and Background of the Business Combination

At the time of the de-SPAC, the proposed rules would require a SPAC to provide an affirmative statement regarding whether the de-SPAC and any related financing is fair to unaffiliated security holders, as well as a discussion of the bases for this belief, and whether the SPAC has received any third-party determination as to the fairness of the transaction. In the event that a report, opinion or appraisal is provided to the SPAC or the SPAC sponsor, the proposed rules require disclosure regarding the details of such materials and how they were prepared that are already generally consistent with Forms S-4 and F-4.

The proposed rules would, in addition to clarifying a variety of existing disclosure practice and preexisting requirements relating to the background of the proposed de-SPAC transaction, impose a requirement that the SPAC specifically disclose the effects of the de-SPAC transaction and any related financing transaction on the SPAC and its affiliates, the SPAC sponsor and its affiliates, the target company and its affiliates and unaffiliated security holders of the SPAC, with a reasonably detailed discussion of both the benefits and detriments of the de-SPAC transaction, with such benefits and detriments quantified to the extent practicable.

Our perspective: Fairness opinions have historically not been common in de-SPAC transactions outside of situations where the sponsor or management team is affiliated with the target company, and the language of the proposed rules regarding the fairness of "any related financing" to unaffiliated security holders represents a deviation from the scope of a typical fairness opinion, which usually covers the fairness to the SPAC itself of the consideration to be paid by the SPAC in the de-SPAC transaction. It is unclear whether it is feasible to obtain such a broad opinion.

Projections

The proposed amendments to Item 10(b) of Regulation S-K would expand and update the SEC's guidance on the presentation of projections of future economic performance in SEC filings. Proposed amended Item 10(b), which would apply generally and not be limited to SPACs, provides that:

- Any projected measures that are not based on historical financial results or operational history should be clearly distinguished from projected measures that are based on historical financial results or operational history.

- It generally would be misleading to present projections that are based on historical financial results or operational history without presenting such historical measure or operational history with equal or greater prominence.
- Projections that include a non-GAAP financial measure should include a clear definition or explanation of the measure, a description of the GAAP financial measure to which it is most closely related and an explanation of why the non-GAAP financial measure was used instead of a GAAP measure.

In addition, proposed Item 1609 of Regulation S-K, which would apply only to de-SPAC transactions, would require disclosure of (i) the purpose for which projections were prepared, (ii) the material bases and assumptions underlying projections, and (iii) any factors that may impact the assumptions. In addition, if projections relate to the performance of the SPAC, the disclosure must include whether the projections reflect the view of the SPAC's management or board about its future performance as of the date of the filing; and, if the projections relate to the target company, the disclosure must state whether the target has affirmed to the SPAC that the projections reflect the view of the target's management or board about its future performance as of the date of the filing of the disclosure.

If the projections no longer reflect the views of the SPAC's or the target company's management or board regarding the future performance of their respective companies as of the date of the filing, the proposed rule requires a statement of the purpose of disclosing the projections and the reasons for any continued reliance by the management or board on the projections.

Our perspective: The substantive requirements of these rules have been the subject of recent SEC comments on de-SPAC transaction filings and appear to reflect the SEC's view that many SPACs are not simply disclosing projections to comply with the requirements of applicable state or foreign law, Regulation M-A and/or anti-fraud provisions of the federal securities laws, but are rather marketing the de-SPAC transaction on the basis of those projections.

Under the proposed rules, investors would be provided with incremental contextual disclosure regarding projections and how they are viewed over time by the participants in the de-SPAC transaction that may help alleviate regulatory concerns that retail investors and other market participants have placed too much reliance on de-SPAC projections despite clear and customary disclaimer language to the contrary. However, SPACs, targets, underwriters and other transaction participants with potential liability for communications during the de-SPAC transaction are likely to be highly apprehensive with these disclosure obligations when, historically, there have been no explicit requirements to update or editorialize projections except in certain extenuating circumstances.

Aligning De-SPAC Transactions with Traditional IPOs

The proposed rules include changes intended to (1) more closely align the non-financial statement disclosure requirements with respect to the private operating company in registration/proxy statements for a de-SPAC transaction with the disclosure required in a Form S-1 or F-1 for a traditional IPO, (2) require a minimum dissemination period for proxy statements in a de-SPAC transaction, (3) treat the private operating company as a co-registrant of the Form S-4 or Form F-4 for a de-SPAC transaction, (4) require a re-determination of smaller reporting company (SRC) status following the consummation of a de-SPAC transaction, (5) amend the definition of "blank check company" under the PSLRA such that the safe harbor for forward-looking information (for example, financial projections) in de-SPAC registration statements would not be available to SPACs, and (6) provide that an underwriter in a SPAC IPO is deemed to be an underwriter in a subsequent de-SPAC transaction if it takes steps to facilitate the de-SPAC transaction or any related

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financing transaction, or otherwise participates (directly or indirectly) in the de-SPAC transaction. These items are addressed in turn below.

Aligning Non-Financial Disclosures in De-SPAC Disclosure Documents

Under the proposed rules, if a target company in a de-SPAC transaction is not subject to the reporting requirements of Section 13(a) or Section 15(d) of the Exchange Act, certain additional Regulation S-K items would be required to be included in the description of the target company in the registration/proxy statement, including: (1) Item 101 (description of business); (2) Item 102 (description of property); (3) Item 103 (legal proceedings); (4) Item 304 (changes in and disagreements with accountants on accounting and financial disclosure); (5) Item 403 (security ownership of certain beneficial owners and management, assuming the completion of the de-SPAC transaction and any related financing transaction); and (6) Item 701 (recent sales of unregistered securities).

Our perspective: Many, if not all, of these items are already included as a part of standard disclosure practice in many de-SPAC transaction disclosure documents. In addition, such information is required in any case in the post-business combination company's "Super 8-K" that is filed within four business days of the consummation of the business combination. As a result, we do not anticipate these rules to have a material impact on current practice in the SPAC market.

Minimum Dissemination Period of 20 Calendar Days for Disclosure Documents in a De-SPAC Transaction

The SEC proposes amending Rules 14a-6 and 14c2, as well as adding instructions to Form S-4 and F-4, to require that prospectuses and proxy and information statements filed in connection with de-SPAC transactions be distributed to shareholders at least 20 calendar days in advance of a shareholder meeting, except in the case of certain jurisdictions where the maximum dissemination period is less than 20 calendar days, in which case the maximum dissemination period would apply.

Our perspective: It has been common practice for SPACs in the last few years to provide their shareholders with at least a 14-calendar day period between mailing of the proxy statement or proxy statement/prospectus and the shareholder meeting. As a result, we do not expect this to have a significant impact on current market practice, so long as SPACs are able supplement the disclosure following the mailing consistent with past practice.

Treating the Private Operating Company as a Co-Registrant of the Registration/Information Statements for a De-SPAC Transaction When a SPAC Is Filing the Registration Statement

Under the proposed rules, the target company would be required to be a co-registrant with the SPAC when a registration statement is filed by the SPAC in connection with a de-SPAC transaction. As a result, Securities Act liability for the disclosure in the de-SPAC registration statement would extend to the target and its officers and directors who would be required to sign the de-SPAC registration statement.

Our perspective: In the current SPAC market, target company disclosures included in a de-SPAC registration statement are vetted through due diligence conducted both the SPAC and target, and their respective counsel and other advisors, both to create a due diligence defense for the SPAC's directors and because the disclosure prepared for the registration statement forms the basis for disclosure included in filings after the de-SPAC transaction. While the proposed rule would expand the category of persons with Securities Act liability for de-SPAC registration statements, we do not expect this proposed rule to change market practice.

Requiring a Re-Determination of SRC Status Following the Consummation of a De-SPAC Transaction

Nearly all SPACs other than the largest few qualify for SRC status prior to the consummation of the de-SPAC transaction, allowing the company

following the de-SPAC transaction to rely on certain scaled disclosure requirements available to SRCs. The proposed rules would require a re-determination of SRC eligibility within four business days following the consummation of a de-SPAC transaction (that is, on the due date for the so-called Super 8-K).

The combined company would make a calculation of its public float within such four-business day window to determine whether the public float is in excess of $250 million (determined through share trading prices during that time) and would base the applicable revenue threshold on the annual revenue of the private operating company as of the most recently completed fiscal year for which audited financial statements are available. The combined company would then need to reflect its determination of whether it is still considered a SRC in its first periodic report thereafter (whether on Form 10-K or Form 10-Q).

A company that fails to qualify for SRC status following a de-SPAC would remain unqualified for the scaled disclosure requirements available to SRCs until its next annual re-determination of such status. In situations where SPAC qualified as a SRC before a de-SPAC transaction and was the legal acquirer in the de-SPAC transaction, the post-business combination company would continue to be able to rely on the scaled disclosure accommodations for SRCs when filing a registration statement between the re-determination date and the post-business combination company's first periodic report.

Our perspective: The timing of this reassessment will require SPACs and target companies to make an early assessment of whether the additional disclosure could be required shortly after the closing of the de-SPAC transaction, and the conclusion could be different depending on the number of redemptions. Companies that have exceeded the SRC thresholds may still be able to avail themselves of the disclosure requirements for emerging growth companies, which are not significantly more onerous than those of an SRC. In any event, the proposed rules would require companies to start preparing any additional required disclosure well in advance if they believe it will be required after the closing of the de-SPAC transaction.

Amending the Definition of "Blank Check Company" under the PSLRA Such That the Safe Harbor for Forward-Looking Information Contained Therein Would Not Apply to SPACs

As mentioned above, the proposed rules would amend the definition of "blank check company" for purposes of the PSLRA to remove the "penny stock" condition and to define the term as "a company that has no specific business plan or purpose or has indicated that its business plan is to engage in a merger or acquisition with an unidentified company or companies, or other entity or person."

The amendment to the definition of "blank check company" would result in the removal of the PSLRA safe harbor with respect to any forward-looking statements (including financial projections) provided in a de-SPAC registration statement, thus subjecting all parties to the de-SPAC transaction, including the newly defined class of "underwriters," to increased risk of liability.

Our perspective: The proposal expands potential Section 11 liability for SPACs, target companies and underwriters for misstatements or omissions relating to forward-looking information in de-SPAC registration statements. In practice, many de-SPAC registration statements are already ineligible for the safe harbor because they are filed by the target company or a newly formed holding company that will be the "issuer" in the transaction, so it effectively is the target's or holding company's initial public offering.

Even if the safe harbor is eliminated for all de-SPAC transactions, SPACs, target companies and underwriters can still rely upon the common law "bespeaks caution" doctrine to defend against claims of misstatements or omissions relating to forward-looking information; the PSLRA safe harbor essentially codified but did not replace the "bespeaks caution" doctrine. The "bespeaks caution" doctrine offers similar protection to that of the safe harbor and provides that forward-looking statements accompanied by meaningful cautionary language

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are not actionable, and thus are subject to dismissal. Such cautionary language can be sufficient to negate the materiality of the alleged misrepresentations or omissions. Notwithstanding the availability of the "bespeaks caution" doctrine, financial institutions may view the removal of the safe harbor as increasing their litigation risk with respect to projections, as certain courts have applied the doctrine in a manner that provides less protection than the safe harbor.

IPO Underwriter Liability in a Subsequent De-SPAC Transaction

Proposed Rule 140a would deem any underwriter of a SPAC's IPO to also be an underwriter in the distribution of the securities of the surviving combination company in connection with the de-SPAC transaction if they take steps to facilitate the de-SPAC transaction or any related financing transaction, or otherwise participate (directly or indirectly) in the de-SPAC transaction. It is common practice in the SPAC market for the IPO underwriters to act as advisors to the SPAC or placement agents in PIPE offerings that are often conducted concurrently with the de-SPAC transaction.

Section 2(a)(11) of the Securities Act defines an underwriter as "any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking."

While it is the SEC's long-standing rule that this definition encompasses any person who acts as a link in a chain of transactions through which securities are distributed from an issuer or its control persons to the public, the proposed rule reflects a significant expansion to the category of persons that could be deemed underwriters where none was envisioned previously. Through this change, the SEC seeks to impose gatekeeper liability on SPAC underwriters, which will force them to conduct a due diligence review of the target similar to what they would conduct in a traditional IPO in order to create an affirmative due diligence defense to civil liability claims under Sections 11 and 12 of the Securities Act.

Our perspective: Together with the elimination of the PSLRA safe harbor for SPACs and requirements under applicable foreign or state law, Regulation M-A and anti-fraud provisions of the federal securities laws for SPACs to disclose projections the board of directors considered in approving a de-SPAC transaction, proposed Rule 140a presents a fundamentally challenging regulatory framework for SPACs. That is, projections may be required to be disclosed, but potential underwriters may be unwilling to agree to take on the risk of Securities Act liability for those projections; which risk is avoidable for underwriters in traditional IPOs and direct listings.

This Catch-22 could cause many financial institutions to decline to be involved in many de-SPAC transactions. In addition, this aspect of the rule proposal may push de-SPAC transaction participants to more closely align their practices with the traditional IPO practice of providing projections only orally to certain institutional investors, having the opposite effect of the SEC's purported goals of increasing retail investor protection and parity of information sharing.

Business Combinations Involving Shell Companies, Shell Company Business Combinations, and the Securities Act of 1933/Rule 145a

Proposed Rule 145a would deem any business combinations of a reporting shell company (including SPACs) involving another entity that is not a shell company to involve a sale of securities to the reporting shell company's shareholders that must be registered on a registration statement (unless a valid exemption from registration existed). Business combination related shell companies, such as shell companies formed solely for purposes of re-domiciling or effecting a business combination transaction,

would not be subject to Rule 145a. If Rule 145a is adopted, shell companies (including SPACs) seeking to complete a business combination should expect to register their de-SPAC transactions on Form S-4 or F-4.

Our perspective: Many de-SPAC transactions are already registered on Form S-4 or F-4. By operation of this rule, however, de-SPAC transactions would no longer be able to be effected using a proxy statement on Schedule 14A. The significance of this rule is also in relation to proposed Rule 140a and the expansion of underwriter liability for disclosures in de-SPAC registration statements, as discuss elsewhere herein.

Financial Statement Requirements in Business Combination Transactions Involving Shell Companies/Article 15 of Regulation S-X

The SEC is also proposing a new Article 15 of Regulation S-X along with related amendments to more closely align the financial statement reporting requirements for business combinations with shell companies (including SPACs) and private companies to those found in traditional IPOs.

Number of Years of Financial Statements/Rule 15-01(b)

Under the current rules, de-SPAC transactions typically require three years of financial statements; however, two years of financial statements are permitted in certain situations, including when:

- The target company is an SRC;
- The target company would be an emerging growth company (EGC) if it were conducting an IPO of common equity securities and the registrant is an EGC that has not yet filed or been required to file its first annual report, even if the target would not be an SRC; or
- The transaction is registered on a Form F-4 and either (1) the target company is a first-time adopter of International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB), or (2) the Form F-4 is the initial registration statement of the private company and it provides US GAAP financial statements.

The proposed amendment would remove the requirement in the second situation above for the shell company to have filed its first annual report.

This would permit target companies in all transactions involving a SPAC and a target that each qualify as an EGC to provide only two years of financial statements in the business combination S-4/F-4 or proxy statement. However, if the target company exceeds revenue thresholds for being an EGC, it must still provide three years of audited financial statements.

Audit Requirements of Predecessor/Rule 15-01(a)

Proposed Rule 15-01(a) would codify existing Staff guidance that the financial statements of the target companies in a de-SPAC transaction would need to be audited in accordance with the standards of the PCAOB.

Age of Financial Statements of the Predecessor/Rule 15-01(c)

Current rules require private operating companies to file financial statements that would be required in an annual report, which do not have the same age requirements as those in registration statements (for example, companies with a net loss in their most recent fiscal year have 90 days to update their third-quarter financial statements in their annual report versus 45 days in an initial registration statement). If a private operating company would be a predecessor to a shell company, the proposed rule would determine the age of such company's financial statements by looking at whether such company would qualify as a SRC if it were to file an initial registration statement. The SEC is not proposing amendments to age requirements for the financial statements of shell company registrants.

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Acquisitions of Businesses by a Shell Company Registrant or Its Predecessor That Are Not or Will Not Be the Predecessor

The SEC is proposing a variety of amendments relating to the financial statements for companies other than the shell company or the target company that have been or are probable to be acquired by either company prior to the closing of the de-SPAC transaction (referred to here as Company C). Existing rules require Company C's financial statements to be filed "only when omission of those financial statements would render the target company's financial statements substantially incomplete or misleading." The proposed rules would instead require that Company C's financial statements be included when required by Regulation S-X's provisions relating to financial statements of an acquired business.

Amendments to the Significance Tests That Dictate When Acquired Business Financial Statements Are Required

Also being proposed are amendments to significance tests in Rule 1-02(w) that dictate when acquired business financial statements are required. The current tests require that the financial information of the registrant, which may be the shell company (including a SPAC), are used in the analysis.

Because shell companies have minimal business activity, many acquisitions appear significant when they may not be. The amendment would require the target company's financial information be used to measure significance, rather than using the shell company registrant's information. This approach would produce results that are more consistent with Rule 3-05, and would provide a better idea of how different acquisitions have different levels of impact.

Currently, when the significance of the financial information of Company C is measured at 50 percent or less, such financial information may be omitted from a registration or proxy statement but if the significance is between 20 percent and 50 percent, they must be filed on a Form 8-K within 75 days of the consummation of the acquisition. The proposed amendment would instead require such omitted financial statements to be filed in the "Super 8-K" that is filed within four business days of the consummation of the business combination.

Financial Statements of a Shell Company Registrant after the Combination with Predecessor/Rule 15-01(e)

This amendment is meant to address questions as to whether the shell company's historical financial statements are required in post-business combination filings. Rule 15-01(e) would allow registrants to exclude SPAC financial statements for any periods prior to the acquisition as long as (1) all of the SPAC's required financial statements have been filed through the closing date of the business combination and (2) the registrant's financial statements include the period in which the business combination was consummated. The proposed rule would apply regardless of how the business combination is structured (that is, forward acquisition of target company or reverse recapitalization).

Status of SPACs under the Investment Company Act of 1940

In response to a renewed focus on whether a SPAC falls under the definition of "investment company" because of a SPAC's asset composition and sources of income, the SEC is proposing a safe harbor to allow SPACs to distinguish themselves from investment companies. A SPAC is not required to rely on the proposed safe harbor. If the proposed rules are adopted, a SPAC that complies with the safe harbor criteria would not need to register as an investment company under the Investment Company Act.

Proposed Safe Harbor under the Investment Company Act

The Investment Company Act contains two tests to determine whether an issuer is an investment company: (1) a subjective test (Investment Company Act § 3(a)(1)(A)) and (2) an objective test (Investment Company Act § 3(a)(1)(C)). The objective test provides that an issuer that is engaged in the business of investing, reinvesting, owning,

holding or trading in securities, and that owns or proposes to acquire investment securities, having a value exceeding 40 percent of the value of the company's total assets (exclusive of government securities and cash items) on an unconsolidated basis, is an investment company. The subjective test provides that an issuer is an investment company if it holds itself out as being engaged primarily in the business of investing, reinvesting or trading in securities. The proposed safe harbor relates to the subjective test.

The proposed safe harbor has several conditions, each of which must be met in order for a SPAC to utilize the proposed safe harbor: (1) nature and management of SPAC assets, (2) SPAC activities, and (3) duration limitation.

The first prong of the proposed safe harbor is satisfied if the SPAC's assets consist solely of government securities, government money market funds and cash items prior to the completion of its initial business combination. This condition is not intended to preclude the SPAC from using its assets for working capital purposes (for example, drawing interest earned on the trust account to pay its taxes).

The second prong of the proposed safe harbor relates to the SPAC's activities and contains two sub-prongs: (1) de-SPAC transaction, and (2) evidence of primary engagement.

The first sub-prong is satisfied when the SPAC completes a single de-SPAC transaction as a result of which the surviving public entity, either directly or through a primarily controlled company, will be primarily engaged in the business of the target company or companies, which is not that of an investment company.

Therefore, a SPAC's business purpose must be aimed at providing shareholders with the opportunity to own interests in a public company that is an operating company (whether directly or indirectly). The surviving company must have at least one class of securities listed for trading on a national securities exchange. This limitation does not intend to prohibit an initial business combination with multiple target companies so long as the closing with respect to the multiple target companies occurs contemporaneously.

The second sub-prong addresses the SPAC's efforts to achieve its business purpose. In order to demonstrate compliance with this sub-prong, the SPAC's directors and officers must be primarily focused on activities related to seeking a target company as opposed to the management of the SPAC's securities portfolio. The SPAC's board of directors would need to pass a resolution evidencing that the SPAC is primarily engaged in the business of seeking to complete a single de-SPAC transaction.

The third prong of the proposed safe harbor requires a SPAC to (1) announce that it has entered into a business combination agreement with a target company no later than 18 months after the effective date (Effective Date) of the SPAC's IPO registration statement and (2) consummate the business combination no later than 24 months after the Effective Date. If the SPAC fails to meet either of the aforementioned deadlines, it would be required to distribute its assets in cash to investors as soon as reasonably practicable thereafter in order to rely on the safe harbor.

Our perspective: The third prong may be difficult for many SPACs to satisfy for a variety of reasons, such as: protracted negotiations with a target that ultimately terminate; the time required for a target to prepare audited financial statements; lengthy SEC review periods; or changing market conditions during a de-SPAC process. In addition, the proposed 18 and 24-month deadlines put pressure on SPAC boards to prioritize speed over diligence and quality, which is at odds with a board's fiduciary duties.

The SEC also noted a concern that the longer a SPAC operates without having identified a business combination, the more likely investors will come to view it as a fund-like investment. However, given that SPACs invest only in short-term treasury securities and money market funds that invest only in short-term treasury securities, it is hard to imagine that investors would ever view SPACs as a fund-like investment. Moreover, the SPAC's sponsor would

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gain nothing from deviating from its stated purpose of finding and consummating a de-SPAC transaction and instead only investing in treasuries.

As stated above, it would seem that this proposed safe harbor was specifically designed to address one failed de-SPAC transaction out of hundreds that attempted to consummate a de-SPAC transaction contrary to its governing documents by proposing to acquire and hold a minority position in another company. Given the difficulties described above, the proposed safe harbor ultimately would do more harm than good when it should already be clear that SPACs are not investment companies.[10] The 36-month requirement in NYSE and Nasdaq listing rules for consummating a de-SPAC transaction should remain the standard.

Notes

1. The proposed rules, which include new rules and amendments to existing rules, are available at *https://www.sec.gov/rules/proposed/2022/33-11048.pdf*.
2. *https://www.whitecase.com/publications/insight/us-spacs-data-hub*.
3. Statement on Proposal on Special Purpose Acquisition Companies (SPACs), Shell Companies and Projections by Chair Gary Gensler (the "Gensler Statement"), available at *https://www.sec.gov/news/statement/gensler-spac-20220330*.
4. For Aristotle's "like cases" maxim, Mr. Gensler cites to Benjamin Johnson and Richard Jordan, "Why Should Like Cases Be Decided Alike? A Formal Model of Aristotelian Justice" (March 1, 2017). After analyzing the maxim, and in particular how cases are determined to be "like" in practice, Messrs. Johnson and Jordan conclude that "far from a core feature of justice, the maxim is either unhelpful or pernicious" and "invoking the like-cases maxim is not just a waste of paper; it may also be deeply insidious."
5. *https://www.sec.gov/about/what-we-do*.
6. Indeed, in 2010, the SEC Staff raised this point in connection with their review of changes that were being made to the SPAC structure in connection with the IPO of a new SPAC, in which members of our firm represented the underwriters. Following discussions, including an in-person meeting with senior SEC Staff at the SEC's office in Washington, DC, the Staff allowed the offering to proceed without requiring registration.
7. While most de-SPAC transactions do not currently include a fairness opinion (unless the transaction involves a conflict of interest), we expect that many SPACs may seek fairness opinions to substantiate their "reasonable belief" as to the fairness of the de-SPAC transaction as a result of proposed Item 1606 of Regulation S-K.
8. *https://www.whitecase.com/publications/alert/spacs-are-not-investment-companies#:~:text=As%20the%20SEC%20has%20recognized,company%20governed%20by%20the%20ICA*.
9. SEC Complaint, SEC v. Mikhail Kokorich, Case No. 1:21-CV-1869, (D.D.C. Jul. 13, 2021), available at *https://www.sec.gov/litigation/complaints/2021/comp-pr2021-124.pdf*.
10. *See supra* n.8.

PROSPECTUS DISCLOSURE

The Struggle to Disclose "Uses of Proceeds" in Registered Public Offerings

By Spencer Feldman

The "Use of Proceeds" section of an offering prospectus affords investors a window into an issuer's operational mindset and serves to drive the entire prospectus disclosure. The use of proceeds establishes management's most important business initiatives, underpins the terms and amount of the offering, provides a snapshot of the issuer's near-term financial condition and identifies the areas where management may need additional or specialized expertise.

From there, the Use of Proceeds section addresses the risk factors involved in the issuer's execution of its business initiatives, informs the liquidity and capital resources section of Management's Discussion and Analysis concerning the sufficiency of the issuer's cash to cover operating expenses for the next 12 months and, of course, is central to the cautionary note regarding the issuer's forward-looking statements.

In fact, the Securities Exchange Commission (SEC) has indicated in its comment letters that, especially in the case of an initial public offering (IPO) by a smaller issuer, the issuer should disclose whether the proceeds from the offering will be used to fund each and every element of the issuer's growth strategy typically included in an issuer's offering prospectus summary.

Item 504 of Regulation S-K requires an issuer to identify the principal purposes for which it plans to use the net proceeds from an offering and the approximate amount intended to be used for each of those purposes. For example, many issuers intend to use the net proceeds from their offering to fund research and product development, marketing and sales, potential acquisitions and repayment of outstanding loans.

For an issuer that is unable to specify its intended use of proceeds, it must alternatively state that it has no current specific plan for a significant portion of the offering proceeds and discuss the principal reasons for the offering at the time of the filing given this lack of a plan, and include as a risk factor its lack of a specific plan.

Despite the importance to investors of understanding the purposes for which an issuer's net proceeds are intended to be used, it appears many issuers are routinely providing little specificity with regard to the allocation of their proposed net proceeds. Instead, the disclosure is often vague without any current specific plan included in the Use of Proceeds section, potentially qualifying the transaction as a "blind pool" under federal and state securities laws, or it is lumped into "general corporate purposes," the most general term that companies can use in this section.

Indeed, in many recent prospectuses, the Use of Proceeds section is the shortest of all substantive disclosure sections in the prospectus. And, most issuers no longer utilize the once customary Use of Proceeds table that listed each use, its respective amount and percentage of the total net proceeds, and prioritized the uses.

In a June 2021 letter from two US Senators to SEC Chair Gensler and Commissioner Lee providing input on the SEC's proposed regulation of issuers' climate change disclosures, the Senators wrote:

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> The SEC can help address [climate change disclosures] by requiring greater transparency and specificity regarding use-of-proceeds declarations in prospectuses. Issuers should clearly communicate to the market what they intend to finance with the proceeds of debt or equity offerings. If the Commission permits issuers to cite "general corporate purposes" with no accountability, there can be no way of knowing whether capital will, in fact, be dedicated to the transition [to low-carbon business models]. More specificity around proceeds will also go a long way towards ensuring financial firms (whether underwriters or asset managers) are meeting their stated climate commitments.

Perhaps some issuers believe that specific information required pursuant to Item 504 of Regulation S-K forces them to publicly reveal business plans that might put them at a competitive disadvantage or they think that a lack of transparency allows them to keep more of their options open. It is unclear whether such an approach is actually benefitting those issuers. Certain academic studies, described in more detail at the end of this blog post, have suggested that more specific use of proceeds disclosure has the potential to reduce IPO underpricing for issuers and assist investors in evaluating an issuer's prospects in the early years following their IPO.

Disclosures in Special Situations

Whether or not an issuer has a specific plan for its offering proceeds in place, there are many instances requiring special Use of Proceeds disclosure under Item 504 of Regulation S-K that an issuer may overlook. A number of special situations are described below.

Repayment of Indebtedness

If the issuer intends to use any of the net proceeds to repay outstanding indebtedness under its promissory notes, loans or credit facilities, the issuer must disclose the interest rate and maturity date of such debt pursuant to Instruction 4 to Item 504. Similarly, if an issuer expects to use a material amount of the offering proceeds to service its debt by paying only the accrued interest on the note, rather than repaying the remaining outstanding amount in full, the same disclosure is required in Use of Proceeds.

Frequently, when the indebtedness is incurred within one year, such as in a pre-IPO bridge financing consisting of promissory notes, an issuer must also include a statement as to how it used the proceeds from the previously incurred debt. This requirement, however, does not include short-term borrowings used for working capital. In certain instances where issuers disclose that they have outstanding debt but do not plan to use any of the proceeds to repay it, the SEC may ask the issuer, typically one with negative working capital, to address how it intends to meet its cash needs, including debt obligations, over the next 12 months.

Drug Development and Clinical Trials

In the biotechnology space, if an issuer intends to use any of the net proceeds for clinical trials of its drug candidates, the issuer must disclose whether it will be able to complete those trials with the offering proceeds or, alternatively, how far the issuer expects to reach in the clinical development process for each of the drug candidates with the proceeds from the offering.

In many instances, the biotech issuer cannot describe in greater specificity how far it expects the net proceeds from the offering to reach in the development of its drug candidates due to the uncertainty of timing for Food and Drug Administration (FDA) marketing and other regulatory approvals, but it is nonetheless required to provide the reasons why that is the case. If the proceeds from the offering are insufficient to cover each specified purpose (which may include not only conducting trial but also clinical and development milestone payments), the issuer

must state the amounts and sources of other funds needed for each specified purpose and the sources for additional funds as required by Instruction 3 to Item 504 of Regulation S-K. Additionally, the SEC has indicated in comment letters that, where the issuer is progressing with multiple drug development programs, proceeds should be allocated by individual development program, rather than disclosed in the aggregate.

In some cases, issuers have aggregated their use of proceeds by stage of development or clinical phase rather than by development program, indicating that this is the appropriate allocation for investors to understand how far the funds from the offering will allow them to proceed with the continued development of their programs.

Beyond the biotechnology industry, this use of proceeds disclosure also applies to issuers in other industries that develop new products or service offerings, where capital is needed to fund discrete development projects over time.

Business Acquisitions

If the issuer intends to use any of the net proceeds from the offering to fund the acquisition costs of a specific pending or future business, the issuer must identify and describe the business, describe the material terms of the acquisition agreements, file the agreements as exhibits to the registration statement, and add risk factors to address any risks associated with the acquisition.

Moreover, if the acquisition is probable at the time of the offering, the issuer must include audited historical financial statements of the business to be acquired and pro forma financial statements showing the effect of the acquisition on the issuer, pursuant to Instruction 6 to Item 504 of Regulation S-K. Under the Use of Proceeds section of the prospectus, the issuer must disclose the approximate dollar value of the amount of net proceeds expected to be used in connection with the acquisition, including a percentage breakdown of the amount for such items as earn-out cash payments, integration-related expenses and other similar matters.

If the issuer intends to use the offering proceeds for acquisitions but it does not have any current plans, arrangements or agreements in place for such acquisitions, it must disclose this fact. In the extreme example of an IPO by a special purpose acquisition company (SPAC), which is specifically formed for the purpose of effecting a future business combination with one or more unidentified businesses, the usual prospectus cover page prominently states that the company has not selected any specific business combination target and it has not, nor has anyone on its behalf, initiated any substantive discussions, directly or indirectly, with any business combination target.

Best-Efforts Offerings

If the public offering is structured as a best-efforts offering with minimum and maximum aggregate offering amounts, the issuer must show its use of proceeds information in multiple scenarios assuming varying levels of proceeds raised and number of shares sold in the offering pursuant to Instruction 1 to Item 504 of Regulation S-K.

Typically, the disclosure would indicate the use of proceeds from the offering based on 25 percent, 50 percent, 75 percent, and 100 percent of the offering being completed, with a discussion of the issuer's priorities for the proceeds at each level. If there is a minimum amount of offering gross proceeds that must be raised to hold an initial closing for the offering, the minimum amount of the gross proceeds should also be reflected among the differing proceeds allocations.

Proceeds Benefitting Related Parties

If the issuer intends to use any of the net proceeds from the offering for a purpose that would benefit an executive officer, director or principal shareholder of the issuer, disclosure of the transaction and the total amount of the offering proceeds that such related party will receive must be included in the Use of Proceeds section of the prospectus.

Examples of these transactions include the repurchase by the issuer of its shares, warrants or other

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securities from a related party, repayment of an issuer's third-party indebtedness that was guaranteed by a related party and repayment of a related party for advances made in connection with the upfront expenses of the offering. Cross-references to disclosure under Certain Relationships and Related Party Transactions should be made to explain any associated conflicts of interest.

Special IPO Bonuses

If the issuer intends to use any of the net proceeds from the offering to pay a one-time bonus to an executive officer, for example, upon the closing of the issuer's IPO if the offering size reached a certain level, the issuer must include this payment in its Use of Proceeds discussion (ideally under a separate line item, rather than working capital), as well as other sections including Executive Compensation.

Secondary Offerings for Selling Shareholders

In a secondary offering, where a resale shelf registration statement involves the sale of securities by selling shareholders, the registrant must disclose that it will not receive any of the proceeds from the offering. However, if the selling shareholders acquired their securities in a pre-IPO private placement or a PIPE offering that included warrants and would be required to exercise the warrants they received for cash prior to the sale of the underlying registered shares of common stock, the registrant must disclose the use of proceeds that it may receive from those selling shareholders who exercise their warrants.

Warrant and Option Exercise Proceeds

If the public offering includes units consisting in part of warrants to purchase common stock for cash, the issuer must disclose the use of proceeds, if any, that it may receive from those investors who exercise their warrants. Similarly, if the proceeds from an underwriter's exercise of its over-allotment option to purchase additional shares in the offering will be used for purposes other than those already delineated for the offering, that disclosure would also be required.

Changes to the Use of Proceeds

Even if an issuer has a current specific plan for its offering proceeds, an issuer is not committed to that particular course of action and may reserve the right to change its stated use of proceeds, provided that such reservation is due to certain contingent events that are discussed specifically and the alternatives to any such uses in those events are indicated, according to Instruction 7 to Item 401 of Regulation S-K.

Additionally, where the issuer indicates that it may draw funds from certain less important business objectives if more funds than estimated are required to complete more pressing objectives, the issuer needs to disclose how it will prioritize the order of the objectives for purposes of deciding from which ones to draw funds. Following an issuer's initial registered offering, Securities Act Rule 463 and Item 701(f) of Regulation S-K require periodic disclosure of the use of offering proceeds so investors can try to follow an investor's changed plans and priorities.

Pending the Use of Proceeds

At the bottom of the Use of Proceeds section, issuers typically indicate that pending application of the stated uses of the offering proceeds, they intend to temporarily invest the net proceeds in "short-term, interest-bearing obligations" or, in other words, "safe" investments. Investing offering proceeds in a highly leveraged hedge fund pending the use of those proceeds would normally not be considered a safe investment.

Use of Proceeds Misstatements and Litigation

In a number of recent enforcement actions, the SEC has indicated that material misstatements and misleading omissions regarding an issuer's use of offering proceeds are violations of the antifraud provisions of Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder.

While public companies may believe that they have the benefit of the Private Securities Litigation Reform Act's safe harbor for forward-looking statements when making their disclosures, the SEC has alleged that because the issuer knew that the statements were false when made, the issuer does not get the benefit of the safe harbor's protection. In particular, the SEC has brought complaints against issuers and executive officers relating to the failure to disclose that funds raised in the offering would be used for stock promotion activities (*SEC v. GPL Ventures LLC*, 1:21-cv-06814 (S.D.N.Y.)) and commissions to be paid to brokers in a Regulation A+ public offering (*SEC v. Davenport*, 8:21-cv-01427 (C.D. CA)), and seeking penalties to make investors whole.

Conclusion

It appears lately that many issuers are struggling with use of proceeds disclosures. Issuers are routinely providing little specificity with regard to the allocation of their proposed net proceeds. This may not necessarily be benefitting those issuers.

A number of academic studies have been conducted over the past ten years on the impact of an offering's use of proceeds disclosure on valuation. The studies looked at use of proceeds disclosures relating to the intended uses of the proceeds (for example, growth, production or financing) and amount committed to specific purposes. These variables were then related to IPO underpricing, survival prediction and expected and realized prospects of the IPOs.

The results suggested that the use of proceeds disclosure has an incremental impact, perhaps more than any other source of information, for underpricing, for predicting firm survival and, in the case of some disclosure categories, for investors' evaluation of the issuer's prospects and risks in the early years following their IPO. One study documented substantial variation in the specificity of this disclosure and found that an increase in such specificity was associated with reduced IPO underpricing. Overall, the results suggested that IPOs with more specific use of proceeds disclosures allow investors to more aptly and confidently estimate secondary market stock performance.

It is likely that as the SEC rolls out additional disclosure requirements centered on items like climate change and cybersecurity to which issuers will be required to dedicate capital, issuers will be expected to provide even greater transparency to investors about the use of their offering proceeds.

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CLIMATE DISCLOSURE

Systemic Climate-Related Financial Risk and the Slow-Boiling Frog

By Kristina Wyatt

The drum beat continues. The climate news in the last month has been sobering—as it was in the prior month, and the month before that. As my friend and colleague, Tim Mohin, discussed in his newsletter, the IPCC (Intergovernmental Panel on Climate Change) report issued April 4th is an urgent call to action.[1] The report's title gives away the punchline: "The evidence is clear: the time for action is now."

Prudential regulators around the world similarly are sharpening their focus on the systemic economic effects of climate change. In the last month, regulators, including the Financial Stability Board and the European Central Bank, and government agencies in the United States, Canada, France, and the United Kingdom have all implemented programs to address climate-related threats to their financial systems.

Many companies have found it difficult to make the connection between climate change and financial risk. There is evidence of a disconnect. This isn't altogether surprising. Climate change poses complicated challenges, which are made worse by the combined *tragedy of the commons* and *tragedy of the horizon*. Company boards and management have acted in what they have judged to be their shareholders' best interests, even when their actions contributed incrementally to the collective climate crisis.

This collective action problem has been amplified by companies' motivation to enhance value in the short term even when today's actions will have an adverse future impact. Climate change has, for many companies, felt complicated, remote, and disconnected from the important work of running the business.

In the last decade, many companies have responded to external pressure to address climate change and other sustainability issues. A typical response has been to form a sustainability team charged with preparing a sustainability report and perhaps leading other efforts to "green" their companies. The problem is that these efforts typically lived in silos far from the boardroom or the CFO's office. Sustainability was a thing "over there" and largely disconnected from core company strategy. Many companies seem to have had a general awareness of climate change but without appreciating its significant financial implications for their businesses and long-term prospects. They have been the slow boiling frog.

All of this is changing incredibly rapidly. I would credit this change to a combination of factors. One is the growing awareness of the urgency of climate change and investors' insistence that companies assess their climate impacts and risks. The second is the release of the recommendations of the Task Force on Climate-Related Financial Disclosures (TCFD).[2]

The third is happening right now. That is the implementation of *mandatory* TCFD reporting requirements by regulators around the world. We see this in the Securities Exchange Commission's (SEC) recent climate proposal, the proposed ISSB standards, and in proposals and laws across Europe, Asia, and North America.

The TCFD turned the sustainability discussion around. It focused companies not only on their "greening" efforts but also on their exposure to the

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material financial impacts of climate change. It provides a framework to guide companies in their assessment of their climate-related risks and opportunities. Its four central pillars can be applied by any organization, in any industry, of any size, in any location.

Those four pillars are, first, governance. How does the company address climate-related risks and opportunities? Are they managed in a distant silo by a public relations or communications team or are they addressed by the board, CFO, and other senior management?

Second, the TCFD guides companies in thinking about their financial exposure to climate risks. These risks might not be obvious and the TCFD framework provides a structure for their identification and analysis. It prompts companies to evaluate their exposure to physical risks, which might be acute (for example, risks associated with facilities susceptible to wildfires, hurricanes or other severe weather), or chronic (for example, risks posed by water scarcity, rising ambient temperatures, and rising sea levels). It also prompts companies to evaluate their transition risks. These are risks associated with the transition to a lower carbon economy and might include changing regulations, carbon pricing, changing consumer and investor demands, supply scarcity, and decreased demand for high carbon products.

The third and fourth pillars address how companies build strategies to address these risks and the metrics they use to measure their progress - including their greenhouse gas emissions.

Why is this important? The TCFD provides an organized mechanism that can guide companies in identifying climate related financial risks that might not otherwise be obvious. It pushes companies to address risks at the appropriate level, and to build strategies to mitigate their risk. Ultimately, this will lend to a more orderly transition to a lower carbon economy, and greater financial stability across the economy. The catalyst driving this progress is the regulatory convergence that will require companies around the world to apply the TCFD as a regulatory imperative.

Notes

1. Tim's newsletter is at *https://www.linkedin.com/pulse/april-8-2022-esg-climate-news-tim-mohin/*; the IPCC release is at *https://www.ipcc.ch/2022/04/04/ipcc-ar6-wgiii-pressrelease/*.
2. *https://www.fsb-tcfd.org/*.

SEC's Proposed Climate Rules: Eight Take-Aways on GHG Emissions Disclosure

By Nick Grabar, Lillian Tsu, and Helena Grannis

1. Likelihood of Adoption. The precise final form that the proposed greenhouse gas (GHG) disclosure rules take is uncertain and will reflect the comment letter process and any potential litigation. However, it is highly likely that rules in some form will be adopted and that registrants will need to deploy resources and develop processes in order to comply.

2. Early Preparation and Collection of Data. While the proposed GHG emissions disclosure requirement is primarily based on aspects of the GHG Protocol, not all registrants have adopted the GHG Protocol and the Securities Exchange Commission (SEC) proposal deviates from the

Nick Grabar, **Lillian Tsu**, *and* **Helena Grannis** *are partners of Cleary Gottlieb Steen & Hamilton LLP. Jonathan Povilonis, Yuan He, and Cleary's Sustainability Working Group also helped prepare this article.*

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GHG Protocol in significant ways. Most registrants likely will face significant challenges in collecting the relevant data and preparing the required disclosure, given the breadth of the proposed rules and the disclosure controls required to include such disclosure in SEC filings.

Registrants should not delay the process of evaluating their organizational boundaries for the purposes of the "scope" analysis or the development of procedures for gathering data, especially if they have not already been voluntarily disclosing their GHG emissions data.

3. Responsibility for Preparation of GHG Emissions Disclosure. Given the nature of the data required for the proposed GHG emissions disclosure, many registrants will not have a dedicated unit or department in place that is capable of obtaining, validating and preparing the required information for disclosure.

A registrant should consider creating a cross-function working group with representatives from accounting, finance, legal, sustainability departments, and internal and/or external audit, as appropriate, to ensure that the relevant expertise on each subject matter is brought to bear on its GHG emissions disclosure.

4. Methodology for Gathering Data and Calculating GHG Emissions. The proposed rules do not mandate a specific methodology for gathering data and calculating GHG emissions. While the proposed rules do identify several factors to guide registrants in the preparation of their GHG emissions disclosures, a registrant nonetheless has significant latitude during several stages of the process.

One issue to consider, and comment on, is whether the limited guidance on methodology for calculating GHG emissions will reduce the comparability, and therefore the utility, of the GHG emissions data. A registrant should assess its internal capabilities and expertise, and remediate any gaps or deficiencies, with respect to its ability to collect and calculate GHG emissions data consistently and accurately well in advance of the applicable compliance date.

As acknowledged in the proposing release, tracking, and collecting GHG emissions data presents a significant challenge for the Scope 3 disclosures in particular, and the SEC has sought to balance this concern with a general safe harbor, an exemption for smaller-reporting companies (SRCs) and a delayed compliance date for Scope 3 emissions disclosure. Nonetheless, an issue to watch and comment on will be the inclusion of further accommodations, including with respect to the amount of time between adoption and effectiveness.

5. Review of Corporate Policies and Procedures. Assuming the proposal is adopted substantially as proposed, the GHG emissions disclosures will be subject to a registrant's disclosure controls and procedures, and to the certification requirements under Sections 302 and 906 of the Sarbanes-Oxley Act.

Major changes in corporate policies and internal procedures governing the production and disclosure of GHG emissions data likely will be required for most registrants to support the certifications. In particular, internal procedures for sub-certification may be required to incorporate data and procedures for GHG emissions disclosure, which may involve significant effort to operationalize.

6. Engagement of Independent Attestation Providers. The attestation report is one of the more controversial requirements of the proposal and will likely be the subject of extensive comments. While the Task Force on Climate-Related Financial Disclosures (TCFD) framework and the GHG Protocol each contain general guidance on the verification of GHG emissions data, neither imposes (or even suggests) a mandatory requirement for the verification of such data by an independent third party.

The cost of verification may be significant and the readiness of registrants to provide it at the required time, even with the delayed compliance date included in the proposal, may involve substantial challenges. Other issues to watch and comment on are whether the level of assurance required under the proposed rules—reasonable assurance—is realistic and appropriate in light of the propose compliance dates, and who will be willing to provide this assurance and assume

the liability of being an "expert" in the event that a registrant's auditor is unable or unwilling to do so.

If the rules are adopted substantially as proposed, registrants should engage potential attestation providers as soon as possible to assess their readiness to comply with all applicable requirements including assessing and adopting necessary policies and procedures to support the attestation when required.

7. Limited Scope of Safe Harbor. The SEC's proposed safe harbor is limited to Scope 3 emissions disclosure due to the SEC's view that there are unique challenges associated with the collection and verification of information derived from third parties. The limitation on this safe harbor is another issue to watch and comment on, as much of the information required by the proposal presents novel and unique challenges for registrants, and the exposure of liability from third parties that registrants would face for such information is potentially high.

8. Foreign Private Issuers Included. The proposed rules apply to foreign private issuers to the same extent as domestic registrants, subject to the compliance dates described above. A registrant that is subject to reporting obligations for GHG emissions or other climate-related information in another jurisdiction should carefully consider the proposed rules in light of such existing obligations to determine what further steps must be taken to comply with the proposed rules.

The SEC has requested comment as to whether compliance with certain alternative reporting regimes should be deemed sufficient to satisfy the proposed rules, so this will be another issue to watch and comment on.

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SEC RULEMAKING

Commenters Battle over the SEC's Beneficial Ownership Proposal

By Randy Wang and Katherine Fleming Ashton

Following the April 11th expiration of the comment period for the Securities Exchange Commission's (SEC) dramatic proposal to amend the Schedule 13D/13G rules, we reviewed submissions to the SEC from some of the notable commenters.[1] While a number of companies and business groups supported the proposals, others, including certain institutional investors, activists and market participants, as well as some academics, strongly opposed key elements of the proposals.

In its proposal, the SEC seeks significant changes, including:[2]

- Significantly accelerating filing deadlines
- Extending the filing cut-off from 5:30 pm ET to 10 pm ET
- Expanding beneficial ownership concepts to include certain cash-settled derivative securities
- Expanding and clarifying the meaning of groups
- Exempting certain communications and consultation from regulation as a group
- Requiring 13Ds and 13Gs be filed using an XML machine-readable data language

Not surprisingly, public companies and their trade groups and advisors generally supported the proposals, including the Business Roundtable, National Investor Relations (NIRI), Society for Corporate Governance, Wachtell Lipton and companies such as FedEx and Freeport-McMoRan. Some proposed more aggressive modifications, such as:

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- Reducing the deadline for initial 13Ds from five days to two business days (NIRI and Society for Corporate Governance) or one business day (Wachtell Lipton)
- Requiring moratorium on further acquisitions until two business days after filing the 13D (Wachtell Lipton)
- Further broadening the definition of beneficial ownership to include any derivative that includes the opportunity, directly or indirectly, to profit or share in any profit of the subject security, subject to certain exceptions (Wachtell Lipton)

By contrast, key elements of the proposal received strong pushback and criticism from other groups, particularly with respect to the expanded definition of the group concept, the inclusion of cash-settled derivatives in beneficial ownership and accelerated filing deadlines.

Elimination of Requirement for "Agreement" to Form a Group

Numerous commenters objected to the elimination of the requirement for an agreement in the concept of a group, including advisors and market participants such as the Securities Industry and Financial Markets Association (SIFMA), Investment Company Institute, Investment Adviser Association, Simpson Thacher & Bartlett, T. Rowe Price, Dodge & Cox, and State Street Corporation and activists such as Elliott Investment Management and Pershing Square.

For example:

- In a deeply researched and analyzed submission, Elliott Investment Management objected

to the "radical redefinition" of a group as conflicting with Section 13(d)(3), which requires a meeting of the minds among group members, and the legislative history which tied group membership with an agreement to act in concert.

- SIFMA, Elliott, Pershing Square and Simpson Thacher all asserted that appellate courts have uniformly interpreted Section 13(d) as requiring an agreement among parties.
- Perhaps foreshadowing potential litigation claims, Elliott discussed its reasoning for concluding the proposal would be subject to invalidation on several grounds, including (i) the *Brand X* doctrine, which is that an appellate court's construction of a statute is binding and not subject to revision, even through agency rulemaking, when the court holds the statute has a clear and unambiguous meaning, (ii) the absence of "reasoned decision-making" under the Administrative Procedure Act (APA), (iii) the departure from past agency practice without adequate explanation, and (iv) the absence of awareness that the SEC is changing its position rather than, as the SEC maintains, clarifying its position.
- Elliott also asserts that this aspect of the proposal violates the First Amendment, because it would impinge upon protected commercial speech and also would violate the Fifth Amendment's due process clause due to the vagueness of the standard as to what conduct would create a group.

Most of the commenters expressed strong concern that the proposal could have a chilling effect on a variety of market transactions and, as noted by Professors Edwards (UNLV), Haan (Washington & Lee), Min (Michigan State) and Stevelman (NY Law), beneficial communications among shareholders seeking ESG change. Some, including a group of 65 law and finance professors, expressed concern with the "dearth of data and academic research" regarding the costs and benefits of the proposed redefinition of "group."

Several also noted that the definition of beneficial ownership is incorporated into a number of other rules, including Section 16, as well as widespread definitions of change of control, including for purposes of M&A, credit, compensation and derivative agreements, which might have potential carryover effects that were not addressed by the SEC's analysis in its proposal.

Inclusion of Cash-Settled Derivatives in Beneficial Ownership

Many of the same institutional investors and market participants objected to the SEC's proposal to include cash-settled derivatives in the definition of beneficial ownership.

- Several commenters noted that the SEC failed to provide evidence of derivatives providing incidents of ownership, such as control over voting or investment power, or any examples of specific cash-settled derivative products giving rise to concern, including commenters such as SIFMA, Council for Investor Rights and Corporate Accountability (CIRCA), Elliott and Simpson Thacher, with SIFMA noting that one of the examples did not even involve a cash-settled derivative.
- Elliott criticized the SEC for asserting "an unsubstantiated belief" that such derivatives "may be used" to improperly pressure counterparties to make decisions regarding voting or disposition of referenced securities, but without providing any evidence of actual instances in the marketplace or any empirical data.
- They view existing law as sufficient to address the SEC's concerns and view the proposal as being inconsistent with the existing beneficial ownership regime.

Several commenters expressed concern that such an expansion could have significant unintended consequences under other federal and state laws, as well as many contracts, including commenters such as the Investment Company Institute, Investment Adviser Association, and Teachers Insurance and Annuity Association of America (TIAA).

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Accelerated Filing Deadlines

The proposed acceleration of filing deadlines received criticism from institutional investors and activists, as well as from academics.

- *Information asymmetry.* Professors Schwartz (Yale) and Shavell (Harvard), two leading academics on financial markets, asserted that the proposal for accelerating filing deadlines is based on a fundamental flaw, because the SEC fails to consider whether a buyer would be willing to invest in the analysis of an investment opportunity if required to disclose the information it acquired prior to purchasing shares; in other words, requiring disclosure before trading deters buyers from effecting trades.Investment Adviser Association, T. Rowe Price and Dodge & Cox voiced strong concern that the shorter deadlines would provide greater opportunities for front running and other predatory trading by free riders, reducing fund returns and harming fund shareholders. Dodge & Cox believes the SEC should not "try to level the playing field by forcing certain market participants to share their intellectual capital and work product with other market participants unless [it] can identify specific harm to markets and/or investors, which it has not done."

  CIRCA expressed concern that shorter deadlines would significantly reduce incentives for investors to effect corporate change.
- *Insufficient time.* Many of the commenters urged that more time is needed to complete filings, noting that the advances in technology cited by the SEC do not actually streamline the processes needed to prepare and verify filings, particularly given corporate structures and different time zones.
- *Qualified Institutional Investors.* The Investment Company Institute, Investment Advisers Association, SIFMA and a number of institutional investors objected to accelerating filing deadlines for qualified institutional investors, noting that they are required to certify the absence of potential to change or influence control and due to the front-running and free riding concerns noted above. Further, institutional investors often have large volumes of 13G filings to make, and shifting to monthly filing would strain resources and present system challenges for collecting data from multiple entities.

Notes

1. All of the comments submitted on this proposal can be found at *https://www.sec.gov/comments/s7-06-22/s70622.htm*.
2. *https://www.bclplaw.com/en-US/insights/blogs/bclp-sec-corp-gov/big-changes-to-13d-13g-reporting-proposed-by-sec.html*.

DELAWARE LAW

Proposed Amendments to DGCL Broaden Corporate Autonomy and Stockholders' Rights

By Michael Walker, Taylor Bartholomew, Christopher Chuff, Matthew Greenberg, and Joanna Cline

Delaware's General Assembly will soon consider significant changes to the Delaware General Corporation Law (DGCL). The proposed amendments include, among others, the introduction of exculpation for officers, the broadening of the authority to delegate the issuance of stock and options, and the expansion of appraisal rights. If adopted, the proposed amendments will go into effect on August 1, 2022, except that the amendments to the appraisal and conversion statutes will only apply to transactions entered into on or after August 1st.

Officer Exculpation

Perhaps the most impactful change under consideration is an amendment to Section 102(b)(7) of the DGCL, which currently allows corporations to eliminate or limit directors' personal liability for monetary damages for breach of the fiduciary duty of care. As proposed, the amendment to Section 102(b)(7) would allow corporations to extend similar protections to their officers as well.

An important exception, however, is that officers may not receive exculpation resulting from derivative claims (that is, those brought by or on behalf of the corporation). Instead, under the proposed amendments, officers can only be exculpated for direct claims (that is, those brought against them by stockholders alleging direct harm to the stockholders).

Additionally, such protection will extend only to certain senior officers: the president, chief executive officer, chief operating officer, chief financial officer, chief legal officer, controller, treasurer, chief accounting officer, or any other person who has, by written agreement with the corporation, consented to be identified as an officer.

Stockholder plaintiffs in corporate litigation often cast a wide net when asserting claims against defendants. It has become increasingly common for senior-level officers to be accused of corporate wrongdoing alongside the board of directors. Often, directors and officers can serve in both capacities. Corporations will now have the option to protect certain officers from stockholder suits largely to the same extent that they can protect their directors.

Broadening of Authority Concerning Stock, Treasury Share, and Option Issuances

The proposed amendments would expand the ability of corporate boards to delegate authority concerning stock, treasury share, and option issuances beyond the corporation's officers to any designated person or body, and they would clarify the parameters of such delegations of authority concerning issuances across Sections 152, 153, and 157 of the DGCL.

Moreover, under the proposed amendments, a delegation of authority by the board of directors must fix (1) the maximum number of rights, options, and shares that may be issued; (2) a time period during which such rights, options, and shares may be

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issued; and (3) a minimum amount of consideration to be received for those issuances. The persons who are delegated such authority may not issue rights, options, or shares to themselves.

Amendments to Appraisal Statute

The proposed amendments will expand stockholder appraisal rights under Section 262 in two material respects. First, the amendments insert a new section that permits a beneficial owner of stock to demand appraisal directly, instead of requiring that the record holder of the stock make the demand on behalf of the beneficial owner.

An appraisal demand under this section would require the beneficial owner who demands appraisal, not just the record holder, to continuously maintain beneficial ownership of the stock. Second, the amendments would provide appraisal rights to stockholders in connection with a conversion of the corporation to a non-Delaware corporation or any other entity. This expands the right to appraisal beyond mergers and consolidations.

Changes Concerning List of Stockholders

A proposed amendment to Section 219 of the DGCL will eliminate the current requirement to make a list of stockholders available at stockholder meetings. However, corporations will still have to maintain a stocklist as a general matter, and the requirement to make the stocklist available to stockholders 10 days before a meeting has not been eliminated.

Stockholder Approval of Conversion

Section 266 of the DGCL would be amended to change the stockholder consent requirement for a corporation to convert to another entity type, such as a limited liability company or limited partnership. Currently, Section 266 requires unanimous stockholder approval for a conversion.

An amendment would change that approval requirement to a majority of stockholders entitled to vote thereon. Another caveat of this amendment is that if a corporation wishes to convert to a limited partnership, any stockholder that is to become a general partner in the limited partnership must vote in favor of the conversion.

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