What SEC Proposal On SPACs Means For Projection Defenses

By **Scott Mascianica and Landon Mignardi** (May 11, 2022)

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Since the U.S. Securities and Exchange Commission released its proposed rule[1] in March to enhance disclosures for special-purpose acquisition companies and de-SPAC transactions, much has been written about the rule's proposed requirements, including enhanced disclosures around forward-looking financial projections.

However, there has been little analysis on the interplay between the proposed projection requirements, SEC enforcement risks and the two primary defenses in SEC enforcement actions regarding forward-looking statements.

In this article, we summarize the relevant proposed provisions, outline the primary defenses in the context of the SEC's rule proposal, and offer some key takeaways from an SEC enforcement perspective.

Summary of Key Projection-Related Proposals

The SEC's proposal includes two key components under Regulation S-K concerning financial projections: (1) proposed Item 10[2] and (2) proposed Item 1609.

Proposed Items 10(b)(1) and (2) include a revised statement on the commission's policy for financial projections — whether involving SPAC or de-SPAC transactions, or otherwise. Generally speaking, Item 10(b) sets forth the commission's policy that "management's projections of future economic performance [must] have a reasonable basis and [must be] presented in an appropriate format." The SEC's rule proposal does not alter this standard.

Instead, under the proposal, the SEC proposes four additions to the existing guidance:

1. The guidelines apply to projections in a registrant's filings "of persons other than the registrant" such as the target company in a business combination transaction.

2. Projected measures not based on historical financial results or operational history must be "clearly distinguished" from those that are.

3. It "generally would be misleading" to present projections based on historical financial results or operational history without presenting those measures "with equal or greater prominence."

4. Additional requirements concerning presentation on non-generally accepted accounting principles financial measures, such as including a clear definition or explanation of those financial measures, a description of the GAAP financial measure to which it is most closely related, and an explanation of why the non-GAAP measure was selected instead of a GAAP measure.

Additionally, as part of the commission's broad suite of Item 1600 proposals, the commission included Item 1609, which includes four general proposed requirements:

1. If projections are included, a registrant must disclose the purpose for which the projections were prepared and the preparing party.

2. Disclose "all material bases of the disclosed projections and all material assumptions underlying the projections, and any factors that may impact such assumptions" including material growth rates, discount multiples, and the reasons for selecting them.

3. For SPAC projections, whether the projections reflect the view of SPAC management or board as of the date of the filing.

4. For target company projections, whether the target company has made any affirmations to the SPAC that its projections reflect management's views as of the date of the filing.[3]

Although the rule is subject to comment and the final form may differ, given the current composition of the commission, it is likely that many — if not all — of the provisions above will be included in the final rule in substantially similar form. With this in mind, it's worth assessing the SEC's enforcement activity concerning financial projections and revisiting the two primary defenses to forward-looking information in SEC enforcement actions.

SEC Enforcement Activity Involving Projections and Key Defenses

The commission has filed a number of enforcement actions in recent years alleging the use of baseless or unsupported projections about future revenues and the use of materially misleading financial projections.[4] The commission has been indiscriminate across industries and transaction types in bringing these enforcement actions, but it has been particularly active in the SPAC space since the SPAC boom in 2020.

These enforcement actions have involved not only scienter-based fraud actions, but also negligence-based proxy violations and books-and-records and controls violations.

Much has been made about the proposed rule's impact on the Private Securities Litigation Reform Act safe harbor.[5] Under the PSLRA safe harbor, a company is protected from liability under the Securities Act or Exchange Act when, among other things, the forward-looking statement is properly identified and accompanied by appropriate cautionary language.

Although the proposed changes will have a significant impact on the PSLRA safe harbor, it only applies in private actions and has no applicability in SEC enforcement actions.[6]

That is not to say that parties subject to SEC enforcement proceedings lack well-established defenses concerning forward-looking statements. Although the SEC makes no mention of their applicability in the proposal, under the appropriate circumstances, parties can argue:

- The forward-looking statements are nonactionable opinions in accordance with the standards set forth in the U.S. Supreme Court's 2015 decision in Omnicare Inc. v. Laborers District Council Construction Industry Pension Fund;[7] or

- The statements are immaterial as a matter of law based on specific cautionary language, known as the "bespeaks caution" doctrine.[8]

Overview of Omnicare

In Omnicare, the Supreme Court reinforced the view that "a sincere statement of pure opinion is not an 'untrue statement of material fact,'" even if an investor can ultimately prove the belief is wrong.[9]

However, there are three ways in which a statement of opinion can be false or misleading for purposes of the federal securities laws: (1) The speaker does not hold the belief professed; (2) the underlying facts supplied in support of the belief professed are untrue; or (3) the speaker omits information that makes the statement misleading to a reasonable investor.[10]

When a reasonable investor hears a statement of opinion from an issuer, she evaluates that opinion under the assumption that the issuer actually believes their statement and the opinion is based on some "meaningful ... inquiry" as opposed to "mere intuition."[11][12]

Yet, the court cautioned against an overly expansive reading of this standard, noting that issuer statements are assessed in light of all the surrounding text, including hedges and disclaimers, and require an evaluation of any competing facts.[13] The court added that there is no expectation that "every fact known" to an issuer supports its opinion statement, and an issuer's failure to disclose facts unfavorable to their position is "not necessarily misleading."[14]

Overview of "Bespeaks Caution" Doctrine

Forward-looking representations are considered immaterial when the defendant has provided the investing public with sufficiently specific risk disclosures or other cautionary statements concerning the statements at issue to nullify any potentially misleading effect.[15] These disclosures can render statements immaterial as a matter of law because no reasonable investor could consider them important in light of adequate cautionary language.[16]

However, not every risk disclosure will be sufficient to immunize forward-looking statements. Rather, as the U.S. Court of Appeals for the Tenth Circuit held in Grossman v. Novell Inc. in 1997, "the cautionary statements must be substantive and tailored to the specific future projections, estimates or opinions."[17]

Boilerplate, generalized disclosures will not be sufficient for purposes of rendering the statements immaterial; they must be specifically tailored to the points at issue.[18] Additionally, the doctrine does not apply to representations of present or historical facts.[19]

Key Takeaways

When considering a client's exposure or potential liability, an evaluation of the proposed rules through the lens of SEC enforcement reveals the following salient points.

Presentation of Non-GAAP Measures

This is an area SEC Enforcement has mined before. The proposed additions to Item 10(b) include language that may be familiar to SEC practitioners: "equal or greater prominence." The thrust of proposed Item 10(b)(iii) is that projected financial information should not be given a bigger spotlight than historical results.

This language is similar to another subsection of Item 10: Subsection (e)(1)(i)(A) requires that when one or more non-GAAP financial measures are included in commission filings, the registrant must include a "presentation, with equal or greater prominence, of the most directly comparable financial measure or measures calculated and presented in accordance with [GAAP]."

The SEC's Division of Enforcement has filed actions when companies have given greater prominence to non-GAAP metrics — such as earnings before interest, taxes, depreciation and amortization — compared to GAAP metrics, such as net income or loss. Given that the SEC has utilized similar provisions under Item 10 as enforcement hooks before and in light of the current enforcement environment, SPAC industry participants should heed caution if Item 10(b) is ultimately adopted.

Will Item 1609(b) Undercut Omnicare Defense Arguments?

Proposed Item 1609(b) would require that that all financial projections associated with a de-SPAC transaction disclose "all material bases of the disclosed projections and all material assumptions underlying the projections, and any factors that may impact such assumptions." If ultimately implemented, the mandatory disclosure could hinder individuals and entities from asserting the "omission" prong of an Omnicare defense.

For example, defendants and respondents in SEC enforcement actions will often assert that omissions from certain disclosures are not misleading because it is "not necessarily misleading when an issuer knows, but fails to disclose, some fact cutting the other way."[20]

However, under the rule proposal, the mandatory requirement to disclose applies not only to all material bases and assumptions but also to any factors that may affect such assumptions. If ultimately approved, this would provide the SEC's Division of Enforcement an opportunity to engage in ex post facto assessments of projections and then assert that omitted information was required to be disclosed under Item 1609(b).

Of course, each matter will turn on the unique facts and circumstances of the disclosures and disclaimers, but this inclusion will undoubtedly make it more difficult for defendants to stave off second-guessing by SEC enforcement and to beat back any enforcement actions post-filing.

Additional Projection Disclosure Requirements Mean Greater Specificity on Disclaimers

As detailed above, for parties to avail themselves of the "bespeaks caution" doctrine, the cautionary statements must be substantive and tailored to the specific future projections, estimates or opinions. Simply put, the greater the disclosure requirements, the greater the specificity required when it comes to risk disclaimers.

Given that the proposal seeks comprehensive disclosure of all material bases and assumptions, industry participants will have to consider corresponding risk disclosures associated with each of these points. Such analysis may necessitate the inclusion of financial, legal and industry professionals to adequately craft such language to ensure fulsome risk disclosures, as failure to do so may limit the ability of participants in SPAC transactions to avail themselves of this defense.

Conclusion

In the ever-changing SPAC landscape, it is critical practitioners and SPAC participants not only understand the scope of these proposed rules, but also the significant implications for key defenses to forward-looking statements. As SPAC industry participants ready for enhanced disclosure requirements, they would be well served to be mindful of the key defenses and draft their disclosures with them in mind. Otherwise, they could find themselves in a more precarious position when it comes to SEC regulatory scrutiny.

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[1] See Special Purpose Acquisition Companies, Shell Companies, and Projections, SEC Release Nos. 33-11048; 34-94546; IC-34549 (proposed Mar. 30, 2022) [hereinafter "Proposed Rule"], available at https://www.sec.gov/rules/proposed/2022/33-11048.pdf.

[2] For purposes of this article, we are focusing on the proposed amendments to Item 10(b) of Regulation S-K. The SEC also proposed amendments to Item 10(f) of Regulation S-K concerning smaller reporting company status.

[3] Concerning (iii) and (iv), if the projections no longer reflect the views of management, a registrant must disclose the purpose for disclosing the projections and the reasons for continued reliance on them.

[4] Proposed Rule, supra note 1, at p.128 n.279.

[5] See Section 27A of the Securities Act and Section 21E of the Exchange Act.

[6] See Proposed Rule, supra note 1, at p.86 n.157; see also Sec. & Exchange Comm'n v. E–Smart Techs., Inc., 74 F.Supp.3d 306, 324 (D.D.C. 2014).

[7] 575 U.S. 175 (2015).

[8] Both Omnicare and the bespeaks caution doctrine have been routinely been applied to SEC enforcement actions. See, e.g., Sec. & Exch. Comm'n v. GenAudio Inc. , No. 19-1454, 2022 WL 1218190, at *12 (10th Cir. Apr. 26, 2022); Sec. & Exch. Comm'n v. Thompson , 238 F.Supp.3d 575, 602 (S.D.N.Y. 2017).

[9] Omnicare, 575 U.S. at 186.

[10] See id. at 182–190.

[11] Id. at 188.

[12] Under Omnicare, a speaker's honestly held belief—even if ultimately wrong—in tandem with appropriate "expected inquiry" into the facts underlying that belief, could shield the speaker from liability for omissions. However, the speaker can be left exposed if the opinion

does not "fairly align" with information in the speaker's possession at the time. See Omnicare, 575 U.S. at 189 n.6. 8. Although the court acknowledged that whether these opinions are misleading always depends on context, the analysis must assess what a "reasonable person" would understand the statement "to convey beyond its literal meaning." Id. at 190, 194. As such, even if the Commission ultimately does not adopt 1609(b), SPAC participants need to be mindful that the "foundation [a reasonable person] would expect an issuer to have before making a statement" can be subject to scrutiny. Id. at 194.

[13] See Omnicare, 575 U.S. at 190.

[14] Id. at 189–90.

[15] Grossman v. Novell, Inc. , 120 F.3d 1112, 1120 (10th Cir. 1997).

[16] Halperin v. eBankerUSA.com, Inc ., 295 F.3d 352, 357 (2d Cir. 2002).

[17] Grossman, 120 F.3d at 1120.

[18] See Sec. & Exch. Comm'n v. Tecumseh Holdings Corp. , 765 F. Supp. 2d 340, 353–54 (S.D.N.Y. 2011) (finding that generic warnings—the investment "involves a high degree of risk" is "highly speculative," and only investors who "can afford a total loss of their investment" should consider subscribing—did not qualify for protection under the doctrine).

[19] P. Stolz Family P'ship L.P. v. Daum , 355 F.3d 92, 96 (2d Cir. 2004).

[20] Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund , 575 U.S. 175, 189 (2015).