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SEC and DOJ Enforcement Actions Aim to Bring SPAC Market Back to Earth

By **Robert J. Anello, Christopher B. Harwood, Brian A. Jacobs, Jeremy H. Temkin & Anthony Sampson**

What do space exploration, electric cars, and Lady Gaga's music label have in common? All three were involved in SPAC transactions this year, and all three transactions caught the attention of Gary Gensler's SEC. These three actions all show the SEC taking a more aggressive approach to regulation, which may result in significant penalties or the interruption of SPAC mergers, reaching even beyond the Earth's orbit.

Following the meteoric rise of SPACs in 2020 and the first half of 2021, financial regulators and prosecutors signaled that SPACs' popularity would not pass without regulatory scrutiny. SEC Chair Gensler said as much, testifying before Congress that the Agency would be carefully scrutinizing SPAC IPOs and mergers to ensure that retail investors were protected and that SPACs did not distort normal market activity. At least initially, the SEC's public posture was cautious, beginning with unremarkable pronouncements that SPACs were not a way to evade the purview of securities laws. Later, the Agency transitioned to a more concrete, but still high-level approach, making official statements that were targeted at particular concerns with SPACs' structure and accounting practices, but still aimed at SPACs as a class of investment vehicles. The Agency began with guidance on the potential disclosure pitfalls unique to SPACs, followed by a staff statement regarding how SPACs should classify particular stock warrants for purposes of internal accounting and compliance reporting. Now, the SEC appears to have moved into a new phase of regulation: attention to individual SPAC mergers.

Houston, We Have a Problem (with Due Diligence)

In perhaps the splashiest of the regulators' moves, the SEC brought charges against a host of players in a proposed SPAC acquisition

SEC Turning its Sights to SPAC Underwriters

By **Christopher B. Harwood, Jeremy H. Temkin & Margaret Vasu**

With the recent surge in popularity of special purpose acquisition companies ("SPACs"), it is no surprise that the SEC has increased its focus on this investment vehicle. Last December, the Commission issued its first guidance regarding disclosures on SPAC IPOs and subsequent business combination transactions. This guidance was, by no means, the SEC's first venture into regulating the SPAC space, but it signaled that enforcement activity will extend to SPAC sponsors.
(cont'd on page 4)

Crypto and SPACs: A Combo Ripe for Regulation?

By **Robert J. Anello, Brian A. Jacobs & Bronwyn Roantree**

Like the Reese's Peanut Butter Cup, for regulators, adding crypto to SPACs is a combination of two great tastes for which the SEC has shown quite an appetite. As SPACs have grown in popularity, exotic companies operating at the fringes of the market, including firms in the crypto space, have started to get into the SPAC game. In the past year, a number of crypto firms have merged with SPACs, and two more significant crypto companies are poised to go public via SPAC mergers in the coming months. With crypto notoriously occupying a regulatory gray area and SPACs drawing increasing attention from regulators and lawmakers alike, the combination of the two seems likely to draw the attention of the SEC in the coming months.
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involving the space technology company Momentus Space. Momentus offers “last-mile” services to commercial space companies—essentially an interstellar tugboat to move satellites and vessels in orbit. The Agency contended that Momentus misled investors in two ways. First, the SEC alleges, the Company lied about the viability of its core technology. According to the SEC, while Momentus “repeatedly told investors that it had ‘successfully tested’ its propulsion technology in space,” its only test of its core product in space failed to demonstrate that the technology was commercially viable.

The SEC also alleged that Momentus concealed the political and national security liabilities presented by its founder and former-CEO, Mikhail Kokorich. Kokorich, a Russian national, caught the eye of the U.S. national security apparatus, and raised concerns that foreign adversaries could coopt Momentus’ proprietary technology. Kokorich’s Russian citizenship complicated or precluded Momentus’ ability to obtain vital governmental contracts, a fact that the SEC deemed material to potential investors. Even after Kokorich stepped down as CEO and divested from the Company, the controversy surrounding his ownership delayed the Company’s launch date and decimated its value.

Momentus and Kokorich were not alone in the SEC’s orbit; the Agency also brought charges against Stable Road Acquisition Corp. (“SRAC”), the SPAC that was set acquire Momentus; SRAC’s CEO, Brian Kabot; and SRC-NI Holdings, LLC (“SRC-NI”), SRAC’s sponsor. SRAC’s violation lay in its failure to conduct adequate due diligence on Momentus’ commercial viability: SRAC did not specifically inquire about the success of Momentus’ propulsion technology in real-world testing—instead, the SPAC simply parroted in its SEC disclosures that Momentus had “successfully tested” its technology in space. Although SRAC knew that national security concerns had prompted the U.S. Government to force Kokorich out of a prior space technology company, SRAC failed to investigate the depth of the national security hurdles that the Company faced. Even after U.S. authorities signaled that Kokorich’s involvement could jeopardize Momentus’ profitability, SRAC included bullish revenue projections in its registration statements, further misleading potential investors, according to the government.

Except for Kokorich, the respondents agreed to a settlement with the SEC. Momentus, SRAC, and Kabot will pay civil penalties of $7 million, $1 million, and $40,000, respectively. SEC Chair Gensler said in a statement that respondents’ violations were emblematic of many of the abuses in the SPAC markets: “This case illustrates risks inherent to SPAC transactions, as those who stand to earn significant profits from a SPAC merger may conduct inadequate due diligence and mislead investors.” In particular, the actions demonstrate that SPACs will not be able to plead ignorance when comes to apparent risks in the target acquisition. As Chair Gensler made clear, “[t]he fact that Momentus lied to [SRAC] does not absolve [SRAC] of its failure to undertake adequate due diligence to protect shareholders.”

For his alleged role in the securities fraud, Kokorich faces a court battle with the SEC, with the Agency seeking permanent injunctions, penalties, disgorgement plus prejudgment interest, and an officer-and-director bar. As for the SPAC merger, the SEC’s enforcement action looms large over the shareholder vote on the merger scheduled for August 2021. With the merger still planned, the upcoming vote represents a test of shareholders’ stomachs for approving a deal that comes with significant regulatory baggage.

Subpoenas Short Circuit Electric Car SPAC

Although the SEC’s action against Momentus and SRAC has largely concluded, investigations into other SPAC mergers are just beginning. In July, electric vehicle maker Lordstown Motors announced that federal prosecutors in the Southern

District of New York are investigating its merger with SPAC DiamondPeak Holdings Corporation. The DOJ investigation is only the latest in a series of setbacks that have beset the Company since the announcement of the merger with DiamondPeak in October 2020. Shortly after the merger, the Company faced allegations from short sellers that it misrepresented the number of preorders and production schedule of its flagship electric truck. According to the allegations, Lordstown used fake orders to give the appearance of robust consumer demand and raise additional capital. In reality, the sellers claimed, the truck was years away from production. That caught the attention of the SEC, which issued two subpoenas to the Company regarding its merger and statements about preorders, a move that devastated Lordstown's share price and resulted in the departure of the CEO and other executives. Lordstown is also facing a consolidated class action claiming that it misrepresented its production capacity and consumer demand.

The government's interest in Lordstown shows that regulators will not view the completion of a SPAC merger as a regulatory finish line. Rather, the SEC and DOJ appear poised to look closely at companies even after they have gone public via a SPAC, likely due to the ways in which the method bypass many of the conventional disclosure requirements of an IPO. Thus, the Government seems likely to look closely at even completed SPAC mergers to ensure that investors were not misled in the acquisition.

Ackman's Novel SPAC Merger Faces the Music

Lastly, one feature of SPACs' recent rise is their ability to attract big-name sponsors. Often, these are celebrity financiers such as Chamath Palihapitiya, but also celebrities from outside the business world such as ex-New York Yankee Alex Rodriguez. Regulators, it appears, are not starstruck. Indeed, in March 2021, the SEC issued an investor alert warning against the dangers of assuming that a SPAC is a wise investment simply because of the glitz and glamour of celebrity involvement.

Now, the SEC has made its first move to prevent a SPAC business combination that was noteworthy, at least in part, because the SPAC in question was backed by Bill Ackman, a famous financier with a reputation for aggressive investing strategies. Ackman bet big on the SPAC market, creating the world's largest SPAC, valued at over $4 billion, called Pershing Square Tontine Holdings ("PSTH"). Ackman pitched PSTH as the SPAC for the People: unlike many SPAC sponsors, he claimed that he would not collect a fee and retail investors on Reddit soon shared speculation about PSTH's eventual target. After rumors that PSTH would acquire AirBnB and the sandwich chain Subway fizzled without a merger, Ackman announced a merger whose structure had not yet been seen in the SPAC market. In fact, no merger would occur. Instead, Ackman announced a novel transaction that he said would favor small-scale investors. In short, PSTH would acquire a large chunk of the existing stock in Universal Music Group ("UMG"), the label of such artists as Lady Gaga, Taylor Swift, and The Rolling Stones, the centerpiece of France's Vivendi SE. PSTH would hold the shares in trust until Vivendi completed its spin off and listing of UMG on the Euronext Amsterdam exchange in September 2021. Only then would PSTH distribute the UMG shares to its investors. In other words, rather than take UMG public itself, the SPAC would become a large shareholder in advance of the IPO that was already in the works. The problem with this novel arrangement, at least according to the SEC, is that it was not a SPAC merger at all. While neither the Agency nor PSTH specified regulators' concerns, Ackman called the SEC's objections a "deal killer," and briefly noted that part of the issue in the Agency's view was that the transaction did not meet the New York Stock Exchange's definition of a SPAC business combination. With the UMG acquisition all but dead, PSTH is back on the clock; the SPAC must acquire a target company in eighteen months or face dissolution. Going forward, Ackman wrote in his update to shareholders, PSTH will pursue a conventional SPAC merger. The specifics of the SEC's objection are still unclear. The failure of PSTH's merger,

however, suggests that the SEC is more likely to bless vanilla SPAC structures and look skeptically on those that seek to add further complications to the traditional model. Likewise, there is good reason to think that regulators will not allow well-known investors or splashy SPAC IPOs to distract them from the fundamentals of a proposed business combination.

The SEC's and DOJ's recent enforcement moves against SPACs are noteworthy not for any uniform regulatory principle or concern, but instead for the diverse priorities they serve. Indeed, each of the enforcement or regulatory maneuvers examined above touches upon a different part of SPAC structures or transactions. In short, regulators are not targeting a specific subset of issues surrounding the SPAC market; they are closely examining the entire panoply of regulatory pitfalls. This holistic approach heralds a new era of regulation, and one that should prompt those contemplating forming SPACs to consider whether any part of their proposed transactions will raise the hackles of financial regulators.

SEC Turning its Sights to SPAC Underwriters (cont'd)

By **Christopher B. Harwood, Jeremy H. Temkin & Margaret Vasu**

The Commission's recent guidance focuses on the role of SPAC IPO underwriters, especially those who perform other functions during the acquisition process, expressing concern that such relationships are ripe for conflicts of interest. Thus, the SEC suggested that when there is an underwriter for a SPAC's IPO, the SPAC should disclose: (1) whether the underwriter will be providing "additional services," (2) the fees the SPAC may pay for such services, as well as any deferred compensation that the underwriter may receive upon completion of a business combination transaction, and (3) any potential conflict of interest the underwriter may have in providing such services, particularly given any deferred compensation agreement.

Although it was only one element of the SEC's guidance, the warning regarding potential conflicts on the part of SPAC IPO underwriters has wide-ranging implications. An underwriter of a SPAC IPO, like a hydra in a millinery shop, has ample opportunity to wear many hats. A bank acting as an underwriter for the SPAC's IPO may also assist in identifying potential targets, act as a placement agent, advise on the subsequent acquisition, and underwrite or arrange debt financing. The underwriting bank can even *simultaneously advise the SPAC and the merger target* through the subsequent combination transaction. And all of this can occur where the bank's compensation for the initial work of underwriting the SPAC IPO is delayed until, and conditioned upon, completion of an acquisition, which can occur long after the IPO (a SPAC IPO typically will provide for a two-year period to complete an acquisition). This fee structure, coupled with an underwriting bank's role in the execution of the subsequent transaction, creates a structure that incentivizes the bank to recommend or otherwise facilitate a suboptimal acquisition in order to ensure it receives all of its potential fees. Given all the possible roles an underwriting bank might play (each of which can give rise to separate fees), the SEC is likely to view a wide variety of SPAC deals as fertile ground for conflicts of interest, and thus, enforcement.

The Commission is already making moves in this direction. According to a July 13 report, the SEC is currently "exploring whether certain fee structures may incentivize underwriters on . . . SPAC listing to secure unsuitable deals when also advising on the later stage merger, potentially putting investors at risk." In particular, the SEC is focused on the fees banks have collected while performing multiple roles in a SPAC's IPO and subsequent combination transactions, and the SEC has reportedly requested information from a number of banks, including top SPAC underwriters. At this stage, it

appears that the SEC is still gathering information, but the new guidance suggests it will be closely examining the role of SPAC sponsors' and other insiders' conflicts of interests.

Crypto and SPACs: A Combo Ripe for Regulation? (cont'd)

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Crypto/SPAC Mergers Are Heating Up

A number of significant players in the crypto world recently have announced mergers with SPACs. In September 2020, Diginex, a Hong Kong-based digital asset financial services company, merged via a SPAC with 8i Enterprises, becoming the first crypto exchange operator to be listed on Nasdaq. In January 2021, Bakkt, a cryptocurrency exchange established by the Intercontinental Exchange (owner of the New York Stock Exchange), announced it was going public via a SPAC. March 2021 saw two big crypto/SPAC partnerships, with Robinhood competitor eToro announcing it would go public via a SPAC in a $10.4 billion deal and Cipher Mining, which specializes in the mining of Bitcoin, merging via a SPAC to create a business with an enterprise value of $2 billion.

Looking ahead, SPACs' appetite for companies in the crypto space continues, with at least two big deals underway involving the crypto companies Circle and Bullish. Circle is somewhat unique among the crypto/SPAC deals, as it is built around a cryptocurrency—USD Coin ("USDC")—rather than a crypto exchange. Boston-based Circle, together with its partner Coinbase, announced plans in early July 2021 to go public via a merger with the SPAC Concord Acquisition Corp., with a predicted valuation of $4.5 billion. USDC is a so-called "stablecoin"—meaning that one USDC is always worth one US dollar—and is backed by reserves, with a July 2021 attestation report disclosing that 61% of USDC is backed by cash and cash equivalents. Also in July 2021, the crypto exchange Bullish announced that it intended to go public via a merger with the SPAC Far Peak Acquisition Corp., which is headed by Tom Farley, former president of the NYSE. The Bullish/Far Peak merger is notable both for personnel involved—backers include Peter Thiel and the Japanese bank Nomura—and also for the size of the deal, an estimated $9 billion. Despite the drop-off in SPAC activity from its peak in early 2021, the crypto/SPAC space remains hot. But do regulatory pitfalls lurk around the corner?

Regulators and Lawmakers Are Taking Note

SEC Chairman Gary Gensler's recent comments demonstrate that the Commission is looking closely at both crypto and SPACs. With regards to crypto, in the past seven years the Commission has brought over 75 enforcement actions, mostly involving allegations of fraud (52%), unregistered securities offerings (69%), or both (37%). Though initial coin offerings ("ICOs") have been a favorite target of the SEC (especially since 2017), market watchers have noted that this might change as issuers explore alternative funding sources—which includes SPACs. The SEC's recent decision to delay completion of SkyBridge Capital's application for a Bitcoin ETF underscored the Commission's reluctance in the crypto space, with some speculating that the reluctance was driven by concern for retail investors in the face of crypto's volatility. With increased pressure on the SEC to regulate both crypto and SPACs from lawmakers in both parties—including Senator Sherrod Brown (D), Chair of the Senate Banking Committee, and Senator John Kennedy (R)—crypto/SPAC mergers may soon face additional scrutiny.

Indeed, Chairman Gensler has raised particular concerns about crypto exchanges (which include Diginex, Bakkt, and Bullish), identifying the lack of oversight of crypto exchanges as the most pressing issue in the regulation of cryptocurrency. Citing, as an example, the fear of front-running on crypto exchanges, Gensler said that he wanted to work with Congress to bring investor protections akin to those on the NYSE to crypto platforms. Regulators and lawmakers have raised similar concerns about the need to ensure adequate protection for retail investors with regards to SPACs, and the union of crypto and SPACs surely will heighten these concerns.

Despite the SEC's increased attention to digital assets, a lack of clarity as to the regulatory status of crypto remains. Combining the ambiguous regulatory status of crypto with the heightened attention currently being paid to SPACs, as well as the concerns about adequate retail investor protections raised by both crypto and SPACs, crypto/SPAC deals—particularly those involving crypto exchanges—present an area ripe for enforcement. All parties in this space, then, would be wise to proceed with caution as the regulatory landscape continues to evolve. There's no wrong way to eat a Reese's, but there may be many wrong ways—at least in the eyes of regulators—to combine crypto and SPACs.

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