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Due diligence reduces the regulatory risk for SPAC transactions

Forensic & Integrity Services | Part 5 of our M&A Integrity Diligence Series

Special purpose acquisition companies (SPACs) raised \$122.2b¹ in 2021 (the capital raised from January to March 2021 exceeded the capital raised in all of the record-breaking 2020).² In a SPAC, a high-profile sponsor raises money, identifies a Target operating business (Target), negotiates a valuation and completes a combination that results in the Target operating business becoming a public company.

A SPAC sponsor contributes their reputation, time and money to guide a Target to the public markets. A Target is typically an early-stage company that must prepare itself for the scrutiny of the public markets in a short time period.

SPAC sponsors typically have two years to identify and complete a business combination. As of August 30, 2021, 439 SPACs have raised \$131b and are searching for Targets.³

The SPAC's popularity as an investment vehicle has led to increased regulatory scrutiny from the SEC and FINRA. In a recent press release announcing settlement of charges against a SPAC, SPAC sponsor and Target, SEC Chair Gary Gensler stated "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."⁴

Now is the time to reassess due diligence procedures and consider supplementing the process to address the increased regulatory risk.

What can be done to mitigate the SPAC regulatory risk?

Customary financial diligence may focus on the quality of earnings and any adjustments required for extraordinary activity. While these approaches are rooted in strong, fundamental due diligence procedures, they are forward-looking and may not cover the regulatory risk of the Target's current and historical spend and processes.

An emerging practice is to perform Integrity due diligence, which leverages forensic procedures to perform a transaction-level analysis of the Target. The anti-fraud and conflicts of interest data analytics provide insight into patterns and trends within the Target's financial data. Apart from potentially identifying improper transactions, the Integrity due diligence helps identify internal control gaps that will need to be addressed to position the Target to comply with the accurate books and records requirements of a public company.

Adding Integrity due diligence procedures does not delay the customary financial and legal diligence process and provides the benefit of meaningful insights to both the sponsor and Target as they move forward as a successful public company business combination.

After a SPAC merger takes a company public, what are the next steps?

Emerging as a public company is a moment of celebration and the culmination of significant changes for the De-SPAC company. The operating business should consider performing a compliance program assessment and periodic audits to evaluate the effectiveness of recently implemented compliance functions and benchmark the current program to the DOJ's Evaluation of Corporate Compliance Programs."⁵

1. SPAC research, <https://www.spacresearch.com/>, accessed August 13, 2021.

2. "SPACs break 2020 record in just 3 months," <https://www.cnbc.com/2021/03/19/spacs-break-2020-record-in-just-3-months.html>, accessed August 13, 2021.

3. "Pre-Deal," <https://www.spacresearch.com/>, accessed August 30, 2021. Note, this includes Pershing Square Tontine SPAC that announced on August 19, 2021, it may seek a shareholder vote to return cash.

4. "SEC Charges SPAC, Sponsor, Merger Target, and CEOs for Misleading Disclosures Ahead of Proposed Business Combination," <https://www.sec.gov/news/press-release/2021-124>, July 13, 2021.

5. The DOJ's "Evaluation of Corporate Compliance Programs." Guidance was updated June 1, 2020 and provides a foundation for considering the effectiveness of a company's compliance program.



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