



This article was originally published in *PLI Current: The Journal of PLI Press*, Vol. 5 (2021), <https://plus.pli.edu>. Not for resale.

PLI Current

The Journal of PLI Press

Vol. 5 (2021)

SEC Enforcement Keeps Pace with New Technology, SPACs, and Market Trends

Todd Rahn, CPA

Michael Houseman

FTI Consulting[±]

[±] *The views expressed herein are those of the author(s) and not necessarily the views of FTI Consulting, Inc., its management, its subsidiaries, its affiliates, or its other professionals. FTI Consulting, Inc., including its subsidiaries and affiliates, is a consulting firm and is not a certified public accounting firm or a law firm.*

FTI Consulting is an independent global business advisory firm dedicated to helping organizations manage change, mitigate risk, and resolve disputes: financial, legal, operational, political & regulatory, reputational, and transactional. FTI Consulting professionals, located in all major business centers throughout the world, work closely with clients to anticipate, illuminate, and overcome complex business challenges and opportunities.

© 2021 FTI Consulting, Inc. All rights reserved. www.fticonsulting.com.

As markets evolve, the SEC's enforcement tools and priorities will also modernize to protect markets and investments.

The goal of the U.S. Securities and Exchange Commission (SEC) is “protecting investors, maintaining fair, orderly and efficient markets, and facilitating capital formation.”¹ In addition to regulation, one of the SEC’s means for achieving this goal is through its Enforcement Division, which brought a total of 775 enforcement actions, including 405 standalone actions, against individuals and companies for civil security law violations, even as the COVID-19 pandemic slowed global economic activity.²

The SEC is organized into six divisions: 1) Division of Corporation Finance; 2) Division of Trading and Markets; 3) Division of Investment Management; 4) Division of Enforcement; 5) Division of Examinations; and 6) Division of Economic Risk and Analysis. The SEC is responsible for:

- interpreting and enforcing federal securities laws;
- issuing new rules and amending existing rules;
- overseeing the inspection of securities firms, brokers, investment advisers, and ratings agencies;
- overseeing private regulatory organizations in the securities, accounting, and auditing fields; and
- coordinating U.S. securities regulation with federal, state, and foreign authorities.³

The Division of Corporation Finance oversees the accuracy of public company disclosures. The Division serves a dual purpose by (i) offering interpretive assistance to

¹ See SEC, What We Do, <https://www.sec.gov/Article/whatwedo.html> (last updated Dec. 18, 2020).

² See SEC Press Release No. 2020-274, SEC Division of Enforcement Publishes Annual Report for Fiscal Year 2020 (Nov. 2, 2020), <https://www.sec.gov/news/press-release/2020-274>.

³ See SEC, Investor Bulletin: An Introduction to the U.S. Securities and Exchange Commission – Organization and Mission (Aug. 20, 2015), https://www.sec.gov/oiea/investor-alerts-bulletins/ib_mission.html.

companies in connection with the SEC's rules; and (ii) providing the SEC with recommendations for new rules driven by knowledge gained through its interactions with registrants.⁴ To ensure compliance, the Division of Corporation Finance routinely reviews public issuers' filings. As such, the Division works closely with the Office of the Chief Accountant to monitor accounting developments, primarily in the United States.⁵

The Division of Enforcement recommends investigations of securities laws violations. The investigations are performed confidentially and presented to the SEC for authorization to file a case in federal court or bring an administrative action. Often, the SEC and the party charged settle the matter without a trial.⁶

The Office of the Chief Accountant is the principal adviser on all accounting and auditing matters for the SEC and works closely with the Financial Accounting Standards Board (FASB). The SEC works with the FASB to set accounting standards that underpin the Commission's enforcement of federal securities laws.⁷ The Office of the Chief Accountant is also responsible for approving the auditing rules set forth by the Public Company Accounting Oversight Board (PCAOB). Due to its involvement with the FASB and the PCAOB, the Office of the Chief Accountant is often called on to assist in the SEC's enforcement actions.⁸

The FASB, an independent, private, not-for-profit organization established in 1973, is responsible for establishing accounting standards in the U.S.⁹ Its goal is to create an effective way to develop accounting standards that balance the need for

⁴ See SEC Division of Corporate Finance, About the Division, <https://www.sec.gov/page/corpfin-section-landing> (last updated Jan. 31, 2017).

⁵ See SEC, Filing Review Process, <https://www.sec.gov/divisions/corpfin/cffilingreview.htm> (last updated Sept. 27, 2019).

⁶ See SEC, How Investigations Work, <https://www.sec.gov/enforce/how-investigations-work.html> (last updated Jan. 27, 2017).

⁷ See Robert K. Herdman, Chief Accountant, SEC, Testimony Concerning the Roles of the SEC and the FASB in Establishing GAAP (May 14, 2002), <https://www.sec.gov/news/testimony/051402tsrkh.htm>.

⁸ SEC, Guidance for Consulting with the Office of the Chief Accountant, <https://www.sec.gov/info/accountants/ocasubguidance.htm> (last updated Nov. 4, 2014).

⁹ FASB, About the FASB, <https://www.fasb.org/facts/> (last updated July 2020).

transparent reporting and disclosures with the cost of compliance. The FASB standard-setting process considers all stakeholders' input and opinions in an attempt to establish high-quality standards.¹⁰ Fundamentally, FASB's purpose is to ensure that financial statements are prepared consistently across issuers and to provide owners/investors, creditors, and potential investors with accurate information about an organization's financial performance to assist in their operating, investing, and financing decisions.

In 2002, the Sarbanes-Oxley Act was passed, and, as a result, Congress established the PCAOB to oversee public company audits with the goal of protecting investors and the public interest.¹¹ Former President George W. Bush characterized the legislation as "the most far-reaching reforms of American business practices since the time of Franklin Delano Roosevelt."¹² The objective of balancing regulation with reasonableness, however, continues to be a challenge.

SEC Commissioner Hester Peirce acknowledged this balance during a speech on February 6, 2020: "When we see people struggling to find a way both to comply with the law and accomplish their laudable objectives, we need to ask ourselves whether the law should change to enable them to pursue their efforts in confidence that they are doing so legally."¹³

In September 2020, Jay Clayton, Chairman of the SEC from May 2017 to December 2020, discussed the regulatory trends over the past three years and called

¹⁰ See Sagar Teotia, Chief Accountant, SEC, Statement in Connection with the 2019 AICPA Conference on Current SEC and PCAOB Developments (Dec. 9, 2019), <https://www.sec.gov/news/speech/teotia-speech-2019-aicpa-conference>.

¹¹ See About the PCAOB, PUB. CO. ACCOUNTING OVERSIGHT BD. <https://pcaobus.org/About/Pages/default.aspx> (last updated Dec. 31, 2020).

¹² George W. Bush Administration, President George W. Bush Record of Achievement, Bush Administration White House Archives, <https://georgewbush-whitehouse.archives.gov/infocus/achievement/chap9.html>.

¹³ Hester M. Peirce, Commissioner, SEC, Running on Empty: A Proposal to Fill the Gap Between Regulation and Decentralization (Feb. 6, 2020), <https://www.sec.gov/news/speech/peirce-remarks-blockress-2020-02-06>.

out areas that need continued attention.¹⁴ He noted that the SEC’s mission is to enhance investor protection, promote capital formation, and ensure a more fair, orderly, and efficient market. Chairman Clayton emphasized the SEC’s belief that each of these goals can be worked toward without sacrificing the others. Highlighting the SEC’s work on easing access to the public markets, he noted expanding the use of scaled disclosures on small and medium-sized companies, amending the definitions of “accelerated filer” and “large accelerated filer,” and expanding an issuer’s ability to “test the waters” prior to a public offering via a non-public staff review of their registration statement.

The accounting profession continues to face challenges created by new technology and evolving markets. This constant evolution creates potential legal consequences for all accounting professionals. Recalling the explosion of initial coin offerings (ICOs) in 2017 and 2018, Chairman Clayton emphasized the importance of the SEC keeping pace with the evolving markets.¹⁵ To achieve this goal, over the past few years the SEC has focused on modernization, including retrospective review of regulations, heavily investing in technology systems, increasing the use of data analytics, and improving cybersecurity capabilities.¹⁶

Many regulations are far past due for a retrospective review. For example, prior to the update in 2019, the public company disclosure requirements in Regulation S-K relating to the description of the business, legal proceedings, and risk factors had not been significantly revised in more than 30 years.¹⁷ Former Chairman Clayton believes that modernizing Regulation S-K gives investors greater insight into the information

¹⁴ See Jay Clayton, Chairman, SEC, Investor-Focused, Nimble and Vigorous Enforcement at the SEC (Sept. 17, 2020), <https://www.sec.gov/news/speech/clayton-vigorous-enforcement-sec-091720>.

¹⁵ See Jay Clayton, Chairman, SEC, Putting Principles into Practice, the SEC from 2017-2020 Remarks to the Economic Club of New York (Nov. 19, 2020), <https://www.sec.gov/news/speech/clayton-economic-club-ny-2020-11-19>.

¹⁶ *Id.*

¹⁷ See SEC Press Release No. 2020-192, SEC Adopts Rule Amendments to Modernize Disclosures of Business, Legal Proceedings, and Risk Factors Under Regulation S-K (Aug. 26, 2020), <https://www.sec.gov/news/press-release/2020-192>.

a public company's management uses to monitor and manage the business while simultaneously reducing compliance burdens and costs.¹⁸

While the leadership in the White House changed in 2021, ultimately driving leadership changes within the SEC, the SEC is expected to continue focusing on modernizing regulations, introducing new regulations to address the evolving market, and investing in technology and data analytics.¹⁹ Chairman Clayton resigned as of December 23, 2020.²⁰

On January 18, 2021, President Joe Biden announced his nomination of Gary Gensler as the next SEC Chairman. Prior to being sworn in on April 17, 2021, Gensler served as an MIT Sloan professor and previously led the Commodity Futures Trading Commission (CFTC) during the Obama administration.²¹ Based on both previous work at the CFTC and past commentary made by Gensler, he is expected to continue focusing on cryptocurrency regulation, data modernization, and fintech regulation.²² During his confirmation hearing on March 2, 2021, the Senate Banking Committee asked Gensler how he would deal with the rise of “gamification” on stock trading. He promised **to analyze and intervene in this area** if necessary. He also expressed support for increased disclosures around climate risk, stating, “Increasingly, investors really

¹⁸ *Id.*

¹⁹ The President of the United States appoints the five commissioners of the SEC, including its Chairman, for five-year terms.

²⁰ See Jay Clayton, Chairman, SEC, Statement of SEC Chairman Jay Clayton Regarding the Conclusion of His Tenure (Dec. 23, 2020), <https://www.sec.gov/news/public-statement/clayton-2020-12-23>.

²¹ See Zach Church, *Biden SEC Pick Gary Gensler on Fintech, Regulation, and Blockchain*, MIT SLOAN SCH. OF MGMT. (Jan 21, 2021), <https://mitsloan.mit.edu/ideas-made-to-matter/biden-sec-pick-gary-gensler-fintech-regulation-and-blockchain>.

²² See Jesse Pound, *SEC Chairman Gary Gensler Says More Investor Protections Are Needed for Bitcoin and Crypto Markets*, CNBC (May 7, 2021), <https://www.cnbc.com/2021/05/07/sec-chairman-gary-gensler-says-more-investor-protections-are-needed-for-bitcoin-and-crypto-markets.html>

want to see tens of trillions of dollars of assets behind it. They want to see climate-risk disclosures. I think issuers would benefit from such guidance.”²³

On March 3, 2021, the Division of Examinations announced its examination priorities, indicating that the Division will be enhancing its focus on climate and environmental, social, and governance (ESG)-related risks to integrate these considerations in the SEC’s broader regulatory framework.²⁴ Another 2021 priority is protecting retail investors through continued focus on compliance with “Regulation Best Interest” including examining whether firms and broker-dealers appropriately mitigate conflicts of interest and disclose conflicts, as necessary.²⁵ The Division noted that it will continue to focus on compliance within the fintech space, including digital assets. These are not intended to be an exhaustive list of the SEC’s upcoming priorities, and one can expect that the SEC will pivot priorities in step with market trends and evolution.

One such recent evolution is the rising popularity of Special Purpose Acquisition Companies (SPACs). While SPACs have been around for many years, their popularity as a means to access public markets is growing. In fact, in January 2021 alone, SPACs raised nearly \$26B.²⁶ SPACs are non-operating publicly traded companies that are created solely for raising capital, with the goal of acquiring an existing company.

The SEC realizes that these investment vehicles are not as well understood by the average investor and is making efforts to educate them. To that end, the SEC’s Office of Investor Education and Advocacy (OIEA) issued an Investor Bulletin detailing what a SPAC is and identifying considerations when investing in a SPAC both at its shell

²³ See Thomas Franck, *Biden SEC Pick Gensler Grilled over Bitcoin, GameStop Mania and Board Diversity*, CNBC (Mar. 2, 2021), <https://www.cnbc.com/2021/03/02/biden-sec-pick-gensler-grilled-over-bitcoin-gamestop-mania-and-board-diversity.html>.

²⁴ See SEC Press Release No. 2021-39, SEC Division of Examinations Announces 2021 Examination Priorities (Mar. 3, 2021), <https://www.sec.gov/news/press-release/2021-39>.

²⁵ See SEC Press Release No. 2019-89, SEC Adopts Rules and Interpretations to Enhance Protections and Preserve Choice for Retail Investors in Their Relationships With Financial Professionals (Jun.5, 2019) <https://www.sec.gov/news/press-release/2019-89>.

²⁶ See Andrew Ross Sorkin et al., *The Issues With SPACs*, N.Y. TIMES (Feb. 10, 2021), <https://www.nytimes.com/2021/02/10/business/dealbook/spacs-blank-check-deals.html>.

company phase and at the time the SPAC combines with the target company.²⁷ Additionally, the Division of Corporation Finance released guidance on disclosure requirements for SPACs.²⁸ The guidance covers disclosure considerations in connection with both the SPACs initial public offering (IPO) and the subsequent business combination.²⁹

At the time the SPAC becomes public through an IPO, it is a shell company (i.e., the entity does not have an underlying operating business and only has assets such as cash and limited investments).³⁰ The timing from when the SPAC has its IPO and the merger or acquisition of the target company can vary widely.³¹ Unlike a traditional IPO in which potential investors can review the operations of the business through an income statement analysis and other disclosures, when a SPAC goes public, it typically only has cash and limited investments.³² Therefore, an investor in a SPAC at the IPO stage has no certainty about what the eventual business will be. As a result, an investor must perform due diligence and research who the management and sponsors of the SPAC are along with the details regarding the trust account, which holds the proceeds of the IPO.

SPAC agreements typically provide a time limit (e.g., two years) to identify and complete the initial business combination. If a SPAC lists securities on an exchange, it is required to complete an initial business combination within three years of the SPAC's IPO.³³ At the time of the initial business combination, shareholders will have

²⁷ See SEC, Investor Alert, What You Need to Know About SPACs – Updated Investor Bulletin (May 25, 2021), <https://www.sec.gov/oiea/investor-alerts-and-bulletins/what-you-need-know-about-spacs-investor-bulletin>.

²⁸ See SEC, CF Disclosure Guidance: Topic No. 11, *Special Purpose Acquisition Companies* (Dec. 22, 2020), <https://www.sec.gov/corpfin/disclosure-special-purpose-acquisition-companies>.

²⁹ *Id.*

³⁰ See SEC, Investor Alert, What You Need to Know About SPACs – Updated Investor Bulletin (May 25, 2021), <https://www.sec.gov/oiea/investor-alerts-and-bulletins/what-you-need-know-about-spacs-investor-bulletin>.

³¹ *Id.*

³² *Id.*

³³ *Id.*

the opportunity to redeem their shares for a pro rata amount of the funds in the trust account or continue as an investor in the surviving operating company.³⁴ Further, the investor will be able to use various financial information of the to-be-acquired business included in the required regulatory filings to make an informed decision.

As an investor in a SPAC, it is important to be aware of the risks that can surface because of the fixed deadline for the initial business combination. SPAC sponsors typically purchase equity in a SPAC at more favorable terms than investors at the IPO or subsequent investors on the public market. As a result, sponsors and possibly other early investors will benefit more from the SPAC completing the business combination than later investors. This cushion on return coupled with the looming deadline may create incentives for the SPAC to complete the initial business combination that results in a less favorable outcome for the other investors.³⁵ To create additional accountability, some SPAC sponsors have created terms stating they will not receive the payout until the merged company hits specific targets.³⁶

The pressure to complete a deal as quickly as possible can boil over to the target company. The target company must be prepared to operate as a public company, including ensuring compliance with financial reporting regulations. With the fixed timeline, the target company sometimes has mere months to become compliant with public company requirements, which is typically a much more condensed timeline compared to a traditional IPO. Unfortunately, for many companies, this can lead to compliance issues post-merger. If the share price suffers post-merger, the shareholders could argue that the SPAC management rushed into an unfavorable deal in order to avoid liquidation. Increased SPAC issuances and poor post-merger performance is likely to lead to increased SEC oversight of these entities.³⁷

³⁴ *Id.*

³⁵ *Id.*

³⁶ See Andrew Ross Sorkin, *Wall Street's New Favorite Deal Trend Has Issues*, N.Y. TIMES (Feb. 10, 2021), <https://www.nytimes.com/2021/02/10/business/dealbook/spac-wall-street-deals.html>.

³⁷ See Bruce A. Ericson et al., *The SPAC Explosion: Beware the Litigation and Enforcement Risk*, PILLSBURY WINTHROP SHAW PITTMAN LLP (Dec. 15, 2020), <https://www.pillsburylaw.com/en/news-and-insights/spac-litigation-enforcement-risk.html>.

Going public via a SPAC rather than a traditional IPO is attractive due to less onerous reporting regulations for SPACs. Specifically, SPACs are able to issue financial projections, whereas such reporting is not permitted in a traditional IPO.³⁸ While sharing forward projections may assist in justifying a valuation, these projections can also create performance pressure on management. Additionally, even though these projections are allowed, it is possible that shareholders will challenge them if they are not met in the future. Accordingly, it is vital to conduct a thoroughly documented critical review of the projections to ensure that they are expressly forward looking and reasonable. Also required is the inclusion of cautionary language disclosing known risks.³⁹

It is possible that shareholders may sue by alleging misleading or fraudulent statements were made in the proxy statement.⁴⁰ Often these suits arise when shareholders are unhappy with the performance of the newly formed entity following the business combination. One way a shareholder could challenge the forward-looking statements in the proxy is by alleging there was no basis to believe the projections in the proxy statement were achievable. Another possible complaint a shareholder may allege is that the company did not disclose all the known financial risks. If these allegations were found to be true, and thus the information was knowingly false when reported, the company would not be entitled to the safe harbor for forward-looking statements afforded by the Private Securities Litigation Reform Act.⁴¹

While SPACs can be an attractive way to raise capital, this approach is not without risks. In July 2021, the SEC announced more than \$8 million in enforcement actions against a SPAC; the target company; their respective current and former CEOs; and

³⁸ See Andrew Ross Sorkin, *Wall Street's New Favorite Deal Trend Has Issues*, N.Y. TIMES (Feb. 10, 2021), <https://www.nytimes.com/2021/02/10/business/dealbook/spac-wall-street-deals.html>.

³⁹ See Bruce A. Ericson et al., *The SPAC Explosion: Beware the Litigation and Enforcement Risk*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE (Jan. 14, 2021), <https://corpgov.law.harvard.edu/2021/01/14/the-spac-explosion-beware-the-litigation-and-enforcement-risk/>.

⁴⁰ See James Heyworth & Julia Bensur, *Recent SPAC Surge May Portend Increased Litigation*, LAW360 (Oct. 15, 2020), <https://www.law360.com/articles/1316118/recent-spac-surge-may-portend-increased-litigation>.

⁴¹ Private Securities Litigation Reform Act, 15 U.S.C. § 78u-4.

the sponsor company for the first time, signaling that SPACs will be subjected to heightened scrutiny under the Biden administration.⁴² To meet the SEC's due diligence and disclosure requirements, the post-acquisition public company needs to have robust accounting, compliance, and internal control organizations and infrastructure to address potential legal, regulatory, or other compliance risks.⁴³ In order for accounting and investment professionals to best serve clients, understanding the unique compliance and litigation risks SPACs and their targets may create is vital.

The markets will continue to evolve, and with that new risks will arise for market participants. While SEC leadership may change, the focus will remain on modernization; protecting investors through education; regulation; and (when necessary) enforcement of complex investments such as cryptocurrencies and SPACs and increasing disclosures around climate related risks. Accounting and investment practitioners must stay up to date with these trends in order to deliver high quality client service.

Todd Rahn is the Bay Area Practice Leader of FTI's SEC & Accounting Advisory practice, bringing more than 23 years of audit, accounting, and advisory experience to his clients. He is often engaged by corporate clients on a variety of accounting advisory matters including the application of US GAAP, IFRS, and auditing standards; operational topics around the structure and strategy of the finance organization; the evaluation of financing alternatives and related reporting; planning for and evaluating the impact and disclosure of transactions including the initial public offering process; the application and response to SEC regulations and investigations; financial restatements; and accounting litigation and disputes.

⁴² See SEC Press Release No. 2021-124, SEC Charges SPAC, Sponsor, Merger Target, and CEOs for Misleading Disclosures Ahead of Proposed Business Combination (July 13, 2021), <https://www.sec.gov/news/press-release/2021-124>.

⁴³ See SEC, Public Statement, Staff Statement on Select Issues Pertaining to Special Purpose Acquisition Companies (Mar. 31, 2021), <https://www.sec.gov/news/public-statement/division-cf-spac-2021-03-31>.

Michael Houseman is a Certified Fraud Examiner, Certified Anti-Money Laundering Specialist and Consultant in the Risk & Investigations practice at FTI Consulting. He works on a wide range of engagements including compliance reviews, investigations, and pre-IPO readiness matters.
