

June 12, 2022

Vanessa A. Countryman
Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549–1090

Re: File Number S7–13–22 – Special Purpose Acquisition Companies, Shell Companies, and Projections – Release Nos. 33–11048; 34–94546; IC–34549

Dear Ms. Countryman:

I wish to thank you and the Commission for taking up the issue of Special Purpose Acquisition Companies (SPACs) and for the opportunity to comment on your proposed rules.

As I explain in the attached 8-page paper forthcoming in the Yale Journal on Regulation Bulletin, SPACs are a trap for unwary investors. In standard public equity securities, even the most naïve investor is protected, first, by the market price—you pay only for what you get—and, second, by the comfort that nothing else is required of an individual investor to realize the full value of the security. SPACs disable both of these protections. Because of SPACs’ redemption option, SPAC shareholders need to do something—decide whether to redeem—and cannot rely on the market price to ensure they are getting value for their money. Predictably, sophisticated repeat players have done well in this game, while less sophisticated players, including retail investors, have done very poorly.

In light of these concerns, I believe the Commission is correct to propose, in its new **Item 1606** of Regulation S-K, a requirement to “[s]tate whether the special purpose acquisition company reasonably believes that the de-SPAC transaction and any related financing transaction are fair or unfair to unaffiliated security holders of the special purpose acquisition company” and “[d]iscuss in reasonable detail the material factors upon which [this belief] is based and, to the extent practicable, the weight assigned to each factor.” As explained in my paper, unfair de-SPACs could be the *raison d’être* for many SPACs because one group of investors’ loss is another’s gain (particularly SPAC promoters’ and IPO investors’). Though the spirit of the U.S. securities laws is not to prohibit such transactions, they should be clearly marked as such. More to the point, the Commission is right to require that SPACs state and explain their belief that they do not fall into this category. Hopefully this will flush out the bad ones.

In its release, the Commission asks specific questions about its proposed new Item 1606. For the reasons given above, my answer to questions 36-38 and 40-41 is “yes”: the Commission should adopt these disclosure requirements. Specifically in answer to question 37, I believe the Commission is right to focus on fairness to “unaffiliated security holders of the [SPAC]” and to include “any related financing transaction.” Only the unaffiliated security holders are in need of this information. Related financing transactions are critical for two reasons. First, they can and often do dilute the SPAC shareholders. Second, their terms are an indicator for the fairness or unfairness of the de-SPAC to SPAC shareholders. If new investors (usually PIPE investors) can acquire new shares for significantly less than the old shares’ redemption value, this presumably means that the shares are worth less than the redemption value and thus that the de-SPAC is not fair to SPAC shareholders (relative to the alternative, liquidation). The Commission

might want to specify explicitly that “fairness” of “any related party transaction” includes such a comparison of the terms of the latter with the redemption value, taking into account not only headline items such as cash consideration paid for new shares but also any side-payments or promises or expectations thereof.

Question 39 asks about the potential costs and benefits of these disclosures. The costs should be minimal because any conscientious SPAC board and management will assemble the requisite information for its own use in assessing the advisability of the de-SPAC anyway. The only additional cost is the lawyer-time to write the disclosure item. This cost is easily outweighed by the enormous benefit that unaffiliated investors would gain from an admission of belief that the de-SPAC is unfair to them, or from an assurance—backed up by a threat of liability for false statements—that the de-SPAC is fair. Most importantly, and as mentioned above, the disclosure has the potential to flush out SPACs that are appealing to sponsors only because they can appropriate as gains the losses of unwary investors.

Very truly yours,

Holger Spamann

(For identification: Lawrence R. Grove Professor, Harvard Law School)

Appendix: Holger Spamann & Hao Guo, *The SPAC Trap: How SPACs Disable Indirect Investor Protection*, YALE J. REG. BULL. (forthcoming).

THE SPAC TRAP

HOW SPACS DISABLE INDIRECT INVESTOR PROTECTION

Holger Spamann & Hao Guo***

A remarkable fact about modern U.S. securities markets is that most public securities can be safely bought and held even by investors who understand nothing of the securities' terms and the underlying business.¹ The underlying mechanisms are what one of us has called “indirect investor protection” – protection that does not rely on the investors themselves or on their agents to be effective.² The most important such mechanism is simply the market price. It is generated by competition for mispriced securities between traders who do understand the underlying terms and business.³ These traders will snatch up any security that is priced too low, and happily (short-)sell any security that is priced too high. This keeps those securities' prices close to their fundamental value, i.e., their expected discounted long-term payoffs. At the right price, no investment is a bad investment.⁴ And once investors have bought a standard security, they do not need to *do* anything to preserve the value of their investment.⁵

Special Purpose Acquisition Companies (“SPACs”) disable indirect investor protection and thus set a trap for unwary investors. SPACs do this by offering two alternative payoffs from the same security, the SPAC share, through its redemption option. The immediate effect is to force investors to *do* something, namely decide whether to redeem. Empirically, in the vast majority of SPACs, the right choice—that sophisticated investors made, and that generated far higher payoff—was to redeem, whereas most unsophisticated investors appear not to have redeemed.⁶ Effectively,

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For generous and very helpful comments, we thank Michael Klausner and Michael Ohlrogge.

¹ This essay is about investors, and the protection of investors. Trading—making money through well-timed round-trip trades—is an entirely different matter and not the topic of this essay except in as much as trading by others is instrumentally useful for investors as described in the main text.

² See generally Holger Spamann, *Indirect Investor Protection: The Investment Ecosystem and Its Legal Underpinnings*, 14 J. LEG. ANALYSIS (forthcoming 2022).

³ This special case of indirect investor protection has long been recognized in the literature. See, e.g., BURTON G. MALKIEL, A RANDOM WALK DOWN WALL STREET (1973); also see id., *The Efficient Market Hypothesis and Its Critics*, 17 J. ECON. PERSPS. 59, 59 (2003). Traces can be found even in ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION & PRIVATE PROPERTY 265 (1932 [2017]) (“buy in the open market on the faith of the market appraisal”).

⁴ Ideally, prices would *equal* fundamental value—an idea known as market efficiency. But attaining this ideal is not necessary for the mechanism to be useful to the ignorant investors. The closer prices are to fundamental value, the less investors can lose by investing at the market price. Even critics of market efficiency acknowledge that “the efficient markets model a useful approximation of reality for individual firms.” Robert J. Shiller, *Speculative Asset Prices*, 104 AM. ECON. REV. 1486, 1501 (2014). See also Andrew Lo, *Adaptive Markets and the New World Order*, 68 FIN. ANALYSTS J. 18, 18 (2012) (“the EMH is not wrong; it is merely incomplete.”).

⁵ Collectively, equity investors need to vote on things like mergers, but (a) an individual shareholder’s abstention has no effect on the overall outcome and (b) whatever the outcome chosen by a majority of investors applies to all investors, i.e., the sophisticated cannot gang up on the unsophisticated.

⁶ That redemption is the better choice in the vast majority of SPACs is probably not coincidental. As explained in this essay, promoters have incentives to set up SPACs even though they do not expect the SPAC to find a valuable merger opportunity that would make SPAC shares worth more than their redemption value. We should thus expect

SPACs have thus decoupled the payoffs received by sophisticated and unsophisticated investors. This also disables indirect protection by the market price. Put bluntly, the market prices the higher payoff received by sophisticated investors, whereas unsophisticated investors get the other, lower payoff. Unsophisticated investors thus systematically overpay for SPAC shares. Their overpayment is captured, directly or indirectly, by sophisticated players: SPAC sponsors and SPAC IPO investors. This allows the latter to make money from SPACs even if SPACs create no or even negative social value.

To preview the more detailed explanations to follow, here is the scheme in a nutshell. Under the terms of a SPAC, its shareholders can elect to redeem their shares for their IPO price of \$10 (plus interest) if and when the SPAC merges with a target (the “acquisition” that the SPAC is set up for). The redemption value sets a floor for the pre-merger SPAC share price: sophisticated traders know that a share includes a right to receive \$10, so the share trades at \$10 or more. But that floor is too high for those who will never exercise that right, instead retaining a share of the post-merger company: the average value of post-merger shares has empirically been far below \$10. Thus, investors who buy at the market price of \$10 or higher without intending to redeem systematically lose money.⁷ Of course, the losing investors’ money does not evaporate: it is directly or indirectly captured by the SPAC’s sponsor and IPO investors, in ways we explain below.

This essay proceeds as follows. Section 1 explains the mechanics of modern SPACs, with particular focus on redemption. Section 2 provides a numerical example how even an efficient market fails to price expected payoffs to unsophisticated SPAC investors, allowing SPAC sponsor and sophisticated investors to enrich themselves by transferring value from unsophisticated investors without creating any social value. Section 3 briefly reviews other authors’ empirical findings of the returns to SPAC investors, which are consistent with our theoretical analysis. Section 4 explains why the SEC’s recent proposal to change SPAC regulation does not address the fundamental problem we identify. Section 5 concludes.

I. SPAC MECHANICS

A SPAC is a blank check company created with the purpose of engaging in a business combination with an unidentified target (“de-SPAC”). A sponsor creates the SPAC and organizes its IPO. Before the IPO, the sponsor obtains shares of the SPAC for a negligible price as the “promote”—customarily one quarter as many shares as will be issued in the IPO, i.e., 20% of the post-IPO total—as well as additional warrants or shares in exchange for the cash required to cover the SPAC’s operating and IPO costs.⁸ In the IPO, the SPAC sells bundles of shares and warrants to public investors, customarily at a price of \$10 per bundle of one share and some number of warrants. SPACs deposit 100% of the IPO proceeds in a trust account invested in treasury

many such SPACs to be formed.

⁷ In principle, the problem is symmetric. If the sophisticated investors anticipated the merger to be beneficial for SPAC shareholders in the sense of generating more than \$10 value per share, they would not redeem and the market price would reflect that higher payoff. Unsophisticated investors who bought at that higher price and then redeemed would lose money. However, this does not seem to be a practical problem because it is hard to see why an unsophisticated investor would buy a share for more than \$10 with the intention of redeeming for \$10. By contrast, it is not hard to see why an unsophisticated investor might buy for \$10 and not redeem in the mistaken belief that the post-merger share will be worth more than \$10.

⁸ Michael Klausner, Michael Ohlrogge & Emily Ruan, *A Sober Look at SPACs*, 39 YALE J. ON REGUL., 228, 232 and 236 (2022).

securities.⁹ Customarily, the SPAC has two years from the IPO to merge with a target, or else it must return the IPO proceeds to the SPAC shareholders.¹⁰ If and when the sponsor identifies a target, the SPAC shareholders vote on the de-SPAC.

Regardless of their vote, modern SPAC shareholders have the right to redeem their shares for their pro rata value in the trust account holding the IPO proceeds plus accrued interest, which makes their investment riskless.¹¹ Non-redeeming SPAC shareholders remain shareholders of the combined entity together with the sponsor (in proportion to the sponsor's promote), the target shareholders (in proportions set by the de-SPAC agreement), and any additional investors brought on to facilitate the transaction (usually, the SPAC raises extra equity capital through a PIPE before the transaction). Non-redeeming shareholders' payoff thus depends on the quality of the target and, more to the point, the terms of the de-SPAC. These must be sufficiently favorable to the SPAC to overcome the dilutive effect of the sponsor's shares and any exercise of warrants (the median post-dilution SPAC cash per SPAC share is \$5.70¹²). With hundreds of SPACs competing for targets in recent years, it was highly unlikely that de-SPAC terms would be so skewed in favor of SPACs, a conjecture borne out by the returns data in section 3.

Shareholders who "approve and redeem" vote for the deal and take their money back at the same time. In earlier SPACs in the 1990s and early 2000s, this was not possible because redemption required voting against the de-SPAC.¹³ The earlier SPACs also conditioned the de-SPAC on redemptions not exceeding 20%.¹⁴ Earlier SPACs thus had a second line of indirect investor protection defense beyond the market price: sophisticated SPAC shareholders' votes and redemption decisions.¹⁵ If sophisticated investors held at least that blocking percentage, the acquisition would not go through if it was a bad deal for non-redeeming SPAC shareholders. At a minimum, sophisticated investors in earlier SPACs could not push for the acquisition while running for the exits themselves. They had to "put their redemption decision where their vote is." Later SPACs, however, tore down this line of defense by detaching redemption from voting and by eliminating the redemption cap. In a broad sample of SPACs from 2010 to 2018, "every SPAC ... gives shareholders the right to redeem their shares" regardless of their vote.¹⁶ The redemption

⁹ Ramey Layne & Brenda Lenahan, Special Purpose Acquisition Companies: An Introduction, HLS Forum on Corporate Governance 2018/07/08, at note 1 (<https://corpgov.law.harvard.edu/2018/07/06/special-purpose-acquisition-companies-an-introduction/#1>) (last visited June 11, 2022); Clifford Chance, *Guide to Special Purpose Acquisition Companies* (Sept. 2021), <https://www.cliffordchance.com/content/dam/cliffordchance/briefings/2021/09/guide-to-special-purpose-acquisition-companies.pdf> (last visited April 22, 2022), at 2; see also Klausner et al., previous note, at 237.

¹⁰ Recent SPACs have reduced this time period to 15 months but with the possibility of extension.

¹¹ "Riskless" subject to the slight discount rate adjustment explained in note 26 and the counterparty risk of the trustee absconding with the money.

¹² Klausner et al., *supra* note 8, at 246.

¹³ *Cf.*, e.g., Millstream Acquisition Co., Amendment No.5 to Form S-1 (Form S-1) (August 1, 2003), p.21. ("we will offer each public stockholder the right to have her shares of common stock converted to cash if she votes against the business combination and the business combination is approved and completed.")

¹⁴ See Vijay Jog & Chengye Sun, Blank Check IPOs: A Home Run for Management, working paper (August 2007), https://ssrn.com/abstract_id=1018242, at 6; Milan Lakicevic & Milos Vulcanovic, *A story on SPACs*, 39, MANAGERIAL FIN. 384, 388 (2013).

¹⁵ That said, even earlier SPACs had terrible returns for investors (but great returns for sponsors). See, e.g., Jug & Sun, previous note; Johannes Kolb & Tereza Tykvová, *Going public via special purpose acquisition companies: Frogs do not turn into princes*, 40 J. CORP. FIN. 80 (2016).

¹⁶ Usha Rodrigues & Mike Stegemoller, *Redeeming SPACs* (Univ. of Georgia Sch. of L. Legal Stud. Research Working Paper, Paper No. 2021-09), https://ssrn.com/abstract_id=3906196, at 28.

cap first rose to an average of 84.23% from 2009 to 2012 and was later eliminated altogether.¹⁷ In modern SPACs, sophisticated shareholders can redeem in unlimited numbers, all while voting for the acquisition, leaving unsophisticated, non-redeeming shareholders holding the bag.¹⁸

SPACs incentivize this “approve and redeem” strategy through the warrants bundled with their IPO shares. The warrants will expire worthless if the SPAC does not complete an acquisition, whereas they retain option value if it does.¹⁹ Some redeeming SPAC shareholders, particularly IPO investors, may also have continuing relationships with the SPAC sponsor (e.g., the expectation of participating in future SPAC IPOs).²⁰ The SPAC sponsor always has a strong incentive to complete an acquisition even if the post-acquisition share value is far below \$10: without the acquisition, the sponsor’s “promote” is worthless; with the acquisition, the sponsor’s promote will be worth something (on average over \$100 million in recent years²¹).

Redemption rates have been significant in the last decade. In a sample from 2010 to 2018, the median (mean) redemption rate was 54.2% (59.9.1%).²² In successful de-SPACs in Q1 2019-Q2 2020 the median (mean) redemption rate was 73% (58%), with a quarter over 95%.²³ While the identity of non-redeeming SPAC shareholders is generally unknown, we do know that SPAC IPOs are almost exclusively subscribed by institutional investors who redeem or sell virtually all their shares before the merger.²⁴ It thus stands to reason that the non-redeeming SPAC shareholders are near-exclusively retail investors and different, less sophisticated institutions

Notice one crucial upshot from this sketch of SPAC mechanics that the numerical example below will amplify: the SPAC sponsor and IPO investors can expect to make money from setting up the SPAC even if they do not expect the SPAC to find an acquisition target on terms that would be an attractive investment at \$10 per share, i.e., even if they expect that non-redeeming SPAC shareholders will get a bad deal. All that is required is that the expected acquisition is not so bad that the sponsor’s promote and other shares and warrants will be worth less than the sponsor’s out-

¹⁷ Milan Lakicevic, Yochanan Shachmurove & Milos Vulanovic, *Institutional Changes of Specified Purpose Acquisition Companies (SPACs)*, 28 N. AM. J. OF ECON. & FIN. 149, 177 (2014); see also Rodrigues & Stegemoller, previous note, at 25.

¹⁸ Cf. Mira Ganor, *The Case for Non-Binary, Contingent, Shareholder Action*, 23 U. PA. J. BUS. L. 390 (2021), esp. 414-16 (suggesting that SPAC shareholders should be allowed to make their redemption decision contingent on the redemption decisions of other SPAC shareholders to allow them to “mimick” the behavior of putatively more sophisticated players); Rodrigues & Stegemoller, *supra* note 16 (pointing out that voting while redeeming is a form of empty voting).

¹⁹ To wit, the post-merger shares *could* become worth more than the exercise price (generally \$11.50) before the warrants’ expiration date even if that is unlikely and the expected value is far below both the exercise price and, more to the point, below \$10.

For the warrants to create incentives to “approve and redeem,” they must be owned by the approving shareholders at the time of the vote. Data on warrant ownership is not available. However, warrants are distributed in the IPO, and most SPAC IPO investors appear to hold their shares until just before the merger (Klausner et al, *supra* note 8, at 241). Unless the IPO investors sold their warrants before they submit their vote, they thus have the incentive to “approve and redeem.” Selling after the vote but before the merger closes is inconsequential. To the extent warrants trade before the vote, a SPAC shareholder might also have acquired warrants post-IPO.

²⁰ Yet another motivation to “approve and redeem” is simply to get the money out: without a merger, the cash remains locked in the SPAC’s trust account until the SPAC expires. Paradoxically, this motivation to approve the deal is strongest when confidence in the SPAC’s management to find a good target is lowest. Unlike the warrants, however, this liquidity motivation and the continuing relationship mentioned in the main text only create incentives to “approve and redeem” ex post, not incentives to participate in the SPAC IPO in the first place.

²¹ *Infra* note 28 and accompanying text.

²² See Rodrigues & Stegemoller, *supra* note 16, at 55.

²³ See Klausner et al., *supra* note 8, at 240-243.

²⁴ See *id.*, at 241-42.

of-pocket costs paid to investment bankers and other service providers. Savvy SPAC IPO investors get the market rate on a safe investment of \$10 per share plus the warrant, i.e., they earn above-market returns.²⁵ Savvy investors who buy SPAC shares after the IPO get at least the market risk-free return if they buy for \$10²⁶, and more if they buy for less. The losers are the non-redeeming SPAC shareholders. Indeed, the non-redeeming shareholders' losses are the source of the sponsor's and warrant holders' gains. The latter gain by obtaining a claim on the cash in the SPAC for free or at least for less than \$10. Non-redeeming shareholders lose through the concomitant dilution. It is the transfer of value from non-redeeming SPAC shareholders to SPAC sponsors and IPO investors that can make the SPAC attractive for the latter even if they do not expect to find a good acquisition target. We do not know if SPAC sponsors and savvy SPAC investors are consciously aware of this feature, and we do not believe that modern SPACs were intentionally designed as a trap for unsophisticated investors. Once the modern structure had evolved through trial and error, however, it is easy to see why sponsors and sophisticated investors came to love it.

II. NUMERICAL EXAMPLE OF THE FAILURE OF PRICE PROTECTION

We will now illustrate how prices fail to protect SPAC investors using a stylized version of a typical SPAC. While we omit some complexities, the rules that we do mention are typical of recent SPACs, and the numbers are roughly representative unless otherwise noted.

Our SPAC issues 25 million shares: 5 million to the sponsor for zero consideration, and 20 million to investors in its IPO for \$10 each.²⁷ The IPO investors' cash consideration is invested in treasury securities in a trust account. For simplicity, we assume that the treasury rate is exactly zero rather than just very low. Thus, after the IPO and until the de-SPAC, our SPAC has $20 \times 10^6 \times \$10 = \200 million in its trust account. Within the two-year deadline, our SPAC proposes a de-SPAC. A majority of SPAC shareholders other than the sponsor vote in favor, but 75% of them elect to redeem and obtain their \$10 cash per share. This leaves 10 million SPAC shares outstanding, half of them held by the sponsor, and $5 \times 10^6 \times \$10 = \50 million in the trust account. Under the merger agreement, target shareholders obtain 40 million shares. After the de-SPAC, the shares trade for \$5 dollars per share. Thus, this SPAC turns out to be a terrible deal for non-redeeming shareholders who bought their share for \$10 in the IPO or later: they lose half their investment.

²⁵ Cf. Douglas Cumming, Lars Helge Hab & Denis Schweizer, *The fast track IPO – Success factors for taking firms public with SPACs*, 47 J. OF BANKING & FINANCE 198, 200 (2014) (describing the SPAC IPO bundles of shares and warrants as “‘riskless’ zero-coupon bond with an option on a future acquisition”).

²⁶ As previously noted, we ignore details of interest rates and discounting for simplicity. Since these details are critical for safe returns, however, we spell them out here. Assuming that the post-merger share will be worth less than \$10, the break-even price of the post-IPO, pre-merger SPAC share for a savvy investor planning to redeem is \$10 plus expected interest discounted at the then-current safe yield for the expected duration of the SPAC. As a first approximation, interest and discount rate exactly offset each other because the trust fund repeatedly invests in short-term treasuries at then-current market rates. The one complication is that the SPAC's horizon (e.g., 15 months) will generally be longer than the short-term duration of the respective treasury securities (e.g., one month). There are two ways to appreciate this complication. One is from the redemption perspective: since redemption generally occurs further into the future than the short-term treasury maturity, it should be discounted at a different (and generally higher) rate than the short-term treasury interest rate. The other is from the perspective of liquidity (and entails an illiquidity discount): short-term discount rates are appropriate for riskless liquid investments, but there is no guarantee that the SPAC shareholder will be able to sell the share before merger for exactly the (short-term discounted) redemption value before the merger. Either way, however, the appropriate discount to the \$10 redemption value is very small, and our argument would go through by substituting that slightly smaller (and time-varying) value for \$10 in the text.

²⁷ This roughly corresponds to the size of the median SPAC. See Klausner et al., *supra* note 8, at 232.

The question is if efficient market prices would protect naïve investors from this fate if they bought in the post-IPO market at the prevailing market price. To see clearly that they do not, imagine the extreme case that all sophisticated players foresee the full trajectory of our SPAC from its founding. Will this lead to a market price of \$5 for the SPAC shares before the de-SPAC, on the theory that efficient market prices reflect the expected value of the future cash flows, which are \$5 for non-redeeming investors? The answer is no. A share includes a right to receive \$10, so it trades at \$10 (or more). If a SPAC share did trade at \$5, sophisticated traders would immediately snap it up because they would earn a certain profit of \$5 by buying for \$5 and redeeming for \$10. Analogous arguments show why no price below \$10 can persist in the market for pre-de-SPAC shares irrespective of the expected value of the post-de-SPAC shares.²⁸ The market is efficient—but it prices the cash flows that will accrue to sophisticated investors who know they can and should redeem. Put differently, the problem is that non-redeeming investors do not *use* what they paid for (namely the right to redeem). With standard equity securities, this simply cannot happen because there is nothing that investors need to do to receive the full value of the security. Thus, for standard securities, even completely naïve investors can safely “buy in the open market on the faith of the market appraisal.”²⁹ The availability of SPACs’ “approve and redeem” strategy renders that appraisal worthless and thus sets a trap for unwary investors.

If the SPAC shares were inefficiently priced *above* \$10 in the post-IPO market, naïve non-redeeming investors purchasing at that price would do even worse. Unlike prices below \$10, prices above \$10 do not necessarily offer a free lunch to sophisticated traders. To profit from the overpricing, they must short-sell the stock, which in turn requires borrowing the stock (and hoping that prices correct before the stock loan is recalled). SPAC shares are often hard to borrow, in part because of the redemption feature: institutional investors who plan to redeem cannot lend out their shares.³⁰

To reassure readers that our example is logically consistent and practically relevant, let us briefly review other participants’ returns and decisions. The sponsor makes money, assuming—realistically—that the cost of setting up the SPAC is less than \$25 million: the post-de-SPAC value of the sponsor’s promote is $5 \times 10^6 \times \$5 = \25 million.³¹ Redeeming shareholders break even assuming they purchased SPAC shares for \$10 in the IPO or later in the open market and do not have warrants. If they do have warrants, they can do better than break-even by voting in favor of the de-SPAC and hoping for a fortuitous development in the target’s business. (Non-redeeming shareholders without warrants will do concomitantly worse.) Target shareholders may have gained or lost in the de-SPAC: it depends on whether the target as a standalone company was worth less or more, respectively, than the \$200 million value of their 40 million post-de-SPAC shares. We would expect targets to agree to a de-SPAC only if target shareholders at least break-even, and we

²⁸ Empirically, market prices of SPAC shares tend to be \$10 or more. E.g., Klausner et al. *supra* note 8, section VII.A.

²⁹ ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION & PRIVATE PROPERTY* 265 (1932 [2017]).

³⁰ Cf. Matthew Fox, *A Handful of Heavily Shorted Stocks are Being Squeezed Higher as Investors Redeem Shares Ahead of Merger*, <https://markets.businessinsider.com/news/stocks/spac-short-squeeze-investors-redeem-shares-mergers-complete-2021-8>.

³¹ Moreover, and as noted above, the sponsor generally obtains additional shares or warrants to offset these costs. In our example, we could imagine that the sponsor obtained warrants, which are worthless if the merged entity has a certain value of \$5 per share; then the analysis in the main text stands unaffected. Alternatively, we could imagine that the sponsor obtained additional shares or that the warrants have value; in that case, the sponsor does better and the non-redeeming shareholders concomitantly worse.

take no position on the hotly debated question whether SPACs create value by taking companies public that otherwise would have stayed private. But our point is that the sponsor and SPAC IPO investors can make money by taking from non-redeeming SPAC shareholders even if the de-SPAC creates no social value. Crucially, this is possible even if non-redeeming SPAC shareholders purchase their shares in a completely efficient market: the market does not price *their* anticipated loss.

III. SPAC PARTICIPANTS' RETURNS

Actual returns of various SPAC participants are in line with our example. Non-redeeming SPAC shareholders have done terribly, while sponsors and redeeming shareholders have done well.

SPACs have long been underperforming for non-redeeming SPAC investors.³² As of April 4, 2022, only 18% of the 345 SPACs that successfully completed a de-SPAC since 2018 were trading above their IPO offer price. The average cumulative return on these 345 SPACs is -32.8%.³³ The more SPAC shareholders redeemed, the worse the remaining ones fared.³⁴

Returns for redeeming SPAC shareholders and sponsors are a different matter altogether. Redemption values have been as high as \$10.30, which is considerable in the extremely low interest rate environment of that period.³⁵ We are not aware of a single redemption below \$10 (or more generally below the IPO share price, in past cases where the IPO share price was different from \$10). On top of this, “approve and redeem” IPO investors get the value of the warrants, as discussed above. That value is positive, even though it has dropped from \$2.20 (\$1.10) per average post (pre) de-SPAC warrant in July 2021 to \$0.55 (\$0.21) on May 27, 2022.³⁶ Sponsors have also done well. Mean sponsor returns in the period 2019-2020 are over \$100 million, for a 549% return rate.³⁷ Another type of participant, the PIPE investors (who often invest at much less than \$10 per share) also did well, averaging a positive 72% return.³⁸

As we indicated before, we cannot pinpoint precisely who redeemed and who did not. Nor do we know precisely who bought when. We can thus not say for sure that retail and other less sophisticated investors were the ones earning the poor non-redeeming returns. But it sure seems plausible.

IV. THE SEC'S PROPOSED RULE

On March 20, 2022, the SEC proposed new rules for SPACs.³⁹ In typical SEC fashion, the proposal focuses on disclosure, and liability for misleading or incomplete disclosure.⁴⁰ The

³² See Klausner et al., *supra* note 8, at 256-258.

³³ Renaissance Capital, *SPAC Merger Returns Crumble, Upending the 2022 SPAC Market*, (April 19, 2022), <https://ipopro.renaissancecapital.com/reviews/2022SPACReportPro.pdf>.

³⁴ Rodrigues & Stegemoller, *supra* note 16.

³⁵ Renaissance Capital, *supra* note 33.

³⁶ Boardroom Alpha, *Average Warrant Price*, (May, 2022), https://app.boardroomalpha.com/spac_tracking/warrants.

³⁷ Klausner et al., *supra* note 8, at 263.

³⁸ Klausner et al., *supra* note 8, at 259.

³⁹ SEC. & EXCH. COMM'N, *Special Purpose Acquisition Companies, Shell Companies, and Projections*, 87 Fed. Reg. 29458 (May 13, 2022).

⁴⁰ See Gibson Dunn, *SEC Proposes Rules to Align SPACs more Closely with IPOs* (April 6, 2022), available at <https://www.gibsondunn.com/wp-content/uploads/2022/04/sec-proposes-rules-to-align-spacs-more-closely-with->

redemption mechanism, and particularly the “affirm and redeem” strategy, is unaffected. Even under the new rules, SPACs would therefore remain a trap for unsophisticated investors.

The SEC’s proposal is grounded in the SEC’s longstanding official framework that assumes investors fend for themselves and that everything will be fine as long as investors have sufficient information. The proposal states: “We are of the view that greater transparency and more robust investor protections could assist investors in evaluating and making investment, voting, and redemption decisions with respect to these transactions.”⁴¹ Tell investors everything, and they will understand and act optimally. Or so the theory goes.

Theoretically, it is possible that more explicit information about fees, expected dilution, and SPAC sponsor conflicts with respect to the de-SPAC will deter unsophisticated investors from SPAC investments, even though the availability of this information in other form did not. If SPAC investors were the type that reads SEC disclosures, however, it would hardly have been necessary for the SEC to remind them, a year earlier, that “[i]t is never a good idea to invest in a SPAC just because someone famous sponsors or invests in it or says it is a good investment.”⁴² In general, the information presented in SEC filings is much too complex and plentiful for unsophisticated investors, particularly retail investors, to absorb.⁴³ The remarkable fact highlighted in this essay’s opening paragraph is that this neglect is usually without consequence, thanks to indirect investor protection.⁴⁴ The problem is that SPACs disable indirect investor protection by decoupling the payoffs to sophisticated redeeming SPAC shareholders from those of unsophisticated non-redeeming SPAC shareholders, as described above. The SEC’s proposal does nothing to re-couple these payoffs.

To be sure, the SEC’s proposal might yet kill SPACs. New rules on underwriters and liability suits might make SPACs too expensive or too cumbersome, or both. Additional disclosures on conflicts and dilution might be picked up by the press and commentators and eventually break the hype around SPACs even if unsophisticated investors themselves never read the disclosures. But the SEC’s proposed rules do not tackle directly what we see as the main problem.

V. CONCLUDING THOUGHTS

We have argued that modern SPACs’ redemption feature sets a trap that allows sophisticated SPAC sponsors and investors to earn above-market returns simply by exploiting naïve investors. Crucially, the redemption feature drives a wedge between the value received by different investors from the same SPAC share. Savvy players who know to redeem their share get at least \$10. This puts a floor on the market price of SPAC shares before the merger: professional arbitrageurs know that the share must be worth at least \$10 to anyone who exercises the redemption right. Retail investors, however, tend not to exercise the redemption right even when they financially should. Because of this wedge, retail investors are not protected by the market price against paying too

ipos.pdf (<https://perma.cc/65UZ-U9WT>).

⁴¹ SEC. & EXCH. COMM’N, *supra* note 39, at 17.

⁴² Sec. & Exch. Comm’n, *Celebrity Involvement with SPACs – Investor Alert*, March 10, 2021, <https://www.sec.gov/oia/investor-alerts-and-bulletins/celebrity-involvement-spacs-investor-alert>.

⁴³ *See, e.g.*, William O. Douglas & George E. Bates, *The Federal Securities Act of 1933*, 43 YALE L.J. 171, 172 (1933); William O. Douglas, *Protecting the Investor*, 23 (n.s.) YALE REV. 522, 523-524 (1934) (Douglas joined the SEC shortly after publication of this article and was SEC Chairman from 1937 to 1939 before becoming Associate Justice of the U.S. Supreme Court); SEC. & EXCH. COMM’N, *DISCLOSURES TO INVESTORS – A REAPPRAISAL OF FEDERAL ADMINISTRATIVE POLICIES UNDER THE ‘33 AND ‘34 ACTS* 51–52 (Mar. 27, 1969), http://www.sechistorical.org/museum/galleries/tbi/gogo_d.php (“The Wheat Report”).

⁴⁴ Spamann, *supra* note 1.

much, as they would be for normal securities. SPACs were probably not designed specifically for the purposes of trapping unsophisticated investors while enriching sophisticated sponsors and investors. But that is what they have evolved into.