

## Disclosure's Limits

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The U.S. Securities and Exchange Committee's (SEC) proposed reforms of how it regulates special purpose acquisition companies (SPACs) lean heavily on the most familiar tool in its arsenal: disclosure.<sup>1</sup> The proposed rules ask for more disclosure, and more standardized disclosure, on a variety of fronts.<sup>2</sup> While as researchers we generally support more disclosure, unfortunately, we are deeply skeptical of the benefits disclosure alone can provide in this particular case to retail investors—the audience to which these reforms are directed. SPACs as currently structured feature a species of empty voting, where a shareholder's voting interest is decoupled from her economic interest.<sup>3</sup> Because of this fundamental disconnect, which is anathema to corporate law,<sup>4</sup> our research indicates that disclosure-based reforms will be of limited utility in protecting investors.

We begin with a basic fact: SPACs are complicated. We've studied them for over a decade.<sup>5</sup> We've talked about them with neighbors, accountants, family, and friends. Few comprehend the SPAC form. Even in the business press there is a tendency to refer to SPACs and deSPAC'ed companies without distinction,<sup>6</sup> even though a SPAC is shell company looking for a merger target, and a post-deSPAC'ed company is a former SPAC that now, post-merger, is actually operating a business—a different animal, indeed. Moreover, the number of unique SPAC features, in comparison to traditional equity securities, provides significant opportunities for misunderstanding.

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1. *See generally* Special Purpose Acquisition Companies, Shell Companies, and Projections, Release Nos. 33-11048; 34-94546; IC-34549 (Mar. 30, 2022), <https://www.sec.gov/rules/proposed/2022/33-11048.pdf> [<https://perma.cc/23X5-WC9F>] [hereinafter SPAC Release].

2. *See id.* at 277-81, 282-84.

3. *See* Henry T.C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S.CAL. L. REV. 811, 815 (2006).

4. *See id.*

5. *See* Usha Rodrigues & Mike Stegemoller, *Exit, Voice, and Reputation: The Evolution of SPACs*, 37 DEL. J. CORP. L. 849, 851 (2013) [hereinafter Rodrigues & Stegemoller, *Evolution*]; Usha Rodrigues & Mike Stegemoller, *What All-Cash Companies Tell Us About IPOs and Acquisitions*, 29 J. CORP. FIN. 111, 119 (2014).

6. *See, e.g.*, Amrith Ramkumar, *SPAC Rout Erases \$75 Billion in Startup Value*, WALL ST. J. (Sept. 2, 2021, 6:12 PM ET), <https://www.wsj.com/articles/spac-rout-erases-75-billion-in-startup-value-11630575180> [<https://perma.cc/R8LR-MCD5>].

Academic commentators and the SEC alike have voiced the concern that the incentives of SPAC sponsors and shareholders are not aligned.<sup>7</sup> After all, the sponsors get 20% of the deSPAC'ed firm if a deal closes, but lose all of their investment if the SPAC fails. Thus, SPAC sponsors can profit even from deals that are bad for their shareholders, who bear the brunt of the 20% dilution.<sup>8</sup> Accordingly, the SEC proposes to require sponsors to disclose to SPAC shareholders that the sponsor's incentives are to make a deal—any deal—and that shareholders that keep holding SPAC shares through the deSPAC will be diluted by at least 20%—often much more.<sup>9</sup>

The SEC makes this dilution point effectively in its proposing release.<sup>10</sup> But so do SPACs themselves, already. For example, one SPAC spells out in tabular form the 20% dilution SPAC shareholders will experience because of the sponsor's stock.<sup>11</sup> A risk factor in another SPAC states: "Our sponsor paid an aggregate of \$25,000, or approximately \$0.004 per founder share, and, accordingly, you will experience immediate and substantial dilution from the purchase of our Class B common stock."<sup>12</sup> The same filing advises shareholders:

Our sponsor paid an aggregate of \$25,000 for the founder shares, or approximately \$0.004 per founder share. As a result of this low initial price, our sponsor, its affiliates and our management team and advisors stand to make a substantial profit even if an initial business combination subsequently declines in value or is unprofitable for our public stockholders.<sup>13</sup>

We have pored over hundreds of SPAC filings. At times we have struggled to make sense of them. As researchers, we appreciate the new data that will be generated from the SEC's proposed rules regarding disclosure about the sponsor, its affiliates and promoters, and conflicts of interest.<sup>14</sup> But one facet of disclosure reform—detailing the extent of the dilution under hypothetical scenarios—won't help retail investors because the disclosure already exists. That is, SPACs are already voluntarily providing information about the risk of dilution. The SEC appears to believe that what these disclosures lack is clarity—that investors don't understand precisely how bad the dilution is—and that depicting the extent of the dilution is what's necessary.

We respectfully disagree. The SEC's proposed disclosures are redundant, but that is beside the point. We believe investors won't read the new disclosures

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7. See generally Michael Klausner, Michael Ohlrogge & Emily Ruan, *A Sober Look at SPACs*, 39 YALE J. ON REGUL. 228 (2022).

8. See Amrith Ramkumar, *SPAC Insiders Can Make Millions Even When the Company They Take Public Struggles*, WALL ST. J. (Apr. 25, 2021, 4:51 PM ET), <https://www.wsj.com/articles/spac-insiders-can-make-millions-even-when-the-company-they-take-public-struggles-11619343000> [<https://perma.cc/5B7Y-TCWG>].

9. See *id.*

10. See SPAC Release, *supra* note 1, at 36-39.

11. Gores Holdings IV, Inc., Prospectus (424B4) 128 (Jan. 23, 2020).

12. FinServ Acquisition Corp., Prospectus (424B4) 51 (Oct. 31, 2019).

13. *Id.*

14. See SPAC Release, *supra* note 1, at 32-35.

any more than they do the current ones, but that too is beside the point. The point is that the cards are stacked against retail SPAC investors in a unique way, and only a structural change can address the problem. Disclosure alone cannot.

Crucially, retail investors usually don't have to pay attention to a company's disclosures. Normally the disclosure mechanism can protect these retail investors whether or not they see a single SEC filing. In ordinary markets, the sophisticated investors who *do* read SEC filings use their money to drive the market, and thus the content of the disclosures is priced into the securities.<sup>15</sup> Because the interests of sophisticated investors and small investors align, the large investors, in looking out for their own interests, also wind up protecting the interests of retail investors.<sup>16</sup>

The key to this inadvertent protection is that the interests of retail investors and more sophisticated players are aligned. SPACs violate that basic assumption by allowing a species of empty voting. We believe the SEC's failure to address this flaw in SPAC design is a mistake.

Describing the empty voting problem in the SPAC context is relatively simple. One of a SPAC's defining features is the redemption right—the right of SPAC shareholders to redeem their shares and get their money (plus interest) back from the trust account.<sup>17</sup> This redemption right can be exercised at the option of the shareholder upon the occurrence of either a successful acquisition of a target or the request for an extension of time to pursue an acquisition.<sup>18</sup> The redemption right is automatically exercised if the SPAC sponsor fails to purchase a target.<sup>19</sup>

This redemption right used to function as a check on the sponsors' drive to close a deal. It used to be that if over 20% of shareholders redeemed their shares, the deal wouldn't close.<sup>20</sup> After all, that trust account was supposed to fund the acquisition, and if there wasn't enough money remaining in the trust account, the acquisition would fail for lack of funds.<sup>21</sup>

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15. See generally Holger Spamann, *Indirect Investor Protection: The Investment Ecosystem and Its Legal Underpinnings* (Eur. Corp. Governance Inst., Law Working Paper No., 594/2021, 2022), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3707249](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3707249) [<https://perma.cc/QR4H-CG75>].

16. See *id.* at 15-18.

17. See Klausner et al., *supra* note 7, at 236-37.

18. See Usha Rodrigues & Michael Stegemoller, *Redeeming SPACs* 9-10 (Univ. Ga. Sch. L., Rsch. Paper No. 2021-09, 2021), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3906196](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3906196) [<https://perma.cc/ZW2L-UZYL>].

19. Rodrigues & Stegemoller, *Evolution*, *supra* note 5, at 913-14.

20. Rodrigues & Stegemoller, *Evolution*, *supra* note 5, at 910 (citing M. Ridgway Barker & Randi-Jean G. Hedin, *SPACs – Continuing to Grow and Evolve*, METRO. CORP. COUNSEL (June 2007), <http://www.metrocorpcounsel.com/articles/8416/spacs-continuing-grow-and-evolve> [<https://perma.cc/T9H2-EP87>].

21. See, e.g., Klausner et al., *supra* note 7, at 276.

As we have documented, SPACs lost that redemption threshold as they evolved.<sup>22</sup> Now there has been a complete decoupling of the proportion of shares redeemed from the question of whether the acquisition should be completed.

There are two important mechanisms in the SPAC structure that should act as a check on transactions going forward even in the absence of a required maximum percentage on redemptions. The first mechanism is that acquisitions generally require a majority vote.<sup>23</sup> The second is the simple economic requirement that there be enough money in the account to fund the acquisition. If too many SPAC shareholders redeem, then there will not be enough money to fund the intended acquisition. Thus, one could logically assume that a completed deSPAC would then be characterized by low redemption rates.

Yet SPACs exhibit very high average redemption rates. Our original empirical study spans SPACs that filed their first public S-1 in years 2010-2019.<sup>24</sup> Because SPACs typically have a maximum of two years in which to complete a transaction, our sample period allows us to account for the full lifecycle of the SPAC, encompassing deals concluded through 2021. We find a mean redemption rate of 54.2%.<sup>25</sup> Some redemption levels have topped 80%—that is, over 80% of the shareholders got out of the deal before the target was acquired.<sup>26</sup>

But SPACs are not all bad news for investors—the market seems to be able to discern bad deals from good ones. Our data are consistent with a negative relation between redemption rates and post deSPAC stock performance.<sup>27</sup> SPACs in the upper quartile of redemption rates, which exhibit redemption rates of over 89%, trade well below the redemption price ten trading days after the deSPAC. The stock price of SPACs in the two middle quartiles of redemption rates is not different from the redemption price, thus giving these stockholders a return not different from an investment in government securities. SPACs in the lowest quartile of redemption rates, which exhibit redemption rates of less than 3%, trade at large and statistically significant premiums to the redemption price.<sup>28</sup>

Then what happened to the two mechanisms that logically should constrain redemption rates? The answer to the economic problem of not having enough cash in the trust account to fund the acquisition is that PIPEs stepped in to fill the

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22. See Rodrigues & Stegemoller, *Evolution*, *supra* note 5, at 872 (citing Order Approving Proposed Rule Change to the Special Purpose Acquisition Company Listing Standards, Exchange Act Release No. 34-63607, 2010 WL 5301044, at \*5 (Dec. 23, 2010)).

23. Unless effectuated by way of a tender offer, which occurred in only 5% of our sample in a previous study. Rodrigues & Stegemoller, *supra* note 18, at 28.

24. *Id.* at 34-35.

25. *Id.* at 55 tbl.3.

26. See Roger E. Barton, *High Redemption Rates See SPACs Relying on Alternative Financing*, REUTERS (Jan. 14, 2022, 11:44 AM EST), <https://www.reuters.com/legal/transactional/high-redemption-rates-see-spacs-relying-alternative-financing-2022-01-14> [<https://perma.cc/6M9C-UDTU>].

27. Rodrigues & Stegemoller, *supra* note 18, at 57 tbl.5.

28. *See id.*

breach.<sup>29</sup> Given the lack of a limit on redemptions, prospective SPAC targets faced an uncertain payout. A bargain struck with a PIPE investor provided the dependable capital needed to fund an acquisition that could not rely on an amount certain in the trust account.<sup>30</sup>

We focus here on the vote. Why is the shareholder vote not serving as the protective mechanism that it typically does? The answer is that the vote is empty—devoid of economic significance. SPAC shareholders can vote yes for a transaction and also redeem their shares. Indeed, SPACs disclose this right to shareholders when explaining their right to vote.<sup>31</sup> The proxy will explain, often in bold, that “[p]ublic stockholders may elect to redeem all or a portion of their public shares even if they vote for the Business Combination Proposal.”<sup>32</sup> Another proxy assures SPAC shareholders: “You may exercise your redemption rights whether you vote your Public Shares for or against the Business Combination Proposal or do not vote your shares.”<sup>33</sup>

Thus, shareholders can vote for a deal while exiting, saying to the sponsors: “Sure, go ahead and buy that company. We don’t want any part of it.” This is a kind of empty voting, where a shareholder’s vote is decoupled from her economic interest. This perverse situation has pernicious ramifications—there is a reason why the law frowns on empty voting.<sup>34</sup>

The puzzle is why someone might vote in the affirmative for a deal while simultaneously exiting it. The answer lies in the warrants—the right to buy the SPACs’ shares in the future, by convention at an \$11.50 strike price.<sup>35</sup> Recall that the SPAC IPO offers units, comprised of warrants and common shares, which afterwards decouple and trade separately. Warrants are only valuable if the stock trades above \$11.50, and that generally only happens if there’s a successful acquisition.<sup>36</sup>

IPO investors—often hedge funds<sup>37</sup>—have every incentive to redeem their shares and pocket their \$10, but still vote *for* the deal and see if the warrants bear fruit. Michael Klausner, Michael Ohlrogge, and Emily Ruan suggest that many

29. See Maria Lucia Passador, *In Vogue Again: The Re-Rise of SPACs in the IPO Market*, BROOK. J. CORP. FIN. & COM. L. 46-47 (forthcoming 2022), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3820957](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3820957) [<https://perma.cc/MHR6-H92G>].

30. See *id.*

31. “Public stockholders may elect to redeem all or a portion of their public shares even if they vote for the Business Combination Proposal.” Diamond Eagle Acquisition Corp., Proxy Statement (DEFM14A) 77–78 (Apr. 15, 2020).

32. *Id.*

33. VectoIQ Acquisition Corp., Proxy Statement, Prospectus and Information Statement (424B3) 11 (May 8, 2020).

34. See Hu & Black, *supra* note 3, at 815 (“Sometimes, [hedge funds and company insiders] hold more votes than shares—a pattern we call ‘empty voting’ because the votes have been emptied of an accompanying economic stake.”).

35. See Klausner et al., *supra* note 7, at 236-37.

36. See *id.*

37. See *id.* at 241.

times they take precisely this investment approach, treating the warrants as compensation that gives some upside when a deal succeeds.<sup>38</sup>

Empty voting is why disclosure won't help retail SPAC shareholders. What the SEC is proposing is that retail investors, if given a more explicit map of how dilution will affect them, will now understand the dilutive aspect of the transaction, the incentives of all the participants, and how institutional shareholders secure gains. We are skeptical that many retail SPAC shareholders even know that they have a redemption right. More importantly, we seriously doubt that investors, in general, understand that their shares lose the \$10 price floor after the deSPAC, when the redemption right expires. For the record, before the deSPAC, SPACs trade with an implicit floor—the redemption price—because the shares represent a claim on the trust account for the redemption amount, generally \$10 plus interest. Even if the market thinks the proposed target is a lousy one, a SPAC share still represents at least \$10, and so will not trade below that price. After the deSPAC, the trust account is gone, and the fate of the shareholders in the newly deSPAC'ed company rests on the value of that company alone.

Do retail investors understand that SPAC shares do not reflect bad news about the target until after the transaction is already completed, so that they cannot rely on past trading history after the deSPAC for reliable information about the target? Do retail investors also understand that unit holders of the SPAC, which are mainly well-informed institutions, have a strong economic incentive to vote yes for a transaction, redeem their shares, and hold onto the warrants? Is disclosure able to address the nuances of a market laden with asymmetric information in a way that compensates for deviating from the law's traditional approach of keeping economic and control interests tied together? The proposed new rules implicitly answer in the affirmative to these questions.

We believe most retail shareholders will never read the proposed new disclosures. Modifying the current disclosures about the target company's risks and about potential conflicts of interest with the SPAC sponsor will not help investors at all if they treat SPAC shares like any other shares they own. (And why shouldn't they, since SPACs trade alongside operating companies?). But, as we described above, typically investors' lack of information doesn't hurt them, because the market provides protection. The big institutional investors vote in their own selfish best interest, and that protects shareholders who are along for the ride. But here, with the vote decoupled from economic interest, when most of those hedge funds redeem,<sup>39</sup> a shareholder who doesn't follow suit isn't along for the ride—she's being taken for a ride.

Our proposed solution is a simple one: the SEC should work with the NYSE and the NASDAQ to require that shareholders vote “no” on a transaction in order

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38. *See id.* at 245-46.

39. *See id.* at 242 & n.26 (“These funds invest in SPAC IPOs with little intention of remaining invested through the merger.”).

to exercise their redemption right.<sup>40</sup> If more than 50% of shareholders vote no, then the deal should not go forward—and all shareholders get their money back. This simple move recouples the voting and economic interest, and our empirics suggest that it will allow transactions that benefit shareholders to go forward. Because, for all the negative press and negative results you read about SPACs, we think there's a baby in that bathwater. SPACs create a different route to public markets for private companies. Some subset of companies choose the SPAC route over a traditional IPO, and make a considerable profit—for themselves, *and* for the SPAC shareholders. Recoupling the vote with the redemption right can help ensure that good deals go forward—and bad deals don't.

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40. For a similar recommendation, see Memorandum from Rick A. Fleming, Inv. Advoc., and the U.S. Sec. & Exch. Comm'n to Adena T. Friedman, President & Chief Exec. Officer, and John Zecca, Exec. Vice President & Glob. Chief Legal & Regul. Officer, Nasdaq, Inc. (Apr. 21, 2022), <https://www.sec.gov/about/offices/investorad/recommendation-of-the-investor-advocate-nasdaq-spac-listing-standards-042122.pdf> [<https://perma.cc/44VD-TBS6>].