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## FINANCIAL INNOVATION AND UNFORESEEN CONSEQUENCES: SPACS, SEC LENDING, AND SHORTS

*Christian A. Johnson\**

Although publicly traded “special purpose acquisition companies” (SPAC) have been trading for decades, the effect of the unique shareholder rights found in SPAC shares should be fully studied and compared with the rights of publicly traded non-SPAC shares. Because of their differences, SPAC shares will not necessarily behave in the same way as non-SPAC shares in certain situations. The short selling of SPAC shares offers a useful case study as well as lessons for regulators, investors, and short sellers about the unforeseen and unintended consequences of financial innovation in the otherwise understood corner of securities lending and short selling of securities.

This article argues that market participants and regulators must fully understand the impact of the unique characteristics of SPAC shares that differentiate these shares from non-SPAC shares.<sup>1</sup> The first part will discuss the nature of SPACs and the issuance of SPAC shares. It will then identify and discuss the unique characteristics of SPAC shares in comparison to non-SPAC shares. The second part will discuss the lending of SPAC shares and the potential consequences of the short sale of SPAC shares, focusing in particular on the right of a lender of SPAC shares to vote and redeem its SPAC shares in certain circumstances. The third part will discuss recommendations to SPAC lenders, words of caution to short sellers, and possible areas of additional study for SPAC shares by the Securities and Exchange Commission (SEC).

### I. SPAC SHARES

Commentators have written extensively about the differences between traditional initial public offerings and initial public offerings involving

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1. For a general discussion of special purpose acquisition companies, see Michael Klausner et al., *A Sober Look at SPACs* (European Corp. Governance Inst., Fin. Working Paper No. 746/2021, 2021), [http://ssrn.com/abstract\\_id=3720919](http://ssrn.com/abstract_id=3720919); Usha Rodrigues & Mike Stegemoller, *Exit, Voice, and Reputation: The Evolution of SPACs*, 37 DEL. J. CORP. L. 849 (2012); Derek K. Heyman, *From Blank Check to SPAC: The Regulator's Response to the Market, and the Market's Response to the Regulation*, 2 ENTREPRENEURIAL BUS. L.J. 531 (2007).

“special purpose acquisition companies.”<sup>2</sup> Over the past several years, there has been enormous activity in initial public offerings (IPO) for SPAC shares.

### A. Going Public

There are several different ways for a private company to go public or become part of a publicly traded company. A common method would be for the owner of a private company to simply sell its business or shares to a publicly traded company. The second would be to have the private company offer its shares as part of an IPO. The third would be for the owner to sell the shares to a SPAC or to have the company be merged into a publicly traded SPAC.

Since the beginning of publicly traded securities markets, a publicly traded non-SPAC company could purchase the shares or the business of a private company from the owners in a private transaction.<sup>3</sup> The privately traded company would then become a subsidiary of the publicly traded non-SPAC company or would be merged directly into the publicly traded company. This is relatively common and non-controversial.

A private company can go public by doing a traditional initial public offering. In 2020, 218 IPOs raised \$78.2 billion.<sup>4</sup> An IPO is a natural progression for a privately held company that wants to access the security markets. In contrast to a SPAC, the private company has revenues and assets as well as a history of operations and results. As the business gets bigger and needs additional capital, the company registers its shares with the SEC and offers its shares to investors through an IPO. Upon completion of the IPO, the shares are publicly traded.<sup>5</sup> The registration process, however, is often perceived as being difficult, complex, and expensive.<sup>6</sup> Direct listing is a similar process but has not proven to be popular, with only twelve companies going public in this way.<sup>7</sup>

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2. See, e.g., Ramey Layne & Brenda Lenahan, *Special Purpose Acquisition Companies: An Introduction*, HARV. L. SCH. F. ON CORP. GOVERNANCE (July 6, 2018), <https://corpgov.law.harvard.edu/2018/07/06/special-purpose-acquisition-companies-an-introduction/>.

3. See Gregory Kovsky, *Selling a Business to a Publicly Traded Company*, IBA (Aug 25, 2020), <https://ibainc.com/blog/gregory-kovsky/selling-a-business-to-a-publicly-traded-company/>.

4. Hester M. Peirce, *Inside Chicken: Remarks Before Fordham Journal of Corporate and Financial Law Conference: “Here to Stay: Wrestling with the Future of the Quickly Maturing SPAC Market”*, SEC (Oct. 22, 2021), <https://www.sec.gov/news/speech/peirce-remarks-fordham-journal-102221>.

5. *What You Need to Know About SPACs—Updated Investor Bulletins*, SEC (May 25, 2021), <https://www.sec.gov/oiea/investor-alerts-and-bulletins/what-you-need-know-about-spacs-investor-bulletin> [hereinafter SEC Investor Alerts].

6. See Peirce, *supra* note 4 (“The expense and time involved in the IPO process, concerns over underpricing, and the varying needs of companies going public have led some companies to explore alternatives to the traditional IPO.”); see also Klausner et al., *supra* note 1, at 3.

7. Peirce, *supra* note 4.

A third method for a private company to become publicly traded is for the company to be purchased by, or merged into, a SPAC. The SPAC has already gone through an IPO and raised large amounts of capital to be used to purchase a private company.<sup>8</sup> Upon raising the funds through an IPO, the sponsors of the SPAC then identify and acquire a private company. The IPO process for a SPAC is simpler because much of the traditional due diligence for the IPO is not necessary since the SPAC does not have any assets, revenues, operations, or prior financial history.<sup>9</sup> Once the private company is acquired by the SPAC, the private company is now effectively a public company. Shareholders of the private company often prefer to be acquired by a SPAC since their new interest in the SPAC will be immediately tradable over an exchange.<sup>10</sup>

## B. Special Characteristics of SPAC Shares

SPACs are publicly traded like companies that go through an IPO. The SPAC, however, has several unique characteristics that should be considered. First, almost all of the proceeds raised by the SPAC IPO are immediately placed into escrow to be used later upon the consummation of an acquisition. Second, the shareholders will be required to vote within eighteen to twenty-four months on the approval of an acquisition. Third, upon the identification of a target company, a SPAC shareholder is permitted to redeem its shares for the amount of the original IPO investment from the escrow of the IPO proceeds, regardless of whether it is the original shareholder or if it voted to approve the acquisition. Finally, if the sponsors are unable to consummate an acquisition within eighteen to twenty-four months, all of the SPAC shares of the investors will be redeemed from the funds in escrow.

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A direct listing offers a company a way to list its shares on an exchange without an underwritten offering. Given the absence of underwriters, a designated market maker, in consultation with the company's financial advisor, sets the opening price. Thereafter, the shares trade on an exchange at market prices based on orders to buy and sell the securities. The direct listing model allows existing shareholders, including employees, to benefit from public market liquidity. Companies have not yet used direct listings to raise capital, but new exchange rules allow them to do so.

*Id.*

8. For a discussion of the IPO of a SPAC, see Layne & Lenahan, *supra* note 2.

9. *Id.*

10. See Brandon Schumacher, *A New Development in Private Equity: The Rise and Progression of Special Purpose Acquisition Companies in Europe and Asia*, 40 NW. J. INT'L L. & BUS. 391, 399 (2020).

### 1. SPACs Generally

SPACs emerged in the early 1990s in response to the regulation of what is commonly referred to as a “blank check” company.<sup>11</sup> The growth over the past several years of SPACs has been extraordinary. SPACs only raised \$36 million in 2009. In contrast, SPAC IPOs raised \$13.6 billion in 2019, \$83.4 billion in 2020, and \$137 billion in 2021.<sup>12</sup> In the initial public offering of a SPAC, the SPAC typically offers a unit of securities composed of a share of stock and a warrant. The unit is typically issued at a price of \$10.00 per share.<sup>13</sup> The sponsors of the SPAC then utilize the cash raised in the SPAC offering and search for a private company to purchase.

The IPO of a SPAC is unique in comparison to that of a traditional IPO. The SEC describes a SPAC as the following:

A SPAC is a company with no operations that offers securities for cash and places substantially all the offering proceeds into a trust or escrow account for future use in the acquisition of one or more private operating companies. Following its initial public offering, or IPO, the SPAC will identify acquisition candidates and attempt to complete one or more business combination transactions after which the company will continue the operations of the acquired company or companies (“combined company”) as a public company.<sup>14</sup>

Because the SPAC is a publicly traded company, its shares trade over a stock exchange and will fluctuate in value like any other publicly traded share. The sponsors, who have a significant stake in the SPAC, are responsible for acquiring the target company.<sup>15</sup> In the prospectus for the SPAC, the sponsors will typically identify an industry or type of business that it is targeting.<sup>16</sup>

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11. Pierce, *supra* note 4 (“Those legislative and regulatory efforts were reactions to widespread abuses in blank check offerings in the 1980s.”).

12. *Id.*

13. See SEC Investor Alerts, *supra* note 5.

In the IPO, SPAC shares are typically priced at \$10.00 per unit. Unlike a traditional IPO of an operating company, the SPAC IPO price is not based on a valuation of an existing business. When the units, common stock and warrants (more below) begin trading, their market prices may fluctuate, and these fluctuations may bear little relationship to the ultimate economic success of the SPAC.

*Id.*

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

15. See Peirce, *supra* note 4 (“Investors rely on the SPAC’s sponsors to identify, value, and propose an acquisition of a promising private operating company.”).

16. SEC Investor Alerts, *supra* note 5.

## 2. *SPACs Only Hold Cash*

SPACs are unique among publicly traded companies because they are not an operating company and only hold the cash proceeds from the IPO.<sup>17</sup> The cash cannot be accessed until the SPAC acquires a private company.<sup>18</sup> Because the SPAC only holds cash, it would appear to be easy to value. However, because the SPAC, at the time of the IPO, intends to purchase an unidentified private company in the future, an investor may be willing to pay less or more for the SPAC shares depending upon their belief about the success or profitability of a future acquisition. In fact, currently most SPAC shares are trading at below their \$10.00 redemption price.<sup>19</sup>

## 3. *SPACs Right to Vote on Acquisition*

Shareholders of a publicly traded company are typically entitled to vote on a variety of actions which may include, for example, voting on a slate of directors.<sup>20</sup> A shareholder of a non-SPAC company may also be asked to vote on merger of the company or major acquisition.<sup>21</sup> In contrast, the shareholders of a SPAC will certainly face a critical shareholder vote within the first eighteen to twenty-four months of the life of the SPAC, when a SPAC considers the purchase of a targeted private company.<sup>22</sup> This vote will completely change the nature and prospects of the SPAC.<sup>23</sup> The voting right is particularly important because sponsors may have difficulty in identifying companies to purchase.<sup>24</sup>

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17. *See id.* (“IPO proceeds are held in the trust account until a SPAC consummates a business combination or liquidates.”).

18. *Id.*

19. *See id.* (“Typically, SPAC IPO proceeds, less proceeds used for certain fees and expenses, are held in a *trust account*. Similar to an escrow arrangement when buying a house, this money is held by a third party until the transaction is consummated . . .”).

20. *Shareholder Voting*, SEC, <https://www.investor.gov/shareholder-voting> (last visited Sept. 9, 2022).

21. *Id.*

22. *See* Afra Afsharipour, *Reevaluating Shareholder Voting Rights in M&A Transactions*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Nov 13, 2017), <https://corpgov.law.harvard.edu/2017/11/13/reevaluating-shareholder-voting-rights-in-ma-transactions/>.

23. *See* Peirce, *supra* note 4 (“Investors in the SPAC receive disclosures about the target company upon which to make their decision of whether they want to stay in or want out.”).

24. *See* SEC Investor Alerts, *supra* note 5 (“If the SPAC seeks shareholder approval of the initial business combination, it will provide shareholders with a proxy statement in advance of the shareholder vote.”).

#### 4. *Right of Redemption upon Acquisition Vote*

An extraordinary difference between non-SPAC shares and SPAC shares is that a shareholder of a SPAC can redeem its shares when a shareholder is asked to vote on the target acquisition.<sup>25</sup> At the time of the vote, the SPAC is required to redeem the shares at the offering price of \$10.00, typically at the option of the shareholder, regardless of whether the shareholder voted for the acquisition.<sup>26</sup> This effectively allows the investor an option to get out of its investment at the amount invested at the time of the IPO.<sup>27</sup>

As the SPAC industry has matured, market practices have evolved as well. Not only are shareholders permitted to redeem their shares but they may do so even if they approve the merger.<sup>28</sup> This redemption would seem to be counter-intuitive given that the shareholder is voting to approve the transaction. SPACs are seeing average redemptions of 60% at the time of a merger vote.<sup>29</sup> There are numerous examples of redemption rates in excess of 80%.<sup>30</sup>

Shareholders have the right to redeem their shares for the offering price at the time of approval.<sup>31</sup> Although the shareholder is required to surrender the SPAC share, it is permitted to retain the warrants issued as part of the IPO

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25. See Peirce, *supra* note 4; SEC Investor Alerts, *supra* note 5 (“Once the SPAC has identified an initial business combination opportunity, the shareholders of the SPAC will have the opportunity to redeem their shares and, in many cases, vote on the initial business combination transaction. Each SPAC shareholder can either remain a shareholder of the company after the initial business combination or redeem and receive its pro rata amount of the funds held in the trust account.”); Klausner et al., *supra* note 1, at 7 (“A key feature of SPACs is that, when the SPAC proposes a merger, shareholders have the right to redeem their shares . . .”).

26. See SEC Investor Alerts, *supra* note 5 (“If the transaction is completed and you decide that you do not want to remain a shareholder, you will be provided with the opportunity to redeem your shares of common stock for your pro rata share of the aggregate amount then on deposit in the trust account by taking the steps outlined in the proxy or information statement.”).

27. See *id.* (“In connection with a business combination, a SPAC provides its investors with the opportunity to redeem their shares rather than become a shareholder of the combined company.”); Klausner et al., *supra* note 1, at 12 (“[W]hen the SPAC proposes a merger, shareholders have the right to redeem their shares at a price equal to the \$10.00 IPO price of the SPAC’s units plus interest accumulated in the trust. The warrants and rights included in the units, however, remain outstanding and trade separately.”).

28. See Roger E. Barton, *High Redemption Rates See SPACs Relying on Alternative Financing*, REUTERS (January 14, 2022), <https://www.bartonesq.com/wp-content/uploads/2022/01/Official-PDF-High-redemption-rates-see-SPACs-relying-on-alternative-financing.pdf> (“Even if a shareholder votes in favor of a business combination, they may still choose to redeem their shares prior to the de-SPAC transaction if they have misgivings regarding the target company’s viability.”).

29. *Id.*

30. *Id.*; Chris Bryant, *Hedge Funds Are Demanding Their SPAC Money Back*, BLOOMBERG (Aug 16, 2021, 1:00 AM), <https://www.bloomberg.com/opinion/articles/2021-08-16/hedge-funds-are-demanding-their-spac-money-back-too-fast>.

31. Klausner et al., *supra* note 1, at 7, 14



unit.<sup>32</sup> Frequently these warrants then permit the redeeming shareholder the right to purchase shares of the de-SPAC company at a substantial discount.<sup>33</sup> Assuming that the shares are trading below the redemption price, it also provides investors a potential arbitrage opportunity to purchase SPAC shares trading below the redemption price and subsequently redeem the shares for the redemption price.<sup>34</sup>

#### 5. *Right of Redemption upon Termination of Acquisition Period*

SPAC investors also enjoy a highly novel right not given to non-SPAC IPO investors. A SPAC generally has only eighteen to twenty-four months to identify an acquisition.<sup>35</sup> If the sponsors are unable to identify an acquisition target within the eighteen to twenty-four month acquisition period, the company is required to redeem the shares of all of the shareholders and return the proceeds that were held in trust.<sup>36</sup> Although it is not a frequent occurrence, some SPACs have been forced to liquidate because of their inability to consummate an acquisition.<sup>37</sup>

## II. SECURITIES LENDING AND SHORTING SPAC SHARES

The lending of SPAC shares provides a unique opportunity to study if new financial products and other innovations create new or unique concerns or issues. The characteristics identified above may cause additional risks and concerns, for example, in securities lending and the short selling of SPAC shares.

### A. Securities Lending of SPAC Shares

Securities lending is a niche “Wall Street” activity in which owners of equity securities “lend” these securities to borrowers. The International Securities Lending Association (ISLA) estimated that hundreds of billions of

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32. *Id.* at 14.

33. *See id.* at 6.

34. Barton, *supra* note 28.

35. *See* SEC Investor Alerts, *supra* note 5.

36. *Special Purpose Acquisition Company (SPAC)*, CORP. FIN. INST., <https://corporate-financeinstitute.com/resources/knowledge/strategy/special-purpose-acquisition-company-spac/> (Sept. 8, 2022).

37. John Coates, *Statement: SPACs, IPOs and Liability Risk Under the Securities Laws*, SEC (Apr. 8, 2021), <https://www.sec.gov/news/public-statement/spacs-ipos-liability-risk-under-securities-laws> (“If the SPAC fails to find and acquire a target within a period of two years, the promote is forfeited and the SPAC liquidates. About ten percent of SPACs have liquidated between 2009 and now.”).



equity securities are regularly “borrowed” and “lent.”<sup>38</sup> In 2021, ISLA estimated that there were approximately \$670 billion publicly-traded securities that were on-loan.<sup>39</sup> It is further estimated that nineteen of the top twenty global asset managers participate in securities lending.<sup>40</sup> The industry is also profitable. The global securities lending market “generated U.S. \$8.66bn in revenue on behalf of beneficial owners in 2019.”<sup>41</sup>

In a securities lending transaction, the lender of the securities typically transfers equity securities to a borrower either for an open period or for a specific term.<sup>42</sup> The borrower, in exchange, transfers cash or other securities as collateral to secure the transaction. Upon the recall of the securities by the lender or the expiration of the term lending transaction, the borrower is obligated to return the securities to the lender.<sup>43</sup> Diagram 1 illustrates the borrowing and lending of a SPAC security in a securities lending transaction:

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38. See *infra* note 42 and accompanying text.

39. See INT’L. SEC. LENDING ASS’N, SECURITIES LENDING MARKET REPORT 17 (15th ed. 2021).

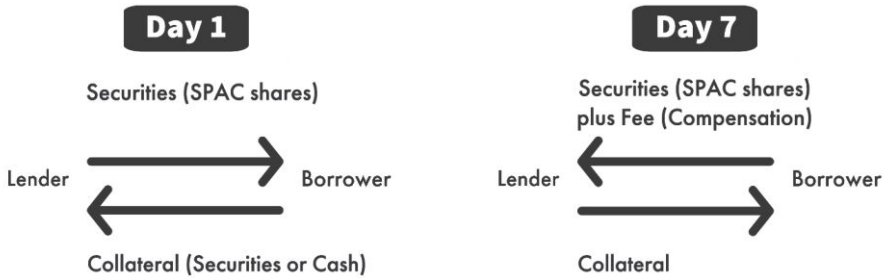
40. BROWN BROTHERS HARRIMAN, AN ASSET MANAGER’S GUIDE TO EVALUATING SECURITIES LENDING 2 (2020).

41. Nancy E. Allen, *Data Matters: Best Practices and Strategies for the Use of Securities Lending Data—Revenue Attribution, Performance Measurement and Alternative Uses of Lending Data*, 13 J. SEC. OPERATIONS & CUSTODY 139, 139 (2020).

42. For a general discussion of securities lending, see BLACKROCK, SECURITIES LENDING VIEWED THROUGH THE SUSTAINABILITY LENS (2021); *Securities Lending*, NAIC (Oct. 14, 2021), [https://content.naic.org/cipr\\_topics/topic\\_securities\\_lending.htm](https://content.naic.org/cipr_topics/topic_securities_lending.htm); Emma Boyde, *What Is Securities Lending. Why Do ETFs Do It and Is It Risky?*, FIN. TIMES, <https://www.ft.com/content/a913d225-6b38-42c2-8ba6-8c621857987b> (last visited Sept. 12, 2022).

43. PAUL HARDING & CHRISTIAN JOHNSON, MASTERING SECURITIES LENDING DOCUMENTATION 8 (Pearson Educ. Ltd., 2011). (“Upon maturity of the transaction, each party has a contractual obligation to return equivalent securities or equivalent cash or securities collateral to its counterparty. In this context ‘equivalent’ means of an identical type, class, nominal value, issue, issuer, description and amount as the securities or collateral originally transferred.”).

### DIAGRAM 1



Although the industry uses the terms “borrower,” “lender,” and “collateral,” legal title to the securities and voting rights are transferred to the other party. The standard clause in a securities lending agreement provides the following:

Borrower shall have all of the incidents of ownership of the Loaned Securities, including the right to transfer the Loaned Securities to others. Lender hereby waives the right to vote, or to provide any consent or to take any similar action with respect to, the Loaned Securities in the event that the record date or deadline for such vote, consent or other action falls during the term of the Loan.<sup>44</sup>

This enables the borrowed securities and collateral to be sold, pledged, or lent. The lender will set up parameters for the lending, such as what securities may be lent and for how long.<sup>45</sup>

A securities lending transaction is typically facilitated by an agent of the lender or the custodian of the lender’s shares. A lending program is often automated and quite efficient to minimize costs in the transaction.<sup>46</sup> The lender is compensated by a “fee” which is calculated in a manner similar to the interest paid on a loan.<sup>47</sup>

Generally, the lenders of equity securities in securities lending transactions are large institutions with portfolios of equity securities that are held as

44. MASTER SECURITIES LOAN AGREEMENT § 7.1 (2000); *see also* HARDING & JOHNSON, *supra* note 43, at 457 (discussing Section 7.1).

45. *See* HARDING & JOHNSON, *supra* note 43, at 10. (“Typically a lender will place limitations on which counterparties can borrow its securities; on what is acceptable collateral and risk concentration levels for securities; and the level of haircut it requires.”).

46. *See id.* (“Custodians also act as agents in managing securities lending programmes for their lending clients.”).

47. *Id.* at 8.

investments.<sup>48</sup> These types of lenders are passive holders of these securities and are not dealers or speculators trading to make short-term profits,<sup>49</sup> but rather they lend securities in order to earn fees paid by the borrowers<sup>50</sup> and increase the yield on their portfolios.<sup>51</sup> The fees earned by securities lending, such as custody fees, also offset the administrative cost of holding the securities.<sup>52</sup>

Borrowers of securities do so for a variety of reasons including short selling, arbitrage opportunities, covering delivery failures, and possibly even to vote the equity securities. Borrowers of securities include institutions that actively trade on the short-term movement of securities prices, such as short sellers, hedge funds, speculators, and other opportunistic investors. This discussion focuses on short selling and the possibility of borrowing in order to vote on SPAC securities.

## B. Short Selling SPAC Securities

Investors that short sell securities (the “short-seller”) believe that the securities to be sold in a short sale transaction (the “shorted securities”) are overvalued and that the securities will fall in value in the short run.<sup>53</sup> In the first leg of a short-sell transaction, the short-seller will borrow the securities in a securities lending transaction. Because the short-seller has title to the borrowed securities, the short-seller will then sell the shorted securities. In the second leg of the short-sale transaction, after the shorted securities have fell in value, the short-seller will repurchase the shorted securities in the public market, pocketing the difference between the sales price and the repurchase price of the securities.

Diagram 2 illustrates a typical short sale:

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48. *Securities Lending by U.S. Open and Closed-End Investment Companies*, SEC, <https://www.sec.gov/divisions/investment/securities-lending-open-closed-end-investment-companies.htm> (last visited Sept. 12, 2022) [hereinafter *Securities Lending SEC*] (“Securities lending is a well-established practice by institutional investors such as U.S. open-end and closed-end investment companies (‘funds’), insurance companies, pension plans, and college endowments.”).

49. *Id.*

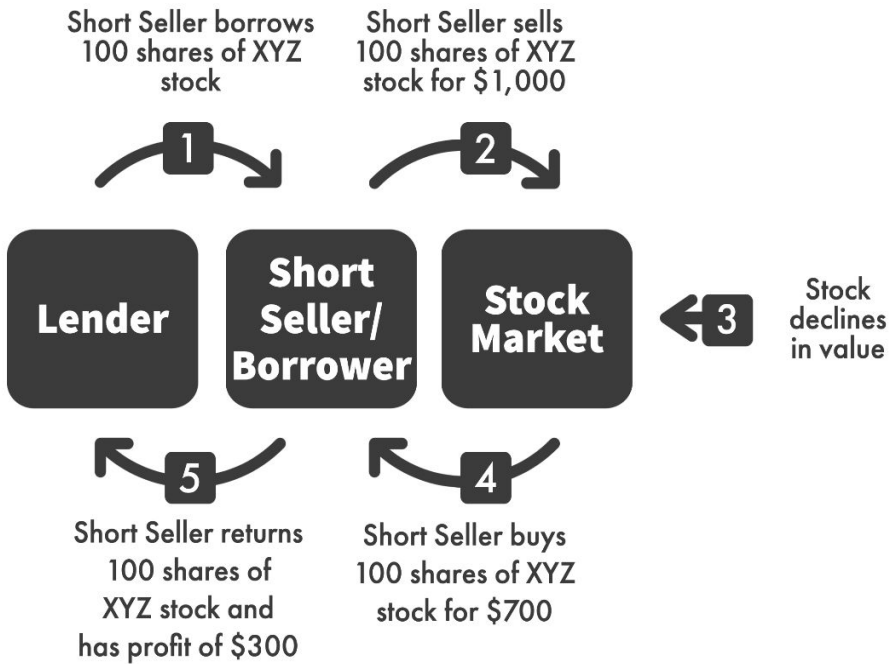
50. *Securities Lending*, CORP. FIN. INST. (Aug. 30, 2021), <https://corporatefinanceinstitute.com/resources/knowledge/trading-investing/securities-lending/>.

51. See *Securities Lending SEC*, *supra* note 48.

52. Thomas A. Peters, *An Overview of Securities Lending*, KREISCHER MILLER (Jan. 26, 2012), <https://www.kmco.com/resource-center/article/leading-edge/an-overview-of-securities-lending/>.

53. See HARDING & JOHNSON, *supra* note 43, at 14 (“Short selling can be defined as borrowing securities in order to sell them in the expectation that they can be bought back at a lower price by the time they need to be returned to the lender.”).

## DIAGRAM 2



As shown from the diagram, the short seller only profits if it can repurchase the shares at a price lower than the original sales price.

The principal risk for the short-seller is that after the short-seller has sold the borrowed securities in the first leg, the shorted-securities increase in value rather than falling in value. In that case, the short-seller will need to repurchase the shorted-securities in the second leg at a price higher than the price that the short-seller sold the securities in the first leg. Thus, the short-seller will suffer a loss. The loss can be compounded if the short-seller finds itself in a “squeeze.”

A squeeze occurs when the short-seller is unable to repurchase the shorted-securities at the original purchase price or below in order to return them to the lender.<sup>54</sup> In the event that the short-seller is unable to repurchase the securities, the short-seller would be liable for damages that are generally equal to the fair market value of the shorted-securities.<sup>55</sup> In the event that the

54. *Short Squeeze*, CORP. FIN. INST. (Jan. 28, 2022), <https://corporatefinanceinstitute.com/resources/knowledge/trading-investing/short-squeeze/>.

55. For a discussion of damages for failure to return the shorted securities, see HARDING & JOHNSON, *supra* note 43, at 498–507.

securities to be repurchased are not available, the price can be driven much higher, increasing losses for the short-seller.<sup>56</sup>

The risk for the lender is that the short-seller will be unable to deliver the shorted-securities when the SPAC shares are recalled by the lender. Instead of delivering the SPAC shares in this situation, the borrower would traditionally pay damages as discussed above. There is no remedy set out in market standard documentation to specific performance in a short sale transaction.<sup>57</sup> Even if such right existed, the problem in a squeeze situation is that the shares are not available for repurchase, or may not become available for repurchase until after a vote has occurred or a redemption period has expired.

SPAC shares are actively sold short in the market. Estimates of SPAC short selling activity show that approximately 1,500 SPAC securities were subject to short sales in 2021, representing a total short interest in the market of approximately \$1.2 billion.<sup>58</sup> Short interest represents the percentage of a company's shares is the market value of the shares being sold short.<sup>59</sup>

The "mean Pre-Announcement Share Price" for shorted SPAC shares between early fall of 2020 and the spring of 2021 is illustrative of the possible opportunities for shareholders. The mean price went from just over \$10.00 per share to approximately \$11.50 per share at its peak before falling to approximately \$9.00 per share by the end of 2021.<sup>60</sup>

There are several factors that might affect how a SPAC share behaves in a short sale situation. First, as discussed above, a shareholder has the right to redeem its shares for the issue price: (1) upon a vote to acquire a private company, and (2) upon the failure to acquire a private company during the acquisition period. This would suggest, absent fraud, that the fair market value of the share should not fall much below the redemption price prior to identification of a target. Second, a short seller of SPAC shares may be more at risk for

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56. The squeeze involving GameStop is a current example. See *A Detailed Overview of the GameStop Short Squeeze*, REBELLION RSCH. (Feb. 25, 2022), <https://www.rebellionresearch.com/a-detailed-overview-of-the-gamestop-short-squeeze>.

57. See HARDING & JOHNSON, *supra* note 43, at 506–507. (Market standard documentation does provide that a "party shall have the rights otherwise available to it under any other agreement or applicable law.")

58. Ihor Dusaniwsky, *SPAC Short Selling Recap*, S3 RSCH. (Nov. 2, 2021), <https://research.s3partners.com/spac-short-selling-recap-4/>.

59. For a discussion of "short interest," see *Short Interest—What It Is, What It Is Not*, FINRA (Apr. 12, 2021), <https://www.finra.org/investors/insights/short-interest>. Unfortunately, the research doesn't show at what stage in the life of a SPAC the SPAC is being sold short.

60. Klausner et al., *A Second Look at SPACs: Is this Time Different?*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Jan. 24, 2022), <https://corpgov.law.harvard.edu/2022/01/24/a-second-look-at-spacs-is-this-time-different/>.

a squeeze because of redemptions due to a lack of supply of SPAC shares for the seller to repurchase.<sup>61</sup>

SPAC shares, however, would appear to be particularly vulnerable to price share increases (i.e., price bubbles) due to the publicity and hype surrounding new SPAC IPOs. For example, SPACs have been promoted by sport stars, celebrities, and other public personas such as “Shaq, Serena, Steph, A-Rod and Ciara.”<sup>62</sup> In response to these celebrity promoted issuances of SPAC shares, the SEC issued an investor alert about the risks of SPACs being promoted by celebrities.<sup>63</sup> The failure of the recent highly-promoted celebrity SPACs highlight the risks of unjustified high valuations.<sup>64</sup>

Two prominent examples of SPAC shares being sold short underscore higher or different kinds of risks in shorting SPAC shares versus non-SPAC publicly traded shares. The first example is the short selling of Digital World Acquisition Corp (DWAC), a SPAC that issued shares in the fall of 2021. The second is Locust Walk Acquisition Corp (LWAC) that issued shares in 2020.

### 1. *Digital World Acquisition Corp.*

DWAC issued 28,750,000 shares on September 8, 2021, that raised \$293.25 million in an initial public offering and began trading on the NASDAQ.<sup>65</sup> \$283.25 million of that amount was placed in escrow to be used to acquire a private company.<sup>66</sup> In the preliminary prospectus, DWAC disclosed that it was formed for the following purposes:

Digital World Acquisition Corp. is a newly organized blank check company formed for the purpose of effecting a merger, capital stock exchange, asset acquisition, stock purchase, reorganization or similar business combination with one or more businesses, which we refer to as our initial business combination throughout this prospectus. We have not selected any specific business combination target and we have not, nor has anyone on

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61. See Dusaniwsky, *supra* note 58 (“Shorting SPACs has a peculiar issue than shorting most other larger cap securities, due to the relatively high percentage of retail long shareholders there is a lack of stock loan supply from the start. Retail shareholders are not usually in stock lending programs and tend have fully paid holdings and do not use margin, which limits the capabilities of brokers using their positions as collateral and lending out their shares.”).

62. See Chris Katje, 5 ‘Celebrity SPACs’ to Consider: Shaq, Serena, Steph, A-Rod and Ciara, INSIDER (Feb. 9, 2021, 5:20 PM), <https://markets.businessinsider.com/news/stocks/5-celebrity-spacs-to-consider-shaq-serena-steph-a-rod-and-ciara-1030062949>.

63. *Celebrity Involvement with SPACs—Investor Alert*, SEC (Mar. 10, 2021), <https://www.sec.gov/oica/investor-alerts-and-bulletins/celebrity-involvement-spacs-investor-alert>.

64. Liz Hoffman & Andrew Beaton, *Colin Kaepernick SPAC Deal Collapses, Testing Celebrity Halo*, WALL ST. J. (Dec. 24, 2021, 2:33 PM), <https://www.wsj.com/articles/colin-kaepernick-spac-deal-collapses-testing-celebrity-halo-11640373559>.

65. Digital World Acquisition Corp., Current Report (Form 8-K) (Sept. 15, 2021).

66. *Id.*

our behalf, initiated any substantive discussions, directly or indirectly, with any business combination target. While we may pursue an initial business combination target in any business or industry, we intend to focus our search on middle-market emerging growth technology-focused companies in the Americas, in the SaaS and Technology or Fintech and Financial Services sector.<sup>67</sup>

At that point DWAC began searching for a private company to purchase.

On October 20, 2021, it was announced that DWAC entered into an Agreement and Plan of Merger with Trump Media & Technology Group Corp. (TMTGC). Former President Donald J. Trump is the Chairman of TMTGC. TMTGC is a media company that intends to provide “people with open media platforms where they can share and create content.”<sup>68</sup>

After the announcement of the merger, by October 22, 2021, DWAC shares surged in price to \$131.00 from an issue price of \$10.00.<sup>69</sup> The surge immediately created comparisons with the “meme-stock frenzy” involving shares such as Gamestop.<sup>70</sup> By February 2022, DWAC was trading at around \$85.00 per share.<sup>71</sup> As of February 2022, DWAC was the “most-discussed stock on Reddit’s r/WallStreetBets forum.”<sup>72</sup> Finally, DWAC price continued to surge as TMTGC began to roll out applications.<sup>73</sup>

On December 6, 2021, DWAC announced that it was facing a probe by the Financial Industry Regulatory Authority (FINRA) and the SEC with respect to its planned merger with TMTGC.<sup>74</sup> The probe centers on “its trading

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67. Digital World Acquisition Corp., Amendment No. 6 to Form S-1 (Form S-1/A) (Sept. 1, 2021).

68. See TRUMP MEDIA & TECH. GRP., <https://www.tmtgcorp.com/> (last visited Sept. 12, 2022) (describing “Our Vision” on the homepage).

69. Aimee Picchi, *SPAC Backing Trump Has Surged More than 800%. That’s Sparking Meme-Stock Comparisons*, CBS NEWS (Oct. 22, 2021, 4:18 PM), <https://www.cbsnews.com/news/dwac-trump-spac-trading-surge/>.

70. *Id.*

71. NASDAQ: DWAC, [www.nasdaq.com/market-activity/stocks/dwac](http://www.nasdaq.com/market-activity/stocks/dwac) (last visited Sept. 12, 2022).

72. Madhukumar Warriar, *Why This SPAC Linked to Donald Trump Is Seeing High Interest on WallStreetBets Today*, BENZINGA (Feb. 2022), <https://www.msn.com/en-us/money/news/why-this-spac-linked-to-dona%E2%80%A6interest-on-wallstreetbets-today/ar-AAU9Kj9?ocid=msedgdhp&pc=U531>.

73. Matthew Fox, *Digital World Acquisition Corp. Soars 14% as Trump’s Truth Social Surges to Most Downloaded on Apple’s App Store*, INSIDER (Feb. 23, 2022, 12:57 AM), <https://www.businessinsider.in/stock-market/news/digital-world-acquisition-corp-soars-14-as-trumps-truth-social-surges-to-most-downloaded-on-apples-app-store/articleshow/89754318.cms>.

74. Mark Decambre, *Digital World Acquisition Corp., Tied to Donald Trump, Falls 5% as Publicly Traded Entity Says It Is Facing a Regulatory Probe*, MARKETWATCH (Dec. 6, 2021), <https://www.msn.com/en-us/money/companies/digital-world-acquisition-corp-tied-to-donald-trump-falls-5percent-as-publicly-traded-entity-says-it-is-facing-a-regulatory-probe/ar-AARwKLq>.



and communications with Trump entities before the announcement of a prospective SPAC deal two months ago.”<sup>75</sup> The SEC announcement was preceded by earlier calls for an investigation by the SEC into the planned merger.<sup>76</sup> These earlier calls asserted that there may have been discussions about a merger with the SPAC prior to its IPO in as early as May 2021.<sup>77</sup>

The possibility of regulatory action with respect to the IPO and merger plans may be what short sellers are currently anticipating, triggering a drop in the DWAC share price. In the event that regulatory actions stop the merger, it might result in the DWAC shares falling in value. During the wait, however, the price movements have been “eviscerating short-sellers.”<sup>78</sup> In January 2022, the short interest in DWAC was approximately \$323 million or 13% of the shares outstanding, and was considered to be “the most shorted one in the world” and the “Top SPAC short of 2022.”<sup>79</sup> However, the short sellers have

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75. *Id.*

DWAC has received certain preliminary, fact-finding inquiries from regulatory authorities, with which it is cooperating. Specifically, in late October and in early November 2021, DWAC received a request for information from FINRA, surrounding events (specifically, a review of trading) that preceded the public announcement of the October 20, 2021 Merger Agreement. According to FINRA’s request, the inquiry should not be construed as an indication that FINRA has determined that any violations of Nasdaq rules or federal securities laws have occurred, nor as a reflection upon the merits of the securities involved or upon any person who effected transactions in such securities. Additionally, in early November 2021, DWAC received a voluntary information and document request from the SEC which sought, *inter alia*, documents relating to meetings of DWAC’s Board of Directors, policies and procedures relating to trading, the identification of banking, telephone, and email addresses, the identities of certain investors, and certain documents and communications between DWAC and TMTG. According to the SEC’s request, the investigation does not mean that the SEC has concluded that anyone violated the law or that the SEC has a negative opinion of DWAC or any person, event, or security.

Digital World Acquisition Corp., Current Report (Form 8-K) (Dec. 4, 2021).

76. Letter from Elizabeth Warren, U.S. Senator, to Gary Gensler, Chairman of the SEC (Nov. 17, 2021), [www.warren.senate.gov/imo/media/doc/11.17.2021%20Trump%20SPAC%20Letter.pdf](http://www.warren.senate.gov/imo/media/doc/11.17.2021%20Trump%20SPAC%20Letter.pdf); see also Matthew Goldstein et al., *Trump’s \$300 Million SPAC Deal May Have Skirted Securities Laws*, N.Y. TIMES (Oct. 29, 2021), <https://www.nytimes.com/2021/10/29/business/trump-spac-digital-world.html> (describing conversations to merge company with SPAC prior to issuance of IPO).

77. Letter from Elizabeth Warren, *supra* note 76.

78. Rohail Saleem, *Trump-Linked SPAC Digital World Acquisition Corp. (DWAC) Is Making Minceat Out of Short-Sellers After Securing a Major Financial Endorsement*, WCCF TECH (Dec. 2, 2021), <https://wccftech.com/trump-linked-spac-digital-world-acquisition-corp-dwac-is-making-minceat-out-of-short-sellers-after-securing-a-major-financial-endorsement/>.

79. Michelle Celarier, *Donald Trump’s New Media Company Is the Top SPAC Short of 2022*, INST’L INV. (Jan. 24, 2022), <https://www.institutionalinvestor.com/article/b1wgp8v822h22v/Donald-Trump-s-New-Media-Company-Is-the-Top-SPAC-Short-of-2022>.

lost almost \$144 million in shorting the stock.<sup>80</sup> In addition, DWAC continues to “outperform[] every other special purpose acquisition company (SPAC), despite the regulatory risks facing the deal.”<sup>81</sup>

In August 2022, the proposed merger of DWAC with TMTGC continues to face problems because of the investigation by the FINRA and the SEC. The fair market value of the DWAC shares continues to tumble due to the ongoing investigation.<sup>82</sup> DWAC is asking its shareholders to delay the deadline for completing the deal until 2023.<sup>83</sup> In August 2022, DWAC traded at approximately \$30.00 per share,<sup>84</sup> a huge decline from when it was trading at \$131.00 in 2021.

Although short-sellers speculate on the potential decline in value of publicly traded non-SPAC shares as well, there would appear to be qualitative differences between the short sale of a SPAC versus a non-SPAC share. Unlike a traditional IPO, there is no operational history for the SPAC. In addition, upon the announcement of an acquisition, the operating history of the target private company has not been scrutinized or reviewed by the SEC in the same manner as the history of a non-SPAC company doing an IPO. The short selling activity would appear to be even more speculative and potentially more volatile than that of non-SPAC companies.

## 2. *Locust Walk Acquisition Corp.*

Locust Walk Acquisition Corp (LWAC) is an example of short sellers being squeezed in a unique way that is different from a classic squeeze situation. LWAC filed its Registration Statement on December 18, 2020.<sup>85</sup> They described their business plan in their registration statement as follows:

While we may pursue an acquisition opportunity in any business, industry, sector or geographical location, we intend to focus on industries that complement our management team’s background, and to capitalize on the ability of our management team to identify and acquire a business, focusing on the healthcare or healthcare related industries in the United States and

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80. *Id.*

81. Anirban Sen, *SPAC Linked to Trump’s Venture Outperforms Others in Sector*, REUTERS (Jan. 24, 2022), <https://www.reuters.com/business/media-telecom/spac-linked-trumps-venture-outperforms-others-sector-2022-01-24/>.

82. Samuel O’Brient, *DWAC Stock Falls Another 30% as SEC Woes Hit Trump’s SPAC*, INV. PLACE (June 14, 2022, 5:05 PM), <https://investorplace.com/2022/06/dwac-stock-falls-another-30-as-sec-woes-hit-trumps-spac/>.

83. Nicholas Reimann, *DWAC Seeks to Delay Merger with Trump’s Truth Social Company Amid Federal Investigations*, FORBES (August 5, 2022, 6:41 PM), <https://www.forbes.com/sites/nicholasreimann/2022/08/05/dwac-seeks-to-delay-merger-with-trumps-truth-social-company-amid-federal-investigations/?sh=991619c70841>.

84. NASDAQ: DWAC, *supra* note 71.

85. Locust Walk Acquisition Corp., Registration Statement (Form S-1) (Dec.18, 2020).

Europe. In particular, we intend to prioritize companies in the life sciences sector where our management team has extensive experience.<sup>86</sup>

On January 12, 2021, LWAC issued 17,500,000 units at an offering price of \$10.00 per unit, raising gross proceeds of \$175 million.<sup>87</sup> LWAC entered into an Agreement and Plan of Merger with eFFECTOR Therapeutics, Inc. on May 26, 2021.<sup>88</sup>

Although the shareholders approved the merger on August 25, 2021, shareholders elected to redeem almost all of their shares as opposed to holding on to them.<sup>89</sup> Shareholders redeemed 17,000,000 shares, leaving only 500,000 shares outstanding.<sup>90</sup> This in turn caused a squeeze on short sellers needing to repurchase the LWAC shares that they had shorted. Many short sellers faced huge losses as the price tripled in the short run as they tried to purchase LWAC shares to cover their short positions.<sup>91</sup> The LWAC experience for short sellers is evidently possible in other situations.<sup>92</sup>

This type of squeeze is entirely unique to SPAC shares versus a squeeze of publicly traded non-SPAC shares. The reason for the difficulty in covering the short sale by buying shares has nothing to do with investors refusing to sell shares to the short sellers. Instead, the lack of supply is caused by a significant redemption of SPAC shares by investors, even though they might have voted for the acquisition, reducing the supply of publicly traded shares available for sale to the short-seller.

### C. Voting and the Redemption of Shares

As explained above, the transfer of securities from the lender to the borrower in a securities lending transaction is not actually a loan, as traditionally understood. Instead, it is the transfer of title of the securities from the lender to the borrower coupled with a simultaneous obligation to return the securities either on demand or for a specific term.<sup>93</sup> This transfer of title not only transfers to the borrower the right to sell or hypothecate the securities but it also transfers the right to vote the securities from the lender to the borrower.<sup>94</sup> In

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86. *Id.* at 9.

87. Locust Walk Acquisition Corp., Current Report (Form 8-K) (Jan. 7, 2021).

88. Locust Walk Acquisition Corp., Current Report (Form 8-K) (May 26, 2021).

89. Locust Walk Acquisition Corp., Current Report (Form 8-K) (Aug. 24, 2021).

90. *Id.*

91. *Id.*

92. “The move in Locust Walk Acquisition could also be playing out in shares of Blue Water Acquisition on Thursday, which soared as much as 199% ahead of its planned merger with Clarus Therapeutics. A shareholder vote on Friday is expected to approve the merger, but investors are likely speculating that there will be a large amount of share redemptions.” *Id.*

93. *See supra* notes 38–52 and accompanying text.

94. BLACKROCK, *supra* note 42, at 3.

order to vote the lent SPAC securities, a lender “has to wait until its securities have been returned.”<sup>95</sup>

The right to vote the lent SPAC securities is an important right given the likelihood that a shareholder will be asked to vote on the approval of an acquisition or to extend the acquisition period. If the shareholder intends to redeem its shares upon an acquisition by the SPAC, it is also important that the lender be the beneficial owner at the time of the redemption.

### 1. *Voting to Approve an Acquisition*

There are at least three situations when the lender will want to vote their SPAC shares. First, a SPAC shareholder that intends to hold the SPAC shares long-term and believes that the acquisition should be approved, will want to vote to approve the acquisition. Second, a SPAC shareholder that believes that the acquisition should not be approved, will want to vote against the acquisition. Third, a SPAC shareholder that wants to redeem its shares but still wants to vote to approve the acquisition in order to be able to exercise its warrants.<sup>96</sup> If the lender is unable to recall the lent SPAC shares, it will be unable to vote the shares. Instead, the shares will be voted by whoever the record holder is at the time it is determined who is entitled to vote.

A lender that wants to protect its right to vote its shares will typically contract for the right to recall the lent securities prior to the vote from the borrower.<sup>97</sup> However, it may be difficult to recall the shares if there has been a squeeze on the short-seller. The short-seller may not be able to repurchase the lent shares if none are available to purchase (e.g., what occurred in the LWAC squeeze). At that point, neither the lender nor the borrower will be able to vote the shares. Instead, the shares will be voted by whomever owns the shares at that time.

Interestingly, the lender may not be interested in recalling the shares to vote them. If the lent shares are subject to a short squeeze, the lender may decide not to recall the shares if the fee or compensation for borrowing the shares has increased. For example, if the shares have become particularly valuable, the lender may decide to simply collect a larger fee and not recall the shares, in particular if it has no opinion about the vote.

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95. Boyde, *supra* note 42.

96. *Id.*

97. Shareholders that redeem their shares keep the warrants and rights that were in the units sold in the SPAC's IPO. See Klausner et al., *supra* note 1, at 6–7. At the time a merger is proposed, shareholders can redeem their shares for the \$10.00 price of units sold in the SPAC's IPO plus interest—keeping their warrants and rights to boot. See *id.* at 12.

## 2. *Voting to Extend the Acquisition Period*

The sponsors of a SPAC must typically identify a private company to be acquired within eighteen to twenty-four months of the SPAC IPO or the SPAC shares will be redeemed and the SPAC liquidated.<sup>98</sup> If the sponsors are unable to consummate a transaction within that period, the SPAC will cause all of the shares to be redeemed from the escrow proceeds. At this point, the sponsors may want to request that the SPAC shareholders vote to extend the acquisition period.<sup>99</sup> It may or may not be in the interest of a shareholder to agree to such an extension.

If the SPAC shareholder is not able to vote the shares, however, because the shares have been lent out, it risks losing control over this decision. It is possible that its shares may be voted to extend the acquisition period when it would otherwise have preferred to have redeemed its shares had the SPAC been otherwise terminated upon the now-extended expiration date of the acquisition period. In this case, its capital will continue to be tied up in the SPAC investment until a target acquisition is identified or the extended acquisition period expires.

It is also possible that the shareholder's respective shares may be voted to terminate the acquisition period when the lender would otherwise have preferred to have extended this period. Such a termination may have been against its interest if the lender held warrants that would become worthless upon the liquidation of the SPAC at the expiration of the acquisition period. The lender may have wanted to give the sponsors more time to locate an acquisition and thus be able to exercise its warrants.<sup>100</sup> Instead, the lender would only receive the redemption amount.

## 3. *Borrowing to Vote*

It is also possible that a borrower of the SPAC shares that has not sold them short may decide to simply vote the shares if the lender of the shares does not recall them. An opportunistic investor may want to vote additional shares through borrowing the SPAC shares in a securities lending transaction.

The right to vote the SPAC shares may depend upon the original purpose of the borrower when borrowing the SPAC shares. Although the borrower is

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98. See Reena Aggarwal et al., *Proxy Voting and the Supply/Demand for Securities Lending*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Jan. 12, 2011), <https://corpgov.law.harvard.edu/2011/01/12/proxy-voting-and-the-supplydemand-for-securities-lending/> (“At the time of a proxy vote, there is a significant reduction in the supply of shares available to lend because institutions restrict or call back their loaned shares prior to a vote.”).

99. See SEC Investor Alerts, *supra* note 5.

100. See *id.* (“The SPAC’s governing instruments may permit it to extend that time period.”).

clearly entitled to vote the shares if the borrower is holding the shares at the time of the vote, Federal Reserve Regulation 220.10 provides what is commonly known as a “purpose test” that would limit the right to borrow shares in order to vote them.<sup>101</sup> The Regulation is generally understood as “limiting the borrowing or lending of securities by broker-dealers to situations involving short sales or ‘fails’ to receive securities needed for delivery.”<sup>102</sup> It is unclear how a SPAC would determine if the shares voted had violated the purpose test or how the restriction would be enforced against borrowers in violation of the test.

There is generally evidence that shareholders of lent shares do actively recall their shares.<sup>103</sup> Although there is no research specifically involving SPAC shares, there is also “some evidence of increased demand around the time of the record date,” suggesting that some borrowing for voting purposes has occurred.<sup>104</sup> However, it appears that “the use of borrowed shares for voting purposes is limited.”<sup>105</sup> Anecdotal evidence further suggests that in certain circumstances, “widespread lending of stock for short-selling often factors in those elections.”<sup>106</sup> Finally, research also suggests that sophisticated investors are borrowing securities to influence votes using securities lending.<sup>107</sup>

#### 4. *Inability to Redeem the Shares*

Another significant risk for a lender could occur if the lender wants to redeem their shares upon an acquisition but is unable to recall its shares. The lender would be unable to tender the shares for redemption if the lender is not the beneficial owner. By the time the shares are eventually returned to the lender, the time for redemption may have passed. The lender may now be holding shares in a SPAC that it would otherwise have redeemed had it been the beneficial owner during the redemption period.

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101. 12 C.F.R. § 220.10 (2022); *see also supra* note 95 and accompanying text.

102. Borrowing by Brokers and Dealers, 63 Fed. Reg. 2806, 2810 (Jan. 16, 1998) (to be codified at 12 C.F.R. pts. 207, 220, 221, 224, 265)

103. *See* BLACKROCK *supra* note 42, at 1, 4 (“In the US, as per the ‘Permitted Purpose rule’ our borrowers need to ensure that borrowing for the purpose of voting does not occur.”).

104. Aggarwal et al., *supra* note 97; *see also* BLACKROCK, *supra* note 42.

105. Aggarwal et al., *supra* note 97.

106. Tim McLaughlin & Ross Kerber, *Securities Lending Boom Sparks Concerns on Returns and Voting*, REUTERS (Nov. 8, 2018, 12:06 AM), <https://www.reuters.com/article/us-funds-lending-analysis/securities-lending-boom-sparks-concerns-on-returns-and-voting-idUSKCN1ND0JA>.

107. Henry T. C. Hu & Bernard Black, *Empty Voting and Hidden (Morphable) Ownership: Taxonomy, Implications, and Reforms*, 61 Bus. Law. 1011, 1017, 1027–28 (2006).

### III. RECOMMENDATIONS

The IPO of SPAC shares has proven to be an extraordinary innovation for financial markets. SPAC shareholders should, however, be aware of the potential risks of participating in what is commonly considered to be the low-risk activity of securities lending. The SEC should also consider additional regulation of the trading and short selling of SPAC shares.

#### A. Restricting the Lending of SPAC Shares

The lending and short selling of SPAC shares should be carefully assessed by both lenders, borrowers, and short sellers. The importance of a shareholder vote within the first eighteen to twenty-four months of the SPAC IPO and the effect of a redemption on the number of SPAC shares available for purchase should inspire caution for all participants in securities lending.

##### 1. *Minimizing Lender Risks*

The lender of shares should consider whether the relatively low returns generated by securities lending justifies the unique risks of losing both voting control and the right of redemption over its holding of SPAC shares.<sup>108</sup> Many minimize the risks of a delivery failure because of the collateral securing the transaction. This, however, only protects against the loss of the value of the shares. It does not protect the lender against any unique costs of losing the right to vote and redeem the shares. At the minimum, lenders should carefully monitor the announcement of votes and recall the shares promptly. It is also suggested that a lender should recall the SPAC shares two to three weeks prior to a vote.<sup>109</sup>

Even with such precautions to recall or collateralize a loan of SPAC shares, the lender may find that a borrower is unable to repurchase the shorted shares and return them to the lender. Although the lender will be holding collateral in the event of such a failure, the lender will still have lost the right to vote the shares. Worse, the lender will also not have the right to tender the shares in the event that it decides to redeem the shares during the acquisition period.

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108. See Axel Hester, *Muted Securities Lending Returns Aren't Always Bad*, STATE ST. GLOB. ADVISORS (Sept. 15, 2021), [https://www.ssga.com/uk/en\\_gb/institutional/ic/insights/muted-securities-lending-returns-are-not-always-bad](https://www.ssga.com/uk/en_gb/institutional/ic/insights/muted-securities-lending-returns-are-not-always-bad) (discussing returns on securities lending).

109. BROWN BROTHERS HARRIMAN, *supra* note 40, at 1, 9 (“Where the decision is made to recall, it’s advisable to give an agent lender two or three weeks of advance notice because recalling for voting purposes is usually covered by different legal obligations than recalling for a security sale”).



## 2. *Minimizing Borrower Risks*

As demonstrated by both the DWAC SPAC and the LWAC SPAC, short selling SPAC shares potentially brings in higher risks not otherwise present in the shorting of non-SPAC shares. The lack of public information available about the acquisition target in a SPAC purchase poses lack of information risks that are not as prevalent in traditional short selling transactions. In the case of the DWAC acquisition, in spite of an almost complete lack of information about the acquisition target, the shares continued to increase in value, subjecting the short-seller to losses.

The complete redemption of almost all of the LWAC shares due to the exercise of redemption rights by SPAC shareholders is an extraordinary risk for short-sellers not posed in shorting non-SPAC shares.<sup>110</sup> This is not simply a situation where shareholders are unwilling to sell to the short-seller. Instead, the finite supply of issued shares has been almost completely redeemed, leaving nothing for the short-seller to repurchase. A short-seller would need to anticipate the effect of such a wholesale redemption in the event that the short-seller is still holding a short position in the SPAC.

### B. Additional study of SPAC shares by the SEC

The SEC has been concerned for years that the securities lending market is opaque and not fully understood. Although the SEC has recently issued proposed rules regarding securities lending, it should consider expanding the proposed rules to cover any special risks posed by SPAC shares.

Acting on its authority under the Dodd-Frank Act,<sup>111</sup> in January of 2022, the SEC issued proposed rules on the reporting of securities loans.<sup>112</sup> Due to the opaque nature of the securities lending market, the SEC has proposed regulations that “would require any person who loans a security on behalf of itself or another person . . . to provide the specified material terms of their securities lending transactions to [a registered national securities association (an “RNSA”)].”<sup>113</sup>

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110. See Fox, *supra* note 73. See generally *supra* Section II.B.

111. See Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong. § 984(a) (2010) (enacted) (It is “unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . [t]o effect, accept, or facilitate a transaction involving the loan or borrowing of securities in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.”).

112. Reporting of Securities Loans, 86 Fed. Reg. 69802 (proposed Dec. 8, 2021) (to be codified at 17 C.F.R. pt. 240).

113. *Id.*

The rules would also require the RNSA to make available to the public certain information concerning each transaction, including aggregate information of securities on loan and available to loan.<sup>114</sup> Notwithstanding the broad mandate of the regulations, there are no special reporting requirements for the lending of SPAC versus non-SPAC shares.

The SEC should consider gathering specific information regarding the lending of SPAC shares. The speculative nature of the purpose of SPACs would suggest that lending of SPAC shares should be monitored carefully by RNSAs and regulators. The effect of redemptions on short selling and the recalling of shares in securities lending transactions should be a matter of concern for both stock exchanges as well as the SEC.

The SEC may also want to consider closely scrutinizing the voting of borrowed shares in securities lending transactions and determining the penalty for borrowing shares in order to vote them. Lenders also may want to carefully monitor the purposes behind the borrowing of their securities or at least require borrowers to represent that they are not borrowing the securities to vote them. Given the automation involved in securities lending, it may be difficult for both the SEC and the lenders to monitor the borrower's purpose behind a securities lending transaction.

#### IV. CONCLUSION

SPACs are one of the most transformative and important financial innovations in recent history. Investors of all types have purchased the IPO shares of SPACs with almost reckless abandon. Given the special and unique characteristics of SPAC shares, however, SPAC shares may introduce concerns of unanticipated and unforeseen risks into U.S. financial markets.

The effect of these unique SPAC shareholder rights on the securities lending market and the short selling of SPAC shares provides an interesting case study of the potential unforeseen and unintended consequences of financial innovation. The escrow of the proceeds raised by the SPAC IPO, the right of redemption at the issue price upon a vote to approve an acquisition, and the obligation of the SPAC to redeem all of the shares in the event that a SPAC is unable to consummate an acquisition, present peculiar risks and distortions to a securities lending transaction of SPAC shares that necessarily may not be present with non-SPAC shares.

Both the lender and borrower of SPAC shares should be aware of the special risks of lending and shorting such shares that might not otherwise be present for non-SPAC shares. Lenders should consider not lending SPAC shares given the potential risks of losing the right to vote the shares in the event that the borrower is unable to return them. This should be weighed

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114. *Id.*

against the relatively modest compensation of lending shares. A short-seller should also be aware that they may be much more at risk of a squeeze than otherwise in the short sale of non-SPAC shares.

Finally, regulators should be aware that SPAC shares pose special risks in securities lending markets not otherwise implicated for non-SPAC shares. The SEC should consider expanding the information that it collects on the lending of SPAC shares beyond what is required in the proposed regulations. The SEC should also continue to be watchful for unforeseen consequences of new financial instruments and products exemplified by what is currently occurring with SPACs.