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This SEC Rule Makes It Harder To Invest—Unless You're Already Rich

Stop limited entrepreneurs' ability to get funding from those they know best.

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Want to support small business growth and expand investor opportunities? Then you should want to reform the "accredited investor definition," a federal rule that largely limits investment in certain private securities offerings to those who are comparatively wealthy.

Private securities offerings are a substantial portion of the capital raised by businesses. From July 1, 2021, to June 30, 2022, twice as much money was raised in this way than by all public offerings. But the Securities and Exchange Commission (SEC) prevents individuals from investing in these offerings unless they qualify as accredited investors by having a net worth of at least $1,000,000 or an annual income of at least $200,000. The SEC estimates that about 13 percent of U.S. households qualify.

There seems to be bipartisan agreement that this rule is broken. This was evident during a February hearing dedicated specifically to the accredited investor definition, and it came up again last week's House Financial Services Committee hearing on "encouraging capital formation and investment opportunity for all Americans."

It's long past time to translate that agreement into action. It's bad enough to paternalistically give the SEC the authority to decide how individuals invest their own money. But even when judged against the SEC's own goal of limiting private offerings to the financially sophisticated, the accredited investor definition is a failure.

Being wealthy is no proxy for financial sophistication. The current cutoff gives an investing green light to lottery winners and to elderly folks with substantial retirement savings; it excludes people with smaller nest eggs but lots of investment knowledge. A bright-line wealth test fares no better at limiting investment to those who can "afford" to take a loss. Such generic metrics cannot capture individualized loss tolerances that vary with many factors, including age, diversification needs, and investing goals.

Eli Velasquez, founder of the Investors of Color Network, testified at the February hearing that despite having "evaluated thousands of deals, vetted hundreds as viable investment opportunities, and partnered with dozens of angel and venture investors"—obvious hallmarks of financial sophistication by any reasonable standard—he was unable to make such investments himself because he didn't meet the definition's wealth thresholds. Similarly, David Olivencia, CEO of Angeles Investors, detailed how he couldn't invest in startups even though he had studied that asset class when he earned his MBA, because he had no family wealth to rely on. Both Brandon Brooks, founding partner of Overlooked Ventures, and Rodney Sampson, executive chairman and CEO of Opportunity Hub, gave similar testimony at last week's hearing.

This mismatch between wealth tests and investor sophistication makes it harder for those who are not already wealthy to make gains. Most Americans depend on the public markets for investment, but there are fewer public companies to choose from today. Companies that do go public these days tend to be more mature and likely past their high growth phase, leading to lower potential returns. But even if there are no better returns, most investors are missing out on the different opportunities available in the private markets, including startup investments and diversification options.

These impacts are felt more acutely by black and Hispanic Americans and those who don't live in relatively wealthy locales. Due to existing wealth divides, those who qualify as accredited investors are disproportionately white and are concentrated on the country's coasts.

And these impacts are not limited to investors. The accredited investor definition limits entrepreneurs' ability to turn to those they know best for business funding. The SEC itself has recognized that minority-owned businesses and businesses in lower-cost-of-living areas may benefit from increased access to accredited investors.

The accredited investor definition also places major hurdles on the path of both entrepreneurs and investors to have an ownership stake in a private business, an important way to accumulate wealth.

Those skeptical of increasing access assert that private securities offerings are too opaque for those who have less to lose. But while private offerings don't make the same mandatory disclosures as public offerings, disclosure is commonplace in practice. Such disclosures—which vary based on the complexity of the transaction and the sophistication of the investors—are subject to anti-fraud rules, just like public securities offerings.

Private market investment is risky, but that is no good reason for this barrier to investment. Risk is a part of both the public and private markets, and investors are compensated for risk by a chance at higher returns. Prohibiting investment eliminates exposure to the potential downside, but it also excludes realization of the potential upside.

There are a number of ideas for reforming this rule, including those scheduled for consideration at committee mark-up today. Congress should, at the very least, find a way to expand access for investors who are financially experienced or can obtain sophisticated advice from regulated financial advisers. You shouldn't have to be wealthy to deserve a chance to invest.

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