

March 18, 2021

The Honorable Patrick Toomey  
Ranking Member  
Committee on Banking, Housing, and Urban Affairs  
United States Senate  
Washington, DC 20515

Via electronic mail to [submissions@banking.senate.gov](mailto:submissions@banking.senate.gov)

Dear Ranking Member Toomey:

My name is Jennifer Schulp, and I am the Director of Financial Regulation Studies at the Cato Institute's Center for Monetary and Financial Alternatives. I write today in response to your February 2, 2021 initiative seeking legislative proposals to increase economic growth and job creation by facilitating capital formation. I propose amending the "accredited investor" definition to include all investors advised by an investment professional who is qualified as accredited under the SEC's definition. Thank you for the opportunity to submit this proposal.

### **Effect of Accredited Investor Standard on Retail Investors and Entrepreneurs**

As you know, the "accredited investor" definition limits investment in a large segment of private offerings to those who earn more than \$200,000 a year or have a net worth of more than \$1 million.<sup>1</sup> To put this in perspective, only about 13 percent of U.S. households qualify as accredited investors under these rules.<sup>2</sup> Although the SEC recently amended this definition to include a subset of financial services professionals, the accredited investor definition still deprives most retail investors the opportunity to invest in private offerings and hinders access to capital for small businesses.<sup>3</sup>

First, the accredited investor definition makes it harder for those who are not already wealthy by locking them out of a private capital market that is larger than the public one. In 2019, for example, registered offerings raised \$1.2 trillion, while exempt offerings raised \$2.7 trillion; Regulation D offerings alone, which are largely limited to accredited investors, raised \$1.5 trillion.<sup>4</sup> As SEC Commissioner Elad Roisman recognized, "all but the wealthiest" have been shut

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<sup>1</sup> 17 C.F.R. § 230.501(a).

<sup>2</sup> SEC. "Accredited Investor Definition." *Final Rule*. Available at <https://www.sec.gov/rules/final/2020/33-10824.pdf> (PDF Page 100).

<sup>3</sup> 17 C.F.R. § 230.501(a)(10). The SEC designated individuals who hold Series 7, 82 and 65 securities licenses as qualifying natural persons for accredited investor status. SEC. "Order Designating Certain Professional Licenses as Qualifying Natural Persons for Accredited Investor Status." *Order*. Available at <https://www.sec.gov/rules/other/2020/33-10823.pdf>

<sup>4</sup> SEC. "Accredited Investor Definition." *Final Rule*. Available at <https://www.sec.gov/rules/final/2020/33-10824.pdf> (PDF Page 4).

out “from upside gains that private companies have made over the last several decades.”<sup>5</sup> As companies take longer to go public, they are likely pass their high growth phase by the time most people can invest.<sup>6</sup> Beyond simple returns, private offerings also provide different investment opportunities, including diversification and supporting a compelling idea or local entrepreneur.

Second, the accredited investor definition deprives many communities of capital needed to grow their businesses. Accredited investors are not representative of the U.S. population: white families, on the whole, are considerably wealthier than others and wealth is concentrated on the U.S. coasts.<sup>7</sup> Would-be entrepreneurs in less wealthy communities are thus limited in their ability to turn to those they know best when building their businesses.<sup>8</sup> Indeed, 74 percent of aspiring entrepreneurs cite networks and connections as barriers to accessing capital, and businesses in rural areas, for example, raise comparatively less capital.<sup>9</sup> The SEC has recognized that minority-owned businesses and businesses in lower-cost-of-living areas, in particular, may benefit from increased access to accredited investors.<sup>10</sup> As the economy continues its recovery from the pandemic, access to capital will be crucial to encourage job growth for both new and existing businesses.<sup>11</sup> Importantly, new businesses have an outsized impact on job creation, and

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<sup>5</sup> Elad L. Roisman. “Statement at Open Meeting on Proposed Amendments to the Accredited Investor Definition.” *SEC Public Statement*. Available at <https://www.sec.gov/news/public-statement/statement-roisman-2019-12-18-accredited-investor>

<sup>6</sup> Stephen Dover. “FOMO? Investors Fear Missing Out as Companies Stay Private for Longer.” *Franklin Templeton*. Available at <https://global.beyondbullsandbears.com/2019/05/24/fomo-investors-fear-missing-out-as-companies-stay-private-for-longer/>; Carol Ryan. “Today’s Tech IPOs Offer Lower Growth for Top Dollar.” *Wall Street Journal*. Available at <https://www.wsj.com/articles/todays-tech-ipos-offer-lower-growth-for-top-dollar-11566050580>

<sup>7</sup> Neil Bhutta, Andrew Chang, Lisa Dettling, and Joanne Hsu. “Disparities in Wealth by Race and Ethnicity in the 2019 Survey of Consumer Finances.” *FEDS Notes*. Available at <https://www.federalreserve.gov/econres/notes/feds-notes/disparities-in-wealth-by-race-and-ethnicity-in-the-2019-survey-of-consumer-finances-20200928.htm>; SEC. “Report on the Review of the Definition of “Accredited Investor.” *SEC Report*. Available at <https://www.sec.gov/corpfin/reportspubs/special-studies/review-definition-of-accredited-investor-12-18-2015.pdf> (Pages 112-113).

<sup>8</sup> As the SEC’s Office of the Advocate for Small Business Capital Formation noted, “[w]omen, minorities, and rural communities have expressed disproportionate challenges with the standard, which often draws a line between the investors’ network and qualification for the most attractive offering exemptions.” Office of the Advocate for Small Business Capital Formation. “Annual Report for Fiscal Year 2019.” *Annual Report*. Available at [https://www.sec.gov/files/2019\\_OASB\\_Annual%20Report.pdf](https://www.sec.gov/files/2019_OASB_Annual%20Report.pdf)

<sup>9</sup> Office of the Advocate for Small Business Capital Formation. “Annual Report for Fiscal Year 2020.” *Annual Report*. Available at <https://www.sec.gov/files/2020-oasb-annual-report.pdf> (Pages 28 and 69). These same entrepreneurs are hampered in accessing capital from angel investors, who tend to invest in near-by businesses. *Ibid.* (Page 32).

<sup>10</sup> SEC. “Amending the “Accredited Investor” Definition.” *Proposed Rule*. Available at <https://www.sec.gov/rules/proposed/2019/33-10734.pdf> (Page 106). The SEC also cites research finding that geographic areas experiencing a larger reduction in the number of potential accredited investors experienced negative effects on new firm entry and employment levels at small entrants.

<sup>11</sup> Minority-owned businesses shuttered at a higher rate in 2020 due to the pandemic, and recent survey results show, in particular, that black business owners will face a tougher road to recovery after Covid-19. Chauncey Alcorn. “Black-Owned Companies are Shutting Down Twice as Fast as Other Businesses.” *CNN*. Available at <https://www.cnn.com/2020/08/04/economy/black-business-coronavirus-study/index.html>; Goldman Sachs.

while the pandemic shuttered many businesses, new businesses have been opening at a rapid rate.<sup>12</sup>

The SEC justifies the accredited investor definition as investor protection, but being wealthy is no proxy for financial sophistication. Rather, shutting investors out of opportunities is a poor substitute for existing investor protections that are more attuned to individual circumstances, including anti-fraud provisions and standards applicable to investment adviser and broker-dealer conduct. Regulating misconduct by issuers and financial professionals on whom investors rely, rather than screening investors, provides better protection while preserving an investor's freedom to invest as he or she sees fit.

### **Description of Legislative Proposal**

I propose amending the “accredited investor” definition to include all investors advised by an investment professional who is qualified as accredited under the SEC’s definition. I have attached proposed legislative language to this letter.

Eliminating the accredited investor definition in its entirety would be the best result, and I am supportive of proposals to do so. However, such an elimination is likely not a straightforward question of simply excising language from the existing regulatory regime. The ideal outcome requires rethinking the broader exemption environment, which would slow the speed at which changes to the definition can be implemented and the benefits accordingly realized.<sup>13</sup>

Therefore, in the interest of expediency, I propose broadening the definition within its current framework to make more investors eligible in the near term. While I propose counting investors who are advised by accredited financial advisers to themselves be accredited, there are a number of alternatives for expanding eligibility that bear consideration, including:

- Scaling the wealth threshold of the accredited investor definition to local metrics, such as median income by state or county;
- Considering home equity as an asset for the purposes of calculating net worth;
- Permitting investors to self-certify to their level of sophistication;<sup>14</sup> or
- Creating or identifying an exam to serve as an accredited investor qualification.

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“Survey: Disappointed and Frustrated, Small Business Owners Feel Left Behind by Congress.” *Goldman Sachs*. Available at <https://www.goldmansachs.com/citizenship/10000-small-businesses/US/infographic-left-behind>

<sup>12</sup> Office of the Advocate for Small Business Capital Formation. “Annual Report for Fiscal Year 2020.” *Annual Report*. Available at <https://www.sec.gov/files/2020-oasb-annual-report.pdf> (Page 28); U.S. Census Bureau.

“Business Formation Statistics.” Available at <https://www.census.gov/econ/bfs/index.html>.

<sup>13</sup> There are several questions that one might want to consider when eliminating the accredited investor definition, including whether there should be any additional required disclosure about the investment or about the disclosure not required in exempt offerings, whether general solicitation rules should be revised, and whether investment eligibility requirements for entities should be altered. An SEC study on these questions would be prudent, but would not be quick.

<sup>14</sup> Jennifer Schulp. “Let Investors Decide, Part II.” *Alt-M*. Available at <https://www.alt-m.org/2020/06/10/let-investors-decide-part-ii/>

Adding advised individuals to the accredited investor definition remedies an inconsistency in the current regulation. The SEC's recent amendments to the accredited investor definition, by their very nature, find that certain investment adviser and broker-dealer representatives are sophisticated enough to make their own investments in private offerings. Yet, ordinary investors who may seek advice from those sophisticated individuals are excluded from the same investment opportunities.

Reliance on advice is already conceptually present in Regulation D, which permits a limited number of non-accredited investors to purchase a Rule 506(b) offering if, individually or together with a "purchaser representative," they have enough knowledge and experience to evaluate the merits and risks of the prospective investment.<sup>15</sup> This allowance has been used sparingly because there is uncertainty as to how to judge an investor's knowledge and experience and because issuers are required to provide additional information to any non-accredited investors who may participate in the offering.

But where an investor's adviser is judged to be sophisticated by the SEC's own rules, a broader reach is appropriate. The adviser is presumed to have the ability to evaluate the merits and risks of the prospective investment for his own account and to invest without any regulatorily required additional disclosure. Other investors should be permitted to access the adviser's skills to invest in private offerings. Moreover, many of these interactions will be subject to fiduciary duties or the best interest standard, depending on the representative's relationship with the client, providing an additional layer of investor protection.

This type of change to the accredited investor definition is simple to implement and gives investors control over their own circumstances. While it may impose additional costs to investing, obtaining an adviser is far easier path to accreditation than any alternative currently available to ordinary investors, including obtaining securities credentials or amassing wealth. Such a rule change may also encourage specialization by advisers in raising capital for underrepresented small businesses, including those serving the adviser's own community.

I am happy to provide further information or answer any questions about my legislative proposal or about other ideas for reforming the accredited investor definition.

Respectfully,



Jennifer J. Schulp

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Center for Monetary and Financial Alternatives  
The Cato Institute

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<sup>15</sup> 17 C.F.R. § 203.506(b).

**A BILL**

To require the Securities and Exchange Commission to revise the rules of the Commission relating to the definition of accredited investors.

1           *Be it enacted by the Senate and House of Representatives of*  
2           *the United States of America in Congress assembled,*

3           **SECTION 1. SHORT TITLE.**

4           This Act may be cited as the “Private Investment Through  
5           Accredited Professionals Act of 2021.”

6           **SEC. 2. EXTENDING ACCREDITED INVESTOR STATUS TO ADVISED**  
7           **INVESTORS.**

8           (a) DEFINITIONS.—In this section, and for the purposes of the  
9           revisions required under subsection (b)—

10                   (1) the term “accredited investor” means the term  
11                   defined under 17 C.F.R. 203.501(a).

12                   (2) the term “advised investor” refers to any natural  
13                   person receiving investment advice or investment  
14                   recommendations from a natural person designated be an  
15                   accredited investor under 17. C.F.R. 203.501(a)(10).

16           (b) INCLUSION OF ADVISED INVESTORS IN ACCREDITED INVESTOR  
17           DEFINITION.—

18                   (1) IN GENERAL.—Not later than 90 days after the date  
19                   of enactment of this Act, the Securities and Exchange  
20                   Commission shall revise section 230.501 of title 17, Code of  
21                   Federal Regulations, to require that, advised investors are  
22                   accredited investors for all purposes for which the  
23                   definition applies.

24                   (2) RULE OF CONSTRUCTION.—

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(a) The term “investment advice” should be interpreted consistently with the interpretation of “engaging in the business of advising others . . . as to the advisability of investing in, purchasing, or selling securities” as used in 15 U.S.C. §80b-2.

(b) The term “investment recommendation” should be interpreted consistently the term “recommendation” as used in 17 C.F.R. §240.15/-1.