ASPEN TECH POLICY HUB

POLICY

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Removing Barriers to Startup Capital: Democratize Accreditation

EXECUTIVE SUMMARY

The Securities and Exchange Commission (SEC) regulates how founders raise capital, including whom they raise from, how, and how much they can raise. Under the SEC's Regulation D, "accredited investors" must meet established thresholds for income ($200K per year individually or $300K for couples) and/or net worth ($1MM, excluding personal residence). Through this definition, both founders and funders face separate and unequal access to startup offering and investment opportunities, based on these criteria. Such a policy disproportionately disadvantages underrepresented stakeholders and should be replaced with regulations that promote equitable access to capital markets. This could be achieved by allowing investors to self-attest that they are aware of and able to tolerate an offering's capital risk and illiquidity.

BACKGROUND

Sources estimate that between 9.8 and 13 percent of Americans meet the qualifications to be "accredited investors," according to SEC standards, meaning the vast majority of Americans are excluded from some of the most lucrative investment strategies, such as investing in Reg D startup and VC fund offerings. Due to the long-term effects of discriminatory barriers to wealth creation, like redlining (housing and loan discrimination) and exclusion from private offerings, Black, Latinx, and female investors are underrepresented, comprising just (1.3, 2.8, and 22 percent of angel investors respectively). The Angel Capital Association notes that "the observed racial disparity [among angel investors] may explain similar disparities in which entrepreneurs receive funding."

Investor segregation through accreditation has a significant economic impact. Because investors tend to invest in those who are most like themselves, access to capital is limited for underrepresented founders, whose lack of access to high net-worth networks contributes to market inefficiencies. The Center for Global Policy Solutions found that discriminatory financing practices cost the U.S. nine million jobs and over $300B in annual collective net income.

The SEC's mission is to "protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation." Yet the current definition of "accredited investor" defies all three of these mandates. The SEC claims that the accredited investor definition serves to protect investors, but only requires accreditation for private-equity investments (e.g., in startups and venture capital funds), not for public equity (e.g., the stock market). Data from Cambridge Associates and Capital Dynamics show that "private equity investments offer greater protection against financial downturns than public equity indices." Restricting access to less volatile, high risk, high return investment options is unfair. Moreover, it impedes the development of efficient private markets. The definition constrains capital formation by using income and net worth as proxies for investment readiness, without regard for investors' individual risk tolerance.

SOLUTION

To do its part to dismantle economic apartheid, the SEC should amend the accredited investor definition to empower investors to self-certify as accredited, by demonstrating that they are adequately informed, sophisticated (having sufficient knowledge and experience in financial and business matters to be capable of evaluating the merits and risks of the prospective investment), and/or have access to sufficient counsel, such as lawyers, certified public accountants (CPAs), and advisors.

The self-certification process could be carried out through a digital attestation system hosted on the website of the SEC's Office of Investors Education and Advocacy, which could also host links to educational materials enabling prospective investors to enhance their sophistication. The digital attestation should disclose that private-equity investments are often long-term, illiquid (can't be easily sold), and can result in total loss. It should also require investors to acknowledge their awareness of and tolerance for an offering's risk and illiquidity. This change would harmonize offering regulations with a "framework that is more consistent and addresses gaps and complexities" while more efficiently facilitating capital formation and wealth creation for those disadvantaged by the current definition.

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ABOUT THE HUB

The Aspen Tech Policy Hub is a Bay Area policy incubator, training a new generation of tech policy entrepreneurs. We take tech experts, teach them the policy process, and support them in creating outside-the-box solutions to society's problems.

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