NOTES

RACIAL EXCLUSION IN PRIVATE MARKETS: HOW THE NEW ACCREDITED INVESTOR STANDARD IS ARBITRARY AND CAPRICIOUS

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Private markets have exploded. This growth has created lucrative opportunities for businesses raising capital and those who qualify to invest. For decades, Securities and Exchange Commission (SEC) rules have restricted most private investments to "accredited investors," a designation that, for members of the general public, was based exclusively on affluence. While critics of this regime have emphasized its role in exacerbating inequality, scholarship has neglected the economic divide between white and Black Americans specifically. This Note fills that void.

In August 2020, the SEC issued the first update to the accredited investor standard since its genesis in the 1980s. Using available data, this Note argues that the accredited investor regime—historically and as amended—systematically excludes Black investors and Black-owned businesses from private markets, which both perpetuates racial inequality and depresses the value of those markets. This Note proposes a framework for an Administrative Procedure Act lawsuit charging that the Securities Act required the SEC to consider these distributional effects when modernizing the accredited investor standard. Finding that the SEC failed to satisfy this statutory requirement and omitted other relevant data, this Note concludes that the accredited investor update was arbitrary and capricious in violation of the Administrative Procedure Act. It then offers guidance on how the agency can remedy its error and avoid repeating it in the future.

Introduction 1967
I. Private Placement and the AI Standard 1972
A. *Legal Framework: The Appeal of AI-Only Transactions* 1972
B. *Market Expansion: Effects on Retail Investors* 1975
C. *Who Qualifies as an AI?* 1979
II. The AI Standard and Racial Exclusion in Capital Markets 1981
A. *Conventional Criticism* 1981

* Copyright © 2021 by Grier E. Barnes. J.D., 2021, New York University School of Law. I am indebted to the late Honorable Robert A. Katzmann for his guidance and encouragement throughout this project. Thank you to my family and friends for their love and patience during my studies, and thank you to my editorial team and members of the *New York University Law Review* for improving this Note immeasurably. Last, my endless gratitude to Parker Tarun—the best partner and writer the world could offer.

1. *The AI Regime Does Not Measure Its Own Participants* 1982
2. *The AI Regime Does Not Protect Investors* 1983
3. *The AI Regime Perpetuates Inequality* 1984
B. *Analyzing the AI Standard and Racial Inequality* ... 1986
1. *White Investors Are More Likely to Qualify as AIs* 1986
2. *The Dearth of Black AIs Disadvantages Black-Owned Businesses* 1989
3. *The AI Regime's Racial Exclusion Constrains Capital Markets* 1990
III. CHALLENGING THE AI FINAL RULE AND PLANNING FOR THE FUTURE 1992
A. *The AI Final Rule is Arbitrary and Capricious*...... 1992
1. *The Administrative Procedure Act* 1992
2. *The Applicable Legal Standard for the Final Rule* 1993
3. *Reviewing the AI Rulemaking Explanation*...... 1997
4. *The Final Rule Was Arbitrary and Capricious Under the APA* 2000
a. The SEC Failed to Consider Relevant Data 2001
b. The SEC Did Not Consider Factors Mandated by Statute 2002
B. *Anticipating Counterarguments and Proposing Next Steps* 2003
1. *The SEC Is Not Charged with Enforcing Socioeconomic Equality* 2003
2. *An APA Suit Would Not Be Impotent* 2004
3. *Designing a Better, Data-Driven AI Standard* ... 2005
CONCLUSION 2007

INTRODUCTION

The ability to accumulate wealth is not a racially equal enterprise in America, a truth maintained by exclusionary government policies. This inequity harms everyone, both minorities acutely and the country's economic well-being overall. One powerful example is "red-lining," a historical housing practice that has urgent relevance for financial policymaking today. The Home Owners' Loan Corporation (HOLC) was the government entity that refinanced home mortgages

after the Great Depression.[1] HOLC created color-coded maps that tracked where to extend—or deny—services to would-be homeowners.[2] HOLC would color Black neighborhoods red—meaning "deny"—under the pretext of designating high default risk.[3] HOLC and subsequent government agencies would then systematically refuse to finance mortgages in these "redlined" neighborhoods, making housing purchases prohibitively expensive for Black families.[4] The traditional defense of the practice was that integrated neighborhoods would suffer depressed real estate valuation, but little evidence supported this notion.[5] In fact, integrated communities often saw property values *increase*, underscoring the racist and economically irrational motivations behind the practice.[6]

Although redlining has been illegal since the 1970s,[7] its legacy persists in both housing and finance. Beyond ensuring racial segregation,[8] redlining cultivated economic inequality. American families trace the majority of their wealth to home equity.[9] By restricting Black access to affordable loans, government policy stunted Black wealth accumulation and contributed to the racial wealth gap that exists today.[10] Even when someone was able to purchase a home in a

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[1] Home Owners' Loan Act of 1933, 12 U.S.C. §§ 1461–68; Richard Rothstein, The Color of Law: A Forgotten History of How Our Government Segregated America 63–64 (2017).

[2] Rothstein, *supra* note 1, at 64; *see also Mapping Inequality*, U. Rich., https://dsl.richmond.edu/panorama/redlining (last visited Aug. 31, 2021) (digitizing HOLC maps).

[3] Rothstein, *supra* note 1, at 64.

[4] *Id.* at 63–67.

[5] *Id.* at 93–94.

[6] *Id.* at 94; *see also id.* at 64 ("[HOLC maps] put the federal government on record as judging that African Americans, simply because of their race, were poor risks.").

[7] The Community Reinvestment Act of 1977 § 801, 12 U.S.C. § 2901(a)(3); The Fair Housing Act, 42 U.S.C. § 3604. For an overview of the history of this legislative effort, see Willy E. Rice, *Race, Gender, Redlining, and the Discriminatory Access to Loans, Credit, and Insurance: An Historical and Empirical Analysis of Consumers Who Sued Lenders and Insurers in Federal and State Courts, 1950-1995*, 33 San Diego L. Rev. 583, 600–10 (1996).

[8] Bruce Mitchell & Juan Franco, Nat'l Cmty. Reinvestment Coal., HOLC "Redlining" Maps: The Persistent Structure of Segregation and Economic Inequality 4 (2018), https://ncrc.org/wp-content/uploads/dlm_uploads/2018/02/NCRC-Research-HOLC-10.pdf ("Redlining buttressed the segregated structure of American cities.").

[9] Aaron Glantz & Emmanuel Martinez, *For People of Color, Banks Are Shutting the Door to Homeownership*, Ctr. for Investigative Reporting: Reveal (Feb. 15, 2018), https://www.revealnews.org/article/for-people-of-color-banks-are-shutting-the-door-to-homeownership.

[10] Danyelle Solomon, Connor Maxwell & Abril Castro, Ctr. for Am. Prog., Systematic Inequality: Displacement, Exclusion, and Segregation (Aug. 7, 2019), https://www.americanprogress.org/issues/race/reports/2019/08/07/472617/systemic-inequality-displacement-exclusion-segregation; *see also Mapping Inequality*, *supra* note 2 ("As homeownership was . . . the most significant means of intergenerational wealth

redlined neighborhood, studies estimate that they gained fifty-two percent less in property appreciation in the past forty years than they would have without redlining.[11] These effects transcend housing value. One 2018 study reported that seventy-four percent of surveyed redlined neighborhoods still experienced depressed *incomes*,[12] effectively "locking neighborhoods into concentrated poverty."[13]

As redlining demonstrates, exclusionary policies that prohibit wealth accumulation on racial lines cause long-term harm—both to the immediate victims of racism and to the whole economy. Disrupting this cycle requires study of how structural decisions today may perpetuate inequality tomorrow.[14] The lasting harm of historic redlining may be familiar to many Americans.[15] Most are less acquainted with the growing phenomenon of racial exclusion in private capital markets. Despite how consequential its policymaking is, financial regulation neglects a sophisticated analysis of systemic racism.[16] For investors, capital markets are critical for building and

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building in the United States in the twentieth century, these redlining practices from eight decades ago had long-term effects in creating wealth inequalities that we still see today.").

[11] Dana Anderson, *Redlining's Legacy of Inequality: $212,000 Less Home Equity, Low Homeownership Rates for Black Families*, REDFIN (June 11, 2020), https://www.redfin.com/news/redlining-real-estate-racial-wealth-gap.

[12] MITCHELL & FRANCO, *supra* note 8, at 4–5, 20.

[13] Tracy Jan, *Redlining Was Banned 50 Years Ago. It's Still Hurting Minorities Today.*, WASH. POST (Mar. 28, 2018), https://www.washingtonpost.com/news/wonk/wp/2018/03/28/redlining-was-banned-50-years-ago-its-still-hurting-minorities-today (quoting Jason Richardson, the director of research of the National Community Reinvestment Coalition study); *see also* MITCHELL & FRANCO, *supra* note 8 (the National Community Reinvestment Coalition's study on redlining).

[14] *See* ANGELA HANKS, DANYELLE SOLOMON & CHRISTIAN E. WELLER, CTR. FOR AM. PROG., SYSTEMATIC INEQUALITY: HOW AMERICA'S STRUCTURAL RACISM HELPED CREATE THE BLACK-WHITE WEALTH GAP (2018), https://www.americanprogress.org/issues/race/reports/2018/02/21/447051/systematic-inequality ("[T]he disparities between white and black Americans can nearly always be traced back to policies that either implicitly or explicitly discriminate against black Americans.").

[15] *But see* Amy Shema, *Moving from Activities to Activist* (explaining that most American schools do not teach the history of redlining), *in* IDEATING PEDAGOGY IN TROUBLED TIMES: APPROACHES TO IDENTITY, THEORY, TEACHING AND RESEARCH 84 (Shalin Lena Raye et al. eds., 2019).

[16] *See, e.g.*, Lisa T. Alexander, *Cyberfinancing for Economic Justice*, 4 WM. & MARY BUS. L. REV. 309, 316–17 (2013); Andrea Freeman, *Racism in the Credit Card Industry*, 95 N.C. L. REV. 1071, 1078 (2017) (lamenting the lack of scholarship investigating racism in consumer credit); Elizabeth M. Iglesias, *Global Markets, Racial Spaces and the Role of Critical Race Theory in the Struggle for Community Control of Investments: An Institutional Class Analysis*, 45 VILL. L. REV. 1037, 1056 (2000) ("The idea that the free market operates in the shadow of racial discrimination, both through the exercise of individualized discretion and institutionalized decision-criteria, is a notion that neo-liberal [economic] ideology refuses to internalize . . . ."); Jasmin Sethi, *Another Role for Securities Regulation: Expanding Investor Opportunity*, 16 FORDHAM J. CORP. & FIN. L. 783, 793–96 (2011)

maintaining wealth[17]—much like home ownership. For businesses, selling securities in capital markets connects them to those investors for the funds necessary to innovate, create jobs, and generate more wealth.[18] By shaping market access for both, securities regulation has the potential to affect how wealth is created and distributed in America for generations. If policymaking remains blind to racial economic disparities, however well-intentioned, it risks perpetuating the legacy of redlining[19] and undermining the full potential of capital markets.[20] The way in which these policies could exacerbate racial inequality is not as easy to see as a color-coded map, and the lack of scholarship on this threat underscores the need for interdisciplinary analysis of securities regulation and racial justice. This Note examines a recent change offering a ripe opportunity for this dialogue.

On August 26, 2020, the Securities Exchange Commission ("SEC" or "Commission") issued a rule to modernize the definition of "accredited investor" (AI), which is the qualifying standard for investors to participate in most private placements.[21] Private placements are opportunities to invest in private capital markets, as opposed to public capital markets composed of securities registered with the SEC. The AI test matters because over time, public markets—generally available to any investor—have contracted as private capital markets have ballooned, making AI status the primary point of entry to an increasingly lucrative pool of wealth.[22] In fact, by 2019, approximately seventy percent of funds raised in U.S. capital markets occurred in private markets, leaving a mere thirty percent to public markets; the

(advocating for securities regulation to emulate developments in other areas, like education and housing, that expand opportunities for historically oppressed racial groups).

[17] *See infra* note 77 and accompanying text.

[18] ALICIA ROBB, OFF. ADVOC., FINANCING PATTERNS AND CREDIT MARKET EXPERIENCES: A COMPARISON BY RACE AND ETHNICITY FOR U.S. EMPLOYER FIRMS 7 (2018), https://www.sba.gov/sites/default/files/FinancingPatternsandCreditMarketExperiencesreport.pdf.

[19] Mariah Lichtenstern, *Investors Still Engage in Racist Redlining. Why Haven't We Done Something About It?*, FORTUNE (Jan. 6, 2021), https://www.fortune.com/2021/01/06/redlining-black-latinx-entrepreneurship-investment-sec; *see also* Mehrsa Baradaran, *Closing the Racial Wealth Gap*, 95 N.Y.U. L. REV. ONLINE 57, 58–59 (2020) ("[P]ublic policy created the wealth gap and must be used to address it.").

[20] *See* NICK NOEL, DUWAIN PINDER, SHELLEY STEWART III & JASON WRIGHT, THE ECONOMIC IMPACT OF CLOSING THE RACIAL WEALTH GAP, MCKINSEY & CO. 19 (2019), https://www.mckinsey.com/industries/public-sector/our-insights/the-economic-impact-of-closing-the-racial-wealth-gap ("Black families face systemic, intersecting barriers that limit their wealth building. Left unchecked, these gaps could continue to grow and constrain the US economy, not just black families."); *see also infra* Section II.B.

[21] Accredited Investor Definition, Release Nos. 33-10824, 34-89669, File No. S7-25-19, 85 Fed. Reg. 64,234 (Oct. 9, 2020) [hereinafter Final Rule].

[22] *See infra* Section I.B.

exemptions are no longer the exception but rather the rule.[23] Historically, the AI standard for individuals has been based exclusively on affluence: To qualify, an investor needed to exceed a certain income or net worth level.[24] Observers have long criticized this approach and its role in limiting wealth-building in private markets to the ultrawealthy.[25] However, securities academy has not focused on the relationship between the AI definition and the economic schism between white and Black Americans specifically. This Note fills this void.

The SEC's new AI standard for individuals added two new qualifications based on professional experience and left the decades-old financial thresholds untouched. Using current data on racial economic inequality, this Note posits that the AI regime—both historically and as amended—systematically excludes Black investors and Black-owned businesses from private markets in a way that depresses the potential value of those markets as a whole. This Note argues that this problem cannot be divorced from the SEC's statutory mandate under the Securities Act of 1933[26] to evaluate the impact of its discretionary AI definition update on competition, efficiency, and capital formation. Since the SEC's rulemaking failed to adequately investigate this dynamic, the SEC violated the Administrative Procedure Act (APA), which requires agencies to make reasoned decisions based on relevant data and factors defined in their organic statutes.[27] Emphasizing how the SEC's self-imposed data deficiency has inhibited the agency's analysis of these trends, this Note offers guidance on how the SEC should address this failure moving forward. While other intersectional inequalities likely also interact with the SEC's financial thresholds, warranting further research, this Note limits its scope to Black-white economic inequality because of its extremity in scale[28] and public availability of relevant data.

Part I summarizes the legal framework behind private placement, explaining how the AI standard functions as a gatekeeper to private markets and what the SEC's last update to the qualifying criteria changed. Part II details conventional criticisms levied against the AI standard and proffers an oft-neglected part of this discourse: how AI

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[23] *See infra* note 71 and accompanying text.

[24] *See infra* Section II.A.

[25] *See infra* Section II.A.3.

[26] Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 (codified as amended at 15 U.S.C. § 77a–77aa (2018)).

[27] 5 U.S.C. § 706(2)(A) (allowing a court to set aside agency action as "arbitrary [or] capricious"); *see infra* Section III.A.1.

[28] Hanks et al., *supra* note 14 n.2 (listing sources substantiating the distinct wealth gap "particularly between white and black households").

status interacts with racial inequality. Part III describes how the SEC did not adequately investigate this distributional effect as part of its 2020 rulemaking to update the AI definition and analyzes the legal consequences of this failure under APA jurisprudence. Specifically, Part III offers an analytical framework arguing that the Securities Act already encompasses this facet of racial inequality and finds that the AI rulemaking was an arbitrary and capricious action in violation of the APA. Part III also tackles two counterarguments by emphasizing that this interpretation relies on the SEC's *existing* statutory requirements, not some radical new obligation, and defending the use of an APA lawsuit as an effective strategy in injecting more rigor in SEC decisionmaking. This Part concludes with a proposal for actions that the SEC could have taken and should consider now for more informed policymaking in the future.

I
Private Placement and the AI Standard

Traditionally, buying securities in the public market was an integral part of wealth generation in America. In the past two decades, private markets have flourished, offering new opportunities to accumulate wealth—assuming an investor qualifies. Section I.A explains the legal framework and how private placement encourages companies to make offerings only available to AIs. Section I.B describes how this scheme contributed to the simultaneous expansion of private markets and contraction of public markets and how that shift harms non-accredited investors ("NAIs" or "retail investors"). Section I.C then turns to the AI definition, detailing how individuals historically qualified and how the SEC recently amended the standard.

A. Legal Framework: The Appeal of AI-Only Transactions

The SEC is the federal agency tasked with regulating the securities market. Its mission is to "[p]rotect investors; [m]aintain fair, orderly, and efficient markets; [and f]acilitate capital formation."[29] One way that the SEC pursues these goals is through the registration of public securities offerings, which include both offers and sales of securities available to any investor.[30] The Securities Act of 1933 (the "Securities Act") requires that the company (or the "issuer") register

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[29] *The Role of the SEC*, U.S. Secs. & Exch. Comm'n, https://www.investor.gov/introduction-investing/investing-basics/role-sec (last visited Aug. 8, 2020); *see also* 15 U.S.C. § 78d (establishing the composition of the Security and Exchange Commission and the duties of its members).

[30] This is nominally the case, but there may be non-regulatory barriers to accessing public markets. *See infra* note 145 and accompanying text.

any public offer or sale with the SEC.[31] Registration involves the submission of detailed filings to the agency, including disclosures about the company's financial condition, most of which the SEC makes available to the investing public.[32] This disclosure regime rests on two assumptions: (1) Investors with sufficient access to information about an investment target can make informed decisions, and (2) disclosure will deter fraud and other predatory behavior.[33]

This regulatory infrastructure aims to protect investors but can be burdensome for issuing companies. Preparing disclosures is costly and time-consuming.[34] Failure to comply with registration obligations may result in penalties under the Securities Act.[35] Once an issuer sells initial public securities, it must continue with recurring disclosures and other expensive responsibilities thereafter.[36] These considerations may discourage companies—especially small businesses—from issuing securities publicly or in U.S. markets at all.

The SEC's one objective of protecting investors must not come at the expense of its other, enabling capital formation. So the SEC provides a number of exceptions to the public offering registration process—known as private placement or exempt transactions.[37] Exempt

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[31] Securities Act, 15 U.S.C. § 77a to aa (2018).

[32] *See* EVA SU, CONG. RSCH. SERV., IF11256, SECURITIES DISCLOSURE: BACKGROUND AND POLICY ISSUES (2019) (describing the litany of documents filed in a public offering process).

[33] FRANCIS M. WHEAT, U.S. SECS. & EXCH. COMM'N, DISCLOSURE TO INVESTORS – A REAPPRAISAL OF FEDERAL ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 ACTS 10 (1969) [hereinafter WHEAT REPORT]; *see also* Nat. Res. Def. Council, Inc. v. SEC, 389 F. Supp. 689, 698 (D.D.C. 1974) ("[T]he principal purpose[] of the federal securities laws is full disclosure of material information; . . . 'sunlight is said to be the best of disinfectants.'" (citation omitted)).

[34] *See generally* SU, *supra* note 32.

[35] Sections 11 and 12(a)(2) of the Securities Act provide negative reinforcement of the registration requirements for public offerings. 15 U.S.C. § 77k (creating a private cause of action for investors to sue a range of persons responsible for certain false or omitted statements in an issuer's registration statement); *id.* § 771(a)(2) (creating a similar private cause of action for false or omitted statements in connection with other disclosure materials). By imposing liability in connection with the use of a registration statement, section 11 does not apply to exempt transactions. *Id.* § 77k. Similarly, the liability imposed by section 12(a)(2) does not apply to exempt transactions because liability "cannot attach unless there is an obligation to distribute a prospectus in the first place." Gustafson v. Alloyd Co., 513 U.S. 561, 571 (1995).

[36] *See generally* SU, *supra* note 32; *see also* DEREK THOMSON, PWC, CONSIDERING AN IPO TO FUEL YOUR COMPANY'S FUTURE? INSIGHT INTO THE COSTS OF GOING PUBLIC AND BEING PUBLIC 14, 19 (2017), https://www.pwc.com/us/en/deals/publications/assets/cost-of-an-ipo.pdf (reporting that two-thirds of companies surveyed estimated their annual costs of public issuing as between $1 million and $1.9 million and listing the array of external advisors commonly required to navigate these challenges).

[37] Registration exemptions at the financial product level, such as commercial paper, *see, e.g.*, 15 U.S.C. § 77c(a)(3) (defining a class of securities, known as commercial paper,

transactions encompass conditions that reduce the risks that the public registration regime seeks to mitigate.[38] Thus private placement compliance procedures are less onerous than those of public offerings.[39] The design theory is that the public offering process combined with a menu of different exemptions creates a safe but flexible market for the businesses that demand capital and the investors that supply it. The statutes authorizing private placement are the Securities Act and the Small Business Investment Incentive Act of 1980, which generally permit the SEC to define exemptions via rulemaking.[40] Pursuant to this authority, the SEC enacted Regulation D in 1982,[41] which covers two of the most flexible transaction exemptions today[42]: Rule 506(b)[43] and, as of 2016, Rule 506(c).[44]

Nominally, Regulation D simplifies fundraising, especially for small businesses;[45] in practice, the design of Rules 506(b) and 506(c) makes them useful tools for businesses of all sizes to raise funds in private markets. These two exemptions permit the offer and sale of an *unlimited value* of securities to an *unlimited number* of AIs.[46] This is because Rule 506(c) offerings are restricted to AIs,[47] and Rule 506(b) may as well be. While Rule 506(b) permits a maximum of thirty-five qualifying NAIs to invest,[48] three factors discourage use of this option.

First, NAIs require a level of disclosure rivaling that of a registered offering, a burden eliminated by restricting the offering to AIs.[49]

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as exempt from other subchapter provisions), do not implicate AI status and are outside the scope of this Note.

38 Concept Release on Harmonization of Securities Offering Exemptions, Securities Act Release No. 33-10,649, 84 Fed. Reg. 30,460, 30,462 (June 26, 2019) [hereinafter AI Concept Release].

39 *Id.* at 30,470.

40 15 U.S.C. § 77c; Small Business Investment Incentive Act of 1980, Pub. L. No. 96-447, 94 Stat. 2275 (amending the Investment Company Act of 1940, Pub. L. No. 76-768, 54 Stat. 789 (codified as amended at 15 U.S.C. § 80a)); *see also* U.S. Secs. & Exch. Comm'n, Report on the Review of the Definition of "Accredited Investor" 10–14 (2015) [hereinafter Definition Report] (describing the statutory architecture behind private exemptions).

41 Proposed Revision of Regulation C, Registration and Regulation 12B, Registration and Reporting, 46 Fed. Reg. 41,971 (proposed Aug. 18, 1981) (to be codified at 17 C.F.R. pts. 201, 230, 240).

42 Definition Report, *supra* note 40, at 1, 3.

43 17 C.F.R. § 230.506(b) (2020).

44 *Id.* § 230.506(c). The Jumpstart Our Business Startups Act (JOBS) allowed the SEC to promulgate Rule 506(c) in 2016 through adding Securities Act section 4(b) as an addition to Rule 506(b) (formerly Rule 506). Pub. L. No. 112-106, § 201(a), 126 Stat. 306, 313–14 (2012).

45 Definition Report, *supra* note 40, at 16.

46 17 C.F.R. § 230.506(b)–(c) (2020); Definition Report, *supra* note 40, at 9.

47 *Id.* § 230.506(c).

48 *Id.* § 230.506(b).

49 *Id.*; Definition Report, *supra* note 40, at 17 n.61.

Second, if an investor does not qualify as an AI, they likely will not have sufficient cash to make the requisite disclosure costs worthwhile to the issuer.[50] Finally, a Rule 506(b) issuer cannot engage in general solicitation, meaning it cannot market its securities broadly to a public audience.[51] While it is difficult to locate NAIs without general solicitation, Rule 506(b) issuers typically do not need general solicitation to find AIs, rendering the ban a mere technicality to an AI-only offering.[52] Issuing data reflects these deterrents: The SEC estimates that only six percent of Rule 506(b) transactions involve NAIs.[53] While Rule 506(c) is not subject to the general solicitation restriction,[54] the majority of private placement still operates under Rule 506(b) (likely because it predated the 2016 addition of Rule 506(c), so issuers and the securities bar are familiar with its practice[55]).

As a result, issuers looking to raise the most private capital at the lowest disclosure cost can either turn to a Rule 506(c) offering or an exclusive AI Rule 506(b) offering: transactions only available to AIs. So if more issuers turn to private placement to fundraise instead of issuing public securities, NAIs will have fewer opportunities to accumulate wealth in capital markets. This next Section will outline how this exact trend unfolded.

B. *Market Expansion: Effects on Retail Investors*

Today, companies of all sizes issue securities with Rule 506, forming the largest segment of the private placement market in terms of capital raised.[56] This is in part due to companies attempting to avoid the regulatory burdens of the public offering process,[57] but there are other benefits to private placement that have induced its use specifically. Exempt transactions allow an issuing company to retain

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[50] *See infra* notes 83–92 and accompanying text.

[51] 17 C.F.R. § 230.506(b).

[52] Issuers may have a pre-existing relationship with AIs, or AIs are simply proactive at seeking out investments.

[53] AI Concept Release, *supra* note 38, at 30,484.

[54] 17 C.F.R. § 230.506(c).

[55] Scott Bauguess, Rachita Gullapalli & Vladimir Ivanov, U.S. Secs. & Exch. Comm'n, Capital Raising in the U.S.: An Analysis of the Market for Unregistered Securities Offerings, 2009-2017, at 15 (2018), https://www.sec.gov/files/DERA%20white%20paper_Regulation%20D_082018.pdf ("The relative novelty of the 506(c) provisions after decades of non-permissibility of general solicitation in Regulation D offerings may be one reason why Rule 506(b) continues to dominate the Regulation D market.").

[56] *Id.* at 4–5, 13–14 (finding that capital raised through Regulation D offerings, of which ninety-nine percent was through Rule 506, exceeds the amount raised by public equity and debt offerings).

[57] *See supra* notes 34–36 and accompanying text.

greater secrecy[58] and control over company decisions.[59] Issuers have also turned to private markets because the SEC has made its regulatory framework more flexible over time. The addition of Rule 506(c) that allows for general solicitation of AIs is one example.[60] The SEC has also relaxed another limitation: holding periods.

Securities sold in private placement are "restricted securities," subject to holding periods following their issuance during which they cannot be resold.[61] This design intends to prevent issuers from sidestepping public offering requirements by reselling newly issued private securities in the public market.[62] But a restricted security is less valuable than a more fungible security because an investor may not be able to capitalize on profitable market timing. That investor will therefore demand a cheaper price for a restricted security—an illiquidity discount—which in turn means that the private issuing company will not be able to access as much capital from the offering.[63] Over time, the SEC has amended the resale requirements to allow for cheaper access to private capital, condensing what was once a two-year holding period to only six months in certain situations.[64] Skeptics have questioned whether the SEC can explain how this dwindling holding period continues to protect investors from companies seeking to evade registration rules.[65] Issuing companies and AIs will certainly

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58 SEC filings of public offers are available online, *see EDGAR Opens It All to Scrutiny*, Tampa Bay Times (Sept. 13, 2005), https://www.tampabay.com/archive/1998/06/28/edgar-opens-it-all-to-scrutiny (describing how the online availability of SEC filings offers insights into corporate matters), meaning that private issuers can avoid a certain level of scrutiny that public issuers cannot. *See* David Brown, Jeff Grabow, Chris Holmes & Jackie Kelly, Ernst & Young, Looking Behind the Declining Number of Public Companies 15 (2017), https://www.sec.gov/spotlight/investor-advisory-committee-2012/ey-an-analysis-of-trends-in-the-us-capital-markets.pdf (citing "accountability to public shareholders" as one drawback to taking a company public not shared by private companies).

59 Public company stock is often owned by a mix of investors that change frequently as the stock gets sold and re-purchased over time. High-turnover investors with divergent goals may influence the company to its detriment; for example, short-term shareholders may pressure companies to exhibit immediate profits in lieu of innovating for long-term payoffs. *See* Justin Fox & Jay W. Lorsch, *What Good are Shareholders?*, Harv. Bus. Rev., July–Aug. 2012, at 49, 52, 55, https://hbr.org/2012/07/what-good-are-shareholders ("[C]ompanies with a large percentage of high-turnover shareholders sold themselves in mergers at a discount, overpaid for acquisitions, and generally underperformed the market.").

60 *See supra* note 54 and accompanying text.

61 17 C.F.R. § 230.144(a)(3) (2020).

62 William K. Sjostrom, Jr., *Rebalancing Private Placement Regulation*, 36 Seattle U. L. Rev. 1143, 1149 (2013).

63 *Id.* at 1150.

64 AI Concept Release, *supra* note 38, at 30,464; *see also* Sjostrom, Jr., *supra* note 62, at 1149–51.

65 *E.g.*, Sjostrom, Jr., *supra* note 62, at 1149–51.

not complain; this change helped increase liquidity and decrease private capital costs.[66]

Combined, these dynamics mean that capital-seeking companies can turn to private placement to minimize cost and maximize business control without sacrificing too much value for investors. By 2009, the private placement market had eclipsed the public market.[67] By 2019, there was a higher frequency of Rule 506 offerings than any other kind of transaction under SEC oversight.[68] Alone, those 506 transactions exceeded the value of the *entire* public capital market.[69] Including all exemptions, approximately seventy percent of funds in American capital markets in 2019 were raised in private offerings, leaving a mere thirty percent to public markets.[70] The exemptions are no longer the exception, but rather the rule.

Many have criticized the role of the SEC's regulatory framework in the simultaneous contraction of the public capital markets[71] and explosive growth of private placement.[72] Of particular relevance to this Note, these trends may harm NAIs directly: While studies report

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[66] *Id*. Granted, regulation is not solely responsible for this trend. Communications technology has also facilitated information access and increased exempt market liquidity. AI Concept Release, *supra* note 38, at 30,464.

[67] AI Concept Release, *supra* note 38, at 30,465. While past academia did not describe private placement and public offerings as direct substitutes, *see* Robert T. Slee, *Public and Private Capital Markets Are Not Substitutes*, BUS. APPRAISAL PRAC. (Spring 2005), http://www.robertsonfoley.com/pdf/public_and_private_capital_markets_are_not_substitutes.pdf, discourse today does characterize them as such, if imperfect. *E.g.* BAUGUESS ET AL., *supra* note 55, at 3 (describing that an issuer selling securities for capital may either register a public offering with the SEC or "[a]lternatively" pursue transaction exemptions).

[68] AI Concept Release, *supra* note 38, at 30,470.

[69] U.S. SECS. & EXCH. COMM'N, OFF. ADVOC. FOR SMALL BUS. CAP. FORMATION, ANNUAL REPORT FOR FISCAL YEAR 2019, at 11 (2019) [hereinafter ADVOCATE 2019 REPORT], https://www.sec.gov/files/2019_OASB_Annual%20Report.pdf (listing $1.4 trillion in Rule 506(b) private placements and $210 billion in Rule 506(c) placements, compared to $50 billion in initial public offerings and $1.2 trillion in other registered offerings).

[70] Facilitating Capital Formation and Expanding Investment Opportunities by Improving Access to Capital in Private Markets, 85 Fed. Reg. 17,956, 17,957 (proposed Mar. 31, 2020).

[71] *See, e.g.*, Frederick A. Elmore IV, Note, *When, As, and If: How an Obscure Security Could Make Initial Public Offerings More Efficient*, 14 VA. L. & BUS. REV. 1, 3–4 (2020) (describing how public markets benefit from a diversity of companies across sectors and at various stages of development, such that decreasing public market variety may reduce aggregate value generation of capital markets overall); ADVOCATE 2019 REPORT, *supra* note 69, at 49 (noting that as job growth correlates with companies going public, a decrease in the number of companies going public may depress job creation).

[72] *E.g.*, Anat Alon-Beck, *Unicorn Stock Options—Golden Goose or Trojan Horse?*, 2019 COLUM. BUS. L. REV. 107, 144; Kevin G. Bender, Note, *Giving the Average Investor the Keys to the Kingdom: How the Federal Securities Laws Facilitate Wealth Inequality*, 15 J. BUS. & SEC. L. 1, 7–8 (2016); Sjostrom, Jr., *supra* note 62, at 1149; *see also* Matt Levine, Opinion, *The Unicorn Stampede Is Coming*, BLOOMBERG: MONEY STUFF (Mar. 22, 2019),

mixed findings regarding returns on public versus private securities,[73] several indicators suggest that the rise of exclusive private markets will mean less money in retail investor pockets.

To understand how that may be, consider a brief overview of how those indicators interact. First, fewer public companies reduces transparency and access to corporate information in the market, making it more challenging for NAIs to make informed investments.[74] Second, though many start-ups fail, some using private placement today may grow to be very successful tomorrow; denying access to NAIs may block a low-priced stock purchase of an emerging unicorn.[75] Third, retail investors may simply have fewer opportunities to build and protect wealth in public markets.[76] Combined, these three effects create a significant disparity between NAIs and AIs, because "[e]quity capital . . . and access to investable assets are key to a stable base of family wealth."[77] To diversify their holdings, an investor needs a mix of investment opportunities to mitigate the risk of individual investments underperforming;[78] a shrinking public market depletes that mix. Finally, the rise of private placement risks decreasing the very value of remaining public investments. When companies raise seed funds privately or otherwise delay an initial public offering until they are more mature, their lower growth potential does not offer as much runway for public market investors to multiply their initial investment,[79] assuming that company ever does issue public securities.

So retail investors shut out from exempt markets suffer when those markets expand and public markets contract, and the SEC has had a hand in shaping this landscape. This phenomenon matters

https://www.bloomberg.com/opinion/newsletters/2019-03-22/money-stuff-the-unicorn-stampede-is-coming.

[73] *Compare* J.P. Morgan, Private Investments: An Alternative Source of Opportunity and Return Potential 1 (2020), https://privatebank.jpmorgan.com/content/dam/jpm-wm-aem/documents/private-investments-2020.pdf (describing private markets as having "structural advantages" that may "deliver a return premium" compared to public securities), *with* Bender, *supra* note 72, at 15 (conceding the advantages of private placement but describing that long-term private returns "ultimately remain lower" (citations omitted)).

[74] *See* Jeff Sommer, *The Stock Market Is Shrinking. That's a Problem for Everyone.*, N.Y. Times (Aug. 4, 2018), https://www.nytimes.com/2018/08/04/business/shrinking-stock-market.html (discussing how retail investors who lack inside information on private companies face a shrinking public market that is less transparent and diverse).

[75] *See* Bender, *supra* note 72, at 15–16.

[76] AI Concept Release, *supra* note 38, at 30,467.

[77] Noel et al., *supra* note 20, at 11.

[78] Bender, *supra* note 72, at 34; *see also* AI Concept Release, *supra* note 38, at 30,467 (noting that even when NAIs access the exempt market, they cannot take advantage of the full diversity of opportunities within it).

[79] Elmore, *supra* note 71, at 3; *see also* Alon-Beck, *supra* note 72, at 111–13.

because it illustrates how interconnected the SEC's regulated landscape is, how none of its policymaking occurs in a vacuum, and how the agency's actions impact the lives of real Americans. The agency has admitted this public-private tradeoff, conceding that "[t]o the extent companies are eschewing our public markets, the vast majority of Main Street investors will be unable to participate in their growth."[80] More precisely, the only investors who will profit from this "growth" are AIs.

C. Who Qualifies as an AI?

SEC Rule 501 defines an AI. Several types of institutional investors qualify.[81] Certain persons are AIs by nature of their employment in the issuing company of the securities in question, such as executive officers.[82] Most relevant here, until August 2020, Rule 501 provided only two options for the general public to achieve AI status: one determined by wealth and one by income. A person is an AI if their net worth exceeds $1,000,000, excluding their primary residence and other calculation specifications.[83] Alternatively, one qualifies with "an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse in excess of $300,000 in each of those years" with a "reasonable expectation" of maintaining that income level.[84]

The purpose of the individual AI standard is to identify people "whose financial sophistication . . . render the protections of the Securities Act's registration process unnecessary."[85] Three ideas inform this statement. An affluent individual has the expertise to invest in complex financial products, the ability to buy such sophistication in the form of advisors, or as a backstop, the resources to withstand large losses from risky investments. The SEC cites a range of

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80 Jay Clayton, Chairman, U.S. Secs. & Exch. Comm'n, Remarks at the Economic Club of New York (July 12, 2017), https://www.sec.gov/news/speech/remarks-economic-club-new-york.

81 *See, e.g.*, 17 C.F.R. § 230.501(a)(1)–(3) (2020) (including certain banks, savings and loan associations, brokers or dealers, private business development companies, and special purpose vehicles as AIs); *id.* § 230.501(a)(8) (including entities as AIs when all equity owners already have AI status).

82 *Id.* § 230.501(a)(4) (including as AIs "[a]ny director, executive officer, or general partner of the issuer of the securities being offered or sold, or any director, executive officer, or general partner of a general partner of that issuer").

83 *Id.* 230.501(a)(5); § 230.501(a)(5)(i).

84 *Id.* § 230.501(a)(6).

85 Regulation D Revisions, Securities Act Release No. 33-6683, 52 Fed. Reg. 3,015, 3,017 (Jan. 30, 1987); *see also* SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953) (determining the standard for Securities Act exemptions should "turn on whether the particular class of persons affected needs the protection of the [Securities] Act").

purported risks to justify restricting most private placements to such people. For instance, the lack of regulatory scrutiny means that fraud or other exploitation may be hard to identify and avoid.[86] Or restricted secondary market liquidity makes it difficult for an investor to recoup their principal investment, requiring an outlay of money without a definitive date of any return on investment.[87] What's more, limited disclosure may obfuscate information necessary to determine whether the price of the security reflects the value of that investment—or may distort the price itself.[88] Simply put, private placement is also "complex,"[89] compounding these difficulties.

To put this policy in action, the SEC considered the AI standard a "cornerstone of Regulation D" because it was the gateway to Rule 506(c) and (most of) Rule 506(b) transactions.[90] The justification for using finite wealth floors instead of a more flexible standard was that thresholds offered a "bright-line test[]," ensuring "clarity" and ease for issuers to identify qualifying purchasers for exempt transactions.[91] But despite the significance of the thresholds, the SEC has not materially updated them since their introduction four decades ago.[92] In 2006 and 2007, the Commission twice proposed expansions but never adopted them,[93] reportedly due to "competing demands and the mixed comments it received during the comment period."[94] In 2010, however, Congress passed the Dodd-Frank Wall Street Reform and

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[86] *See* AI Concept Release, *supra* note 38, at 30,468 ("[I]t is difficult to draw rigorous conclusions about the extent of fraud in exempt securities offerings.").

[87] *See supra* notes 61–66 and accompanying text.

[88] *See* Basic, Inc. v. Levinson, 485 U.S. 224, 241 (1988) (describing that securities policymaking relies on the hypothesis that "the price of a company's stock is determined by the available material information regarding the company and its business").

[89] *See* U.S. Gov't Accountability Off., GAO-13-640, Securities and Exchange Commission: Alternative Criteria for Qualifying as an Accredited Investor Should Be Considered 10 (2013) [hereinafter GAO-13-640] (describing private placement offerings as illiquid and complicated, thereby posing a high risk to unwary investors).

[90] Definition Report, *supra* note 40, at 17.

[91] *Id.* at 6. By failing to abide by the Regulation D restrictions, an issuer that sells private securities to NAIs has engaged in an unregistered public offering, which the SEC enforces through fines. *See* 15 U.S.C. § 77x.

[92] The two changes were the addition of the spouse joint income threshold of $300,000, Definition Report, *supra* note 40, at 41, 72; 17 C.F.R. § 230.501(a)(6) (2020), and the omission of an investor's primary residence in the net worth standard in 2011. Net Worth Standard for Accredited Investors, Securities Act Release No. 33-9287, 76 Fed. Reg. 81,793, 81,795 (Dec. 29, 2011).

[93] Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles; Accredited Investors in Certain Private Investment Vehicles, Securities Act Release No. 33-8766, 72 Fed. Reg. 400, 414 (Jan. 4, 2007); Revisions of Limited Offering Exemptions in Regulation D, Securities Act Release No. 33-8828, 72 Fed. Reg. 45,116 (Aug. 10, 2007).

[94] GAO-13-640, *supra* note 89, at 11.

Consumer Protection Act (Dodd-Frank Act), which expressly requires the SEC to review the AI definition every four years after 2014 and consider necessary amendments.[95]

In December 2020, the SEC adopted amendments to the AI standard (the "Final Rule") pursuant to this mandate.[96] The Final Rule expanded the qualification menu for members of the general public with two new categories based on industry experience: An individual can become an AI through (1) "certain professional certifications and designations," such as licensing exams for investment advising, or as a (2) "knowledgeable employee[]" within specialized financial businesses, like hedge funds.[97] Remarkably, the 2020 amendments left the four-decades-old financial thresholds unchanged. The Final Rule stated that the SEC finds it "not necessary or appropriate to modify the definition's financial thresholds at this time."[98]

II
The AI Standard and Racial Exclusion in Capital Markets

Section II.A outlines conventional criticisms of the AI definition to explore the landscape that informed the Final Rule. This Section argues that while this discourse has lessons for the SEC's rulemaking, it has generally omitted a critical variable: racial economic inequality. Indeed, if the legal discourse around racial inequities in capital markets "is impoverished, then we should expect that the solutions that observers propose to this problem will be impoverished as well."[99] Section II.B tries to fill this void by analyzing the intersection between racial economic disparities and the amended AI definition.

A. Conventional Criticism

The AI standard for individuals has received a significant amount of criticism that, while not focused on racial inequality, runs parallel to that inquiry. This Section explores three challenges: the SEC does not collect data necessary to analyze the standard's effects on real mar-

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95 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, 413(b)(2)(A)–(B) (2010).

96 *See* Final Rule, *supra* note 21.

97 *Id.* at 64,241, 64,244. The SEC may also designate additional certifications or credentials by order. *Id.* at 64,241.

98 *Id.* at 64,253. The rest of the amendments relate to AI entities and fall outside this Note's scope.

99 Khiara M. Bridges, *Racial Disparities in Maternal Mortality*, 95 N.Y.U. L. Rev. 1229, 1235 (2020) (making this argument in the context of racial disparities in rates of maternal mortality and morbidity).

kets; the regime may not protect investors as designed; and the standard may worsen wealth inequality generally.

1. The AI Regime Does Not Measure Its Own Participants

Given the unparalleled access to private markets that AI status grants,[100] the SEC should understand who qualifies. But it does not, and this impairs its analysis of the topic.

The agency can guess how many people could be AIs. In its 2019 annual report, the SEC estimated that thirteen percent of U.S. households qualified under the financial thresholds—millions of people.[101] Of course, this number does not necessarily reflect the actual demographic of active market participants. Simply because an investor qualifies in theory does not mean that they invest in fact.[102]

So the SEC emphasizes another number in its reporting instead. On average each year, fewer than 320,000 AIs participated in Regulation D offerings from 2009 to 2017.[103] The SEC calculates this figure by compiling data from Form D reports—notices collected after the sale of securities under Regulation D, including Rule 506(b) and 506(c) offerings.[104] But a series of problems undermine confidence in this figure. As Form D does not currently request data on the identity of participating investors, the 320,000 estimate includes both natural persons and institutional investors.[105] Then, that number likely overestimates the true demographic of participating AIs because it counts repeat investors each time they appear in a transaction.[106] Plus, while Form D is technically required, failing to submit the form has no penalty, and an issuer does not have to correct an initial filing if transaction participants change.[107] Consequently, issuers may fail to file a Form D correctly or file one at all.

So Form D data are deeply misrepresentative of the true number of private placement participants. The agency claims that, though maintaining a list of active AIs would improve transparency, it would be "impractical" and "could raise privacy concerns."[108] This explana-

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[100] *See supra* Section I.B.

[101] AI Concept Release, *supra* note 38, at 30,471 tbl.3.

[102] Like any purchase, aptitude for private placement investing may depend on a combination of factors including investment expertise, choice of financial advisor, personal network, awareness of opportunity, or liquidity of assets.

[103] BAUGUESS ET AL., *supra* note 55, at 34.

[104] *Id.* at 7; 17 C.F.R. § 230.503.

[105] *See* U.S. SECS. & EXCH. COMM'N, FORM D: NOTICE OF EXEMPT OFFERINGS OF SECURITIES, Item 14 (2021), https://www.sec.gov/files/formd.pdf.

[106] BAUGUESS ET AL., *supra* note 55, at 34.

[107] *See* DEFINITION REPORT, *supra* note 40, at 1 n.4, 108.

[108] GAO-13-640, *supra* note 89, at 17.

tion seems pretextual given that the SEC proposed—and did not retract—amendments to change Form D in this way,[109] and those concerns could be mitigated.[110] Either way, the SEC concedes that Form D data "may not reflect the actual number of accredited investors who participated in any particular offering."[111] This is noteworthy. The SEC is extremely limited in what it can reasonably conclude about the true population of private placement participants or the transactions themselves. All the agency can say is that each year, fewer than 320,000 investors of unknown identity (individual, institutional, racial, or otherwise) *may* participate in the most lucrative (and growing) pool of wealth in American capital markets[112]—*and* this figure is subject to an unknown margin of error.[113] This knowledge gap hamstrings the SEC's ability to evaluate whether the AI criteria perform as intended, whether current investors are adequately protected, and whether excluded investors would be harmed if they had market access. Notably, two Commissioners dissented from the Final Rule amending the AI standard in part because of this self-imposed data deficit.[114]

2. *The AI Regime Does Not Protect Investors*

Critics have long charged that AI criteria fail to protect investors as designed, a criticism that remains relevant today because the Final

[109] In 2013, the SEC proposed to amend item 14 to collect information on the number of natural persons who participate in a particular Rule 506 offering. Amendments to Regulation D, Form D and Rule 156, 78 Fed. Reg. 44,806, 44,810 (July 24, 2013) (to be codified at 17 C.F.R. pt. 230, 239). As of March 2021, the SEC has yet to promulgate a final rule on this matter. *Id.*

[110] For instance, the SEC could maintain such a list for internal analysis alone, preserving confidentiality. A corrolary benefit makes this kind of idea all the more appealing. Other federal and state securities laws use the AI standard, so a central source of AI data would make enforcement faster and more efficient in those areas too. *See* Definition Report, *supra* note 40, at 85–86 (describing the various provisions of federal and state law that implicate the AI standard).

[111] *Id.* at 108.

[112] *See supra* Section I.B.

[113] The SEC tries to approximate this demographic through other means, *see* Definition Report, *supra* note 40, at 108–09 (estimating upper bound of potential Regulation D investors by reference to number of U.S. households with direct retail stock investments), but they regularly decline to pinpoint the true number of natural person investors in Regulation D filings. *See* GAO-13-640, *supra* note 89, at 2 n.4 ("[The] SEC does not track the number of accredited investors and the total population of this type of investor is unknown."); *see also* Final Rule, *supra* note 21, at 64,243 ("[W]e are unable to predict how many individuals will be newly eligible under the final rules.").

[114] Comm'rs Allison Herren Lee & Caroline Crenshaw, *Joint Statement on the Failure to Modernize the Accredited Investor Definition*, U.S. Secs. & Exch. Comm'n (Aug. 26, 2020), https://www.sec.gov/news/public-statement/lee-crenshaw-accredited-investor-2020-08-26.

Rule left the core AI standard intact. The conventional argument is that affluence alone does not correlate with investment savvy or the wherewithal to hire a knowledgeable advisor.[115] In a parallel argument, critics flag that if the SEC really thought that the wealth floor protected investors, they would have updated the thresholds to account for inflation—which the SEC has never done[116] and declined to do in the Final Rule.[117] Even if wealth correlates with sophistication in a way that protects investors, it is a less precise proxy than other measures such as education attainment, investment expertise, or use of a financial advisor.[118] In other words, knowledgeable NAIs may be denied investment opportunities that they perfectly understand.

While the Final Rule's expansion to certain financial professionals may begin to address the latter concern, the AI standard is still an impotent investor protection mechanism if private placement causes harm beyond transaction parties themselves. As detailed above, the expansion of private markets may cause public markets to decrease in size, value, and opportunities for hedging risk, harming retail investors directly while denying them any upside.[119] The AI standard does not control those risks.[120] And, of course, the AI standard does nothing to mitigate many of the risks of private placement—complexity, lack of transparency, potential for fraud—that also plague spaces where the public can invest freely, like public markets[121] or real estate.

3. *The AI Regime Perpetuates Inequality*

Critics also charge that any investor protection accomplished by the AI regime pales in comparison to the social harm caused by its

[115] *See, e.g.*, Thomas M. Selman, *Protecting Retail Investors: A New Exemption for Private Securities Offerings*, 14 VA. L. & BUS. REV. 41, 41 n.1 (2020).

[116] *See* Sjostrom, Jr., *supra* note 62, at 1157–58; Selman, *supra* note 115, at 51 n.53.

[117] Final Rule, *supra* note 21, at 64,253.

[118] *See* DEFINITION REPORT, *supra* note 40, at 57.

[119] *See supra* Section I.B.

[120] *See, e.g.*, Sethi, *supra* note 16, at 803 (arguing that even if retail investors do not participate in private transactions, the AI definition does not shield those retail investors from systemic risk caused by hedge funds and other actors in private markets).

[121] Some criticize public markets disclosure as too confusing because it yields "too much disclosure of some information [but] too little of other information." Kevin S. Haeberle & M. Todd Henderson, *A New Market-Based Approach to Securities Law*, 85 U. CHI. L. REV. 1313, 1327 (2018). And despite enforcement efforts, securities fraud persists in publicly traded securities. *See, e.g.*, *Senior Executive of Oil-Services Company Pleads Guilty to Securities Fraud Scheme that Caused Over $886 Million in Shareholder Losses*, Press Release, U.S. DEP'T OF JUSTICE (Oct. 13, 2021), https://www.justice.gov/opa/pr/senior-executive-oil-services-company-pleads-guilty-securities-fraud-scheme-caused-over-886.

aggravation of wealth disparities generally, race aside.[122] At least one scholar has demonstrated empirically that restricted private placements combined with the dwindling ability of retail investors to achieve satisfactory portfolio diversification have resulted in the "investing elite [becoming] even wealthier relative to the middle class."[123] Others still have estimated the missed gains that retail investors would have realized on the public markets had private placement companies gone public as early as older companies did in the past.[124] At best, assuming that the wealth criteria provide some measure of protection for investors, the SEC has passively allowed the AI pool to grow beyond reasonable bounds of financial sophistication. At worst, the SEC has maintained arbitrary wealth restrictions that fail to protect qualifying investors and that also pose a formidable barrier for sophisticated NAIs unless they achieve the requisite wealth elsewhere.

The SEC is not unfamiliar with these ideas. The agency has recognized the "frustration with the idea that 'you have to be rich to get rich' under the current rules"[125] and that Rule 506 in particular has shaped "a large and vibrant market for raising capital" accessible only to the lucky few.[126] These concessions appear in the materials that the SEC executed as part of its 2020 re-evaluation of the AI standard, and the addition of the alternative two professional qualifications tries to address these concerns.[127] However, though they recognize that certain demographics are less likely to qualify as AIs,[128] the SEC dedicated almost no discussion to the specific impact of the AI definition on both Black investors and Black entrepreneurs, and the economic consequences of this intersection have remained unexplored by securities academia.[129] This next Section tries to fill that void.

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[122] *See, e.g.*, John Berlau, *Let Middle-Class Investors Join the 'Accredited' Club*, FORBES (Aug. 27, 2018, 1:44 PM), https://www.forbes.com/sites/johnberlau/2018/08/27/let-middle-class-investors-join-the-accredited-club; So-Yeon Lee, Note, *Why the "Accredited Investor" Standard Fails the Average Investor*, 31 REV. BANKING & FIN. L. 987, 987 (2012).

[123] Bender, *supra* note 72, at 36.

[124] *See* Andres Trujillo, *The Accredited Investor Requirement Needs to Change*, CARTA: BLOG (Oct. 29, 2019), https://carta.com/blog/accredited-investor-rule (showing that for an investor in Uber's IPO to realize the same gains as an investor in Amazon's IPO, Uber's valuation would have to be more than two times the global GDP in 2018, while an investment in Facebook's IPO would be worth only a fraction of an equally sized investment made when the company was founded); *see also supra* Section I.B.

[125] ADVOCATE 2019 REPORT, *supra* note 69, at 43.

[126] AI Concept Release, *supra* note 38, at 30,470.

[127] *See generally* Final Rule, *supra* note 21.

[128] *E.g.*, ADVOCATE 2019 REPORT, *supra* note 69, at 42.

[129] *But see* Lichtenstern, *supra* note 19.

B. Analyzing the AI Standard and Racial Inequality

As the AI criteria for natural persons have been historically determined by income and wealth, this Section argues that the AI standard likely excluded—and continues to exclude—Black investors and Black-owned businesses from capital markets, which materially harms the economy overall. This is because "any changes to the definition of 'accredited investor' . . . will have dual impacts on investors' access to investment opportunities as well as the supply of capital to the exempt markets."[130]

This Section does not purport to offer thorough statistical authority to this effect, especially given the SEC's self-imposed data constraints.[131] Rather, this exposition uses publicly available information to make three connected statements. *First*, white and Black Americans experience extreme disparities in income and wealth, which, because of the AI financial thresholds, means that white investors are substantially more likely than Black peers to qualify as AIs. Given the lack of diversity in finance, the 2020 rule change—adding new professional categories but maintaining the same financial thresholds[132]—will either have a de minimis effect or make this trend worse. *Second*, combined with current financing behaviors, this dearth of Black investors means that Black-owned businesses are more likely to be excluded from private capital compared to white peers. *Third*, these effects on both the supply and demand of funds in exempt markets undermine the potential of capital markets as a whole. Although this inquiry is the kind that an expert agency should be able to make at a minimum, such analysis has been conspicuously absent in the SEC's materials regarding the AI standard, the legal consequences of which Part III tackles.

1. White Investors Are More Likely to Qualify as AIs

With respect to the AI income prong, a white individual is much more likely to achieve the requisite income levels during their lifetime than a similarly positioned Black individual. In 2016, whites in the ninetieth percentile of income distribution earned approximately $117,986; conversely, Black individuals in the ninetieth percentile earned only $80,502.[133] This means that in the wealthiest demo-

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130 ADVOCATE 2019 REPORT, *supra* note 69, at 42.

131 *See supra* Section II.A.1.

132 *See supra* notes 97–98 and accompanying text.

133 RAKESH KOCHHAR & ANTHONY CILLUFFO, PEW RSCH. CTR., INCOME INEQUALITY IN THE U.S. IS RISING MOST RAPIDLY AMONG ASIANS 10 (2018), https://www.pewsocialtrends.org/2018/07/12/income-inequality-in-the-u-s-is-rising-most-rapidly-among-asians.

graphic, a Black person made sixty-eight cents for every dollar a white person made. This is not an isolated phenomenon. Stark income disparities appear between white and Black workers across multiple echelons, despite controlling for relevant factors.[134] Past economic crises have also disproportionately affected Black earning potential,[135] meaning that racialized consequences of the COVID-19 crisis[136] could further hamper Black income rates.

Data paint a similar, if not worse, picture for the second prong of the individual AI test, suggesting that a white person is much more likely than a Black individual to attain the necessary wealth to qualify as an AI. In 1992, the average wealth gap between Black and white families was approximately $100,000.[137] By 2016, an upper bound estimate of this gap was a staggering $700,000,[138] with white Americans owning as much as *ten times* the wealth of Black Americans at the median.[139] This change is due to significant growth in the wealth of white families during this period, whereas the median wealth of Black families plateaued.[140] Compounding income disparity is obviously one contributor to this dynamic.[141] The lower degree of intergenerational

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[134] Elise Gould, Econ. Pol'y Inst., State of Working America: Wages 2018, at 29 (2019), https://www.epi.org/publication/state-of-american-wages-2018; *see also* Valerie Wilson & Jhacova Williams, *Racial and Ethnic Income Gaps Persist amid Uneven Growth in Household Incomes*, Econ. Pol'y Inst.: Working Econs. Blog (Sept. 11, 2019), https://www.epi.org/blog/racial-and-ethnic-income-gaps-persist-amid-uneven-growth-in-household-incomes (detailing how the median Black household in 2018 earned fifty-nine cents on the dollar compared to white counterparts).

[135] *Compare* Kochhar & Cilluffo, *supra* note 133, at 31 (describing how unemployment in Black communities reached a peak of 16.8% in 2010), *with* Evan Cunningham, *Great Recession, Great Recovery? Trends from the Current Population Survey*, Monthly Lab. Rev., Apr. 2018, at 3, https://www.bls.gov/opub/mlr/2018/article/great-recession-great-recovery.htm (detailing that white unemployment during the Recession only peaked at nine percent). Almost a decade after the Recession, while other demographics recovered, Black households were alone in receiving median incomes below pre-Recession levels. Wilson & Williams, *supra* note 134.

[136] *See The COVID Racial Data Tracker*, COVID Tracking Project & B.U. Ctr. for Antiracist Rsch. (Mar. 7, 2021), https://covidtracking.com/race (describing that Black people experience death by COVID-19 at more than twice the rate of white people); *see also* Connor Maxwell, *The Coronavirus Crisis is Worsening Racial Inequality*, Ctr. for Am. Progress (June 10, 2020), https://www.americanprogress.org/issues/race/news/2020/06/10/486095/coronavirus-crisis-worsening-racial-inequality (chronicling how Black Americans were more likely to have lost employment income due to the pandemic and more likely to experience housing instability than whites).

[137] Noel et al., *supra* note 20, at 5.

[138] *Nine Charts About Wealth Inequality in America*, Urban.org (Oct. 5, 2017), https://apps.urban.org/features/wealth-inequality-charts.

[139] Hanks et al., *supra* note 14, at 8.

[140] Noel et al., *supra* note 20, at 5.

[141] Dionissi Aliprantis & Daniel Carroll, *What Is Behind the Persistence of the Racial Wealth Gap?*, Econ. Comment. (Feb. 28, 2019), https://www.clevelandfed.org/newsroom-

home equity, shaped in part by redlining, is another.[142] On average, white families also accumulate more wealth over their lifetimes through inheritance or gifts from pre-existing familial money,[143] and Black families tend to carry more student loan debt.[144] In turn, these elements reduce the amount of liquid capital that Black Americans can put aside for investment or other financial services—systems that Black individuals are already less likely to use given historical barriers to formal financial systems.[145]

The SEC's addition of two professional qualifiers to the AI criteria[146] will either have a negligible effect on the exclusion of Black investors or worse, may exacerbate racial inequality. By virtue of working in financial services, individuals in the new categories may already qualify under the existing thresholds given high compensation levels in the industry.[147] Also by virtue of their profession, the lack of racial diversity in these industries means any new candidates will likely be white.[148] As the SEC concedes, the estimated number of newly eligible individuals is insignificant compared to the pre-existing qualified demographic and may have "*minimal effects* on the private offering market generally."[149] This change does little to mitigate the investor demographic distortion detailed above, especially as the SEC left the decades-old thresholds untouched.

Just as the SEC does not know who actually transacts in private placement,[150] these figures only contemplate who could participate, not those who do. Without more data on real transactions, it is impossible to substantiate that active AI participants—historically and

and-events/publications/economic-commentary/2019-economic-commentaries/ec-201903-what-is-behind-the-persistence-of-the-racial-wealth-gap.aspx.

142 *See supra* Introduction.

143 *Nine Charts About Wealth Inequality in America*, *supra* note 138.

144 *Id.*

145 Noel et al., *supra* note 20, at 11–12, 18; *see also* Lenore Palladino, The Contribution of Shareholder Primacy to the Racial Wealth Gap (Feb. 2020) (Roosevelt Inst. Working Paper), https://rooseveltinstitute.org/wp-content/uploads/2020/07/RI_TheContributionofShareholderPrimacy_Working-Paper_202001.pdf (arguing that disproportionate access to U.S. *public* markets exacerbates the racial wealth gap).

146 *See supra* note 97 and accompanying text.

147 *See Financial Services Professional Salary*, ZipRecruiter, https://www.ziprecruiter.com/Salaries/Financial-Services-Professional-Salary (last updated July 30, 2021) (listing the average financial services salary as $77,289).

148 *See* Alessandra Malito, *Three Reasons You Don't See Many People of Color in the Financial Services Industry—and How to Fix It*, MarketWatch (July 8, 2020, 12:19 PM), https://www.marketwatch.com/story/three-reasons-you-dont-see-many-people-of-color-in-the-financial-services-industry-and-how-to-fix-it-2020-06-11 (listing a range of statistics demonstrating the lack of Black representation in financial services).

149 Final Rule, *supra* note 21, at 64,243 (emphasis added).

150 *See supra* Section II.A.1.

under the Final Rule—are overwhelmingly white. That said, the sum of these factors suggests that this is a reasonable conclusion.[151]

2. *The Dearth of Black AIs Disadvantages Black-Owned Businesses*

The AI standard obviously shapes the pool of qualifying investors directly, but it also indirectly impacts which businesses actually receive investment. Although causation is difficult to prove with available data, a dearth of Black AIs may disproportionately decrease the ability of Black-owned businesses to obtain capital through private markets.

Where available, data demonstrate that rampant bias plagues enterprise fundraising. Black entrepreneurs' bank loan requests are three times less likely to be approved than those of white entrepreneurs, despite controlling for eligibility requirements.[152] Even when Black entrepreneurs receive bank loans, they are twice as likely to not receive their requested amount[153] and face higher interest rates on average compared to white-owned businesses.[154] The average Black-owned business starts its lifecycle with approximately three times less capital than comparable white-owned businesses.[155] Minority-owned businesses also rely more on personal savings for startup capital, despite experiencing wealth levels as little as one tenth of white counterparts.[156] At the very least, this suggests that access to private capital would bestow outsized benefits on Black-owned businesses compared to similarly-situated white peers.

Given the lack of AI market data, there is minimal research regarding racial biases in exempt transactions; however, it is naive to deny the possibility that such biases are present, especially when the data available signal that this is the case. Interview-based studies describe that Black-owned businesses are "discouraged from entering capital markets"[157] and thereby forced to operate with "substantially less capital overall—both at startup and in subsequent years" compared to similar white-owned businesses.[158] Approximately sixty percent of Black entrepreneurs report that they do not receive the full amount of funds requested in equity financing—often conducted

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[151] *See infra* note 161 (detailing the dearth of Black angel investors).

[152] Victor Hwang, Sameeksha Desai & Ross Baird, Access to Capital for Entrepreneurs: Removing Barriers 11 (2019), https://www.kauffman.org/wp-content/uploads/2019/12/CapitalReport_042519.pdf [hereinafter Kauffman Report].

[153] Robb, *supra* note 18, at 4.

[154] Advocate 2019 Report, *supra* note 69, at 30.

[155] *Id.*

[156] Robb, *supra* note 18, at 47; *see also supra* note 138 and accompanying text.

[157] Robb, *supra* note 18, at 5 (citations omitted).

[158] *Id.* at 11 (citations omitted).

through some form of private placement—compared to forty percent of white counterparts.[159] Studies have also demonstrated that at least a shared *ethnicity* between venture capitalist and business founders is correlated with a higher probability of successful investment.[160] Perhaps studies would yield the same result along racial lines, but limited data hinders this research because the venture capital space is so overwhelmingly white.[161]

Further research into these trends is necessary, especially by the SEC, the agency responsible for this landscape and equipped with expertise to measure it. At the very least, available data suggest that the AI standard—both historically and as amended—not only excludes Black investors from private markets but, as a consequence, denies capital to Black-owned businesses as well.

3. *The AI Regime's Racial Exclusion Constrains Capital Markets*

Racial inequality is a sociopolitical harm that restricts the liberty and dignity of Black Americans, warranting discussion in its own right,[162] but it is also an economically irrational problem for everyone.[163] A report from the consulting firm McKinsey estimated that racial inequality's "dampening effect on consumption and investment will cost the US economy between $1 trillion and $1.5 trillion between 2019 and 2028—4 to 6 percent of the projected GDP in 2028."[164] In other words, "[t]he persistent racial wealth gap in the United States is a burden on [B]lack Americans *as well as the overall economy*."[165] Specific to this Note, the interaction between racial inequality and the AI criteria is a discrete manifestation of this "dampening effect."

The racial impact of the AI regime acutely hurts Black businesses and investors, which constrains capital markets as a whole. The phe-

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159 *Id.* at 26.

160 *See* Ola Bengtsson & David H. Hsu, *Ethnic Matching in the U.S. Venture Capital Market*, 30 J. Bus. Venturing 338, 340 (2015).

161 *See* Laura Huang, Andy Wu, Min Ju Lee, Jiayi Bao, Marianne Hudson & Elaine Bolle, Angel Cap. Ass'n, The American Angel 7 (2017), https://www.angelcapitalassociation.org/data/Documents/TAAReport11-30-17.pdf?rev=DB68 (describing that out of a survey of angel investors, only 1.3% of the sample self-identified as Black). "The observed racial disparity may explain similar disparities in which entrepreneurs receive funding. In particular, investors tend to invest in 'people like them.'" *Id.* at 8.

162 *See, e.g.*, Ta-Nehisi Coates, *The Case for Reparations*, Atlantic (June 2014), https://www.theatlantic.com/magazine/archive/2014/06/the-case-for-reparations/361631.

163 *See* Robb, *supra* note 18, at 49 ("These improvements [to credit, wealth, and banking relationships for Blacks and other minorities] are not only needed for fairness, but for our economy to operate at full capacity.").

164 Noel et al., *supra* note 20, at 5–6.

165 *Id.* at 3 (emphasis added).

nomenon is anti-competitive because it disadvantages Blacks compared to white peers on both sides of the fundraising equation.[166] This harm is also inefficient because the market is less able to connect high-potential Black-owned businesses to funds they need, which deprives investors of worthwhile wealth-generation opportunities.[167] At least one report—which the SEC cited in its rulemaking for a separate proposition, but without referencing this particular claim[168]—suggests that "financial returns from equity capital investments in minority-owned businesses can often exceed those from white-owned ventures."[169] Even if this were not the case, investors invariably squander potential returns when they deny Black businesses capital.[170] Morgan Stanley estimates that the venture capital industry misses out on as much as *$4 trillion* in value by not investing in more diverse founders, including Black founders.[171]

These dynamics disrupt rational capital formation, depressing Black-owned businesses' revenue, hindering their ability to reinvest in innovation, and constraining their role in job creation. The SEC's own Office of the Advocate for Small Business Capital Formation reported[172] that almost a quarter of Black entrepreneurs estimate that their profitability is impacted by lack of capital access, whereas only 8.9% of white owners report the same.[173] Venture capital "bias in favor of companies run by white men" was estimated to cost the American economy over 1.1 million minority-owned businesses and more than 9 million possible jobs in 2016 alone.[174] And approximately

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166 *See supra* Sections II.B.1–2.

167 *Cf.* Dell Gines & Rodney Sampson, Brookings Inst., Building Racial Equity in Tech Ecosystems to Spur Local Recovery 9–10 (2020), https://www.brookings.edu/wp-content/uploads/2020/07/BrookingsMetro_RecoveryWatchEssays_Building-Racial-Equity_FINAL.pdf (estimating the economic benefits of developing racial equity in tech ecosystems).

168 Amending the "Accredited Investor" Definition, 85 Fed. Reg. 2,574, 2,601 (proposed Jan. 15, 2020) (to be codified at 17 C.F.R. pt. 230, 240) [hereinafter Proposed Rule]. The Final Rule does not cite this report. *See generally* Final Rule, *supra* note 21.

169 Kauffman Report, *supra* note 152, at 11 n.65 (citation omitted).

170 *See* Paul Gompers & Silpa Kovvali, *The Other Diversity Dividend*, Harv. Bus. Rev., July–Aug. 2018, https://hbr.org/2018/07/the-other-diversity-dividend ("Diversity significantly improves financial performance on measures such as profitable investments at the individual portfolio-company level and overall fund returns.").

171 Molly Wood, *VCs Are Leaving Trillions on the Table by Bypassing Diverse Leaders, Study Says*, Marketplace Tech (Oct. 25, 2019), https://www.marketplace.org/shows/marketplace-tech/vcs-are-leaving-trillions-on-the-table-by-bypassing-diverse-leaders-study-says.

172 As detailed in Part III, despite the institutional connection to the SEC, the Final Rule neglects further discussion of this report.

173 Advocate 2019 Report, *supra* note 69, at 31.

174 Jeanette Settembre, *Venture Capitalists Still Give Most of Their Money to White Men, Study Finds*, MarketWatch (Feb. 13, 2019, 1:43 PM), https://www.marketwatch.com/

9.5% of U.S. businesses are owned by Black entrepreneurs,[175] so these harms are replicated across sectors.

III
Challenging the AI Final Rule and Planning for the Future

Parts I and II paint a frightening picture: Private markets—restricted to mostly white AIs via Rule 506—are expanding at the expense of NAIs in a way that systematically excludes Black investors and Black-owned businesses. This phenomenon denies investors valuable returns, inhibits profit-driven allocation of capital to businesses in need, and stunts American capital markets. The SEC has limited empirical insight to inspire confidence that these racially disparate costs are somehow worth the protection that the AI regime grants to NAIs—if it provides any protection at all. The scale of these problems dwarfs the Final Rule's minor amendment to the AI definition. Observers should scrutinize whether the agency's rulemaking sufficiently addressed these concerns.

This next Part offers an analytical framework to challenge the SEC's Final Rule in this way. Section III.A concludes that, under the APA, the SEC had a statutory obligation to investigate and address this material problem as applied to its AI definition—a duty abdicated in the promulgation of the Final Rule. Section III.B then suggests guidance for the SEC moving forward.

A. *The AI Final Rule is Arbitrary and Capricious*

This Section briefly explains the APA, the statute that governs agency decisionmaking, and outlines the case law relevant to the SEC's Final Rule. This Section then annotates the SEC's Final Rule to see how it would map onto this standard in an APA lawsuit and concludes that, failing those metrics, the AI Final Rule is arbitrary and capricious, in violation of the APA.

1. *The Administrative Procedure Act*

The mechanism by which to review the SEC's Final Rule is the Administrative Procedure Act.[176] This Act outlines "the procedures by which federal agencies are accountable to the public and their

story/venture-capitalists-still-give-most-of-their-money-to-white-men-study-finds-2019-02-13.

175 *See* Advocate 2019 Report, *supra* note 69, at 29 (estimating that of the 8 million minority owned businesses—29.3% of U.S. firms—2.6 million are Black-owned).

176 Administrative Procedure Act, Pub. L. No. 79–404, 60 Stat. 237 (1946) (codified as amended in scattered sections of 5 U.S.C.).

actions subject to review by the courts."[177] Generally, the APA mandates that agencies like the SEC use "reasoned decisionmaking."[178] It accomplishes this by creating a presumption of judicial review for legal injuries caused by agency action.[179] The Final Rule, a "notice-and-comment" rulemaking under section 553 of the APA, is an example of such an agency action.[180] Of particular focus here, a litigant challenging the substance of the Final Rule needs to allege that the rulemaking was "arbitrary and capricious" under section 706 of the APA and should thus be "set aside."[181]

A court performing arbitrary and capricious review must not "substitute its judgment" in place of the agency's expertise.[182] Rather, this analysis involves a narrow evaluation of whether the agency made a decision rooted in "a consideration of the relevant factors and whether there has been a clear error of judgment."[183] "That task involves examining the reasons for agency decisions—or, as the case may be, the absence of such reasons."[184] So, a court looks to the statutes governing the agency's rulemaking for factors the agency should consider and then analyzes this standard against the agency's explanation in the proposed and final text of its rule.[185] The next two Subsections tackle each part of this inquiry in turn.

2. *The Applicable Legal Standard for the Final Rule*

The Final Rule is a discretionary rule, which the SEC chose to promulgate after completing its duty to review the AI standard under the Dodd-Frank Act. Specifically, Dodd-Frank instructs that, every four years after 2014, the SEC:

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177 Dep't of Homeland Sec. v. Regents of the Univ. of Cal., 140 S. Ct. 1891, 1905 (2020).

178 *Id.* (quoting Michigan v. EPA, 576 U.S. 743, 750 (2015)).

179 *Id.* at 1897 (quoting Abbott Lab'ys v. Gardner, 387 U.S. 136, 140 (1967)). This presumption is subject to two exceptions not applicable here: (1) when the statute precludes judicial review, or (2) when actions are committed to agency discretion, 5 U.S.C. § 701(a)(2), like agency non-action. Heckler v. Chaney, 470 U.S. 821, 831–35 (1985). A litigant must also clear procedural hurdles, such as exhaustion of administrative remedies, RICHARD J. PIERCE, JR., ADMINISTRATIVE LAW 80 (2d ed. 2012), or Article III standing to bring suit in federal court. This Note limits its discussion to the analytical framework of an APA lawsuit on the merits.

180 *See* 5 U.S.C. § 553 (outlining notice-and-comment procedures).

181 *Id.* § 706(2)(A) (2012).

182 *Dep't of Homeland Sec.*, 140 S. Ct. at 1905 (quoting FCC v. Fox Television Stations, Inc., 556 U.S. 502, 513 (2009)).

183 *Id.* (quoting Citizens to Preserve Overton Park, Inc. v. Volpe, 401 U.S. 402, 416 (1971)).

184 Judulang v. Holder, 565 U.S. 42, 53 (2011).

185 Stephen Hylas, *Final Agency Action in the Administrative Procedure Act*, 92 N.Y.U. L. REV. 1644, 1655 (2017).

> [S]hall undertake a review of the [AI] definition, . . . as such term applies to natural persons, to determine whether the requirements of the definition should be adjusted or modified for the protection of investors, in the public interest, and in light of the economy. . . . [T]he Commission may, by notice and comment rulemaking, make such adjustments to the definition . . . as the Commission may deem appropriate for the protection of investors, in the public interest, and in light of the economy.[186]

So the SEC must evaluate the AI standard every four years to determine whether revisions are necessary "for the protection of investors, in the public interest, and in light of the economy," and if so, adjust the definition as it sees fit. When the SEC engages in rulemaking that requires the Commission "to consider or determine whether an action is necessary or appropriate in the public interest," as is the case here, the Commission must also consider "whether the action will promote efficiency, competition, and capital formation."[187] This is a dual statutory obligation: The SEC must comply with Dodd-Frank's mandate and then, if it issues a rule, ensure that discretionary rule satisfies the Securities Act tripartite standard too.

The last fifteen years has seen a series of successful APA attacks on the SEC in the D.C. Circuit, and these cases offer guidance for an APA suit challenging the Final Rule. This jurisprudence has interpreted the SEC's Securities Act task of promoting efficiency, competition, and capital formation as a serious hurdle for the agency, requiring rigorous economic analysis backed by relevant evidence. This bar is particularly high when the agency makes a purportedly data-driven decision to issue a rule in its own discretion rather than by mandate.

First, in the 2005 case *Chamber of Commerce v. SEC*, the D.C. Circuit considered an SEC rule barring mutual funds from certain transactions if they failed to have enough independent directors on their boards.[188] The D.C. Circuit found that the SEC violated the APA through two procedural failures that rendered the rule arbitrary and capricious.[189] The SEC first failed to obey its duty to reasonably investigate the rule's costs to businesses, specifically with respect to hiring independent directors.[190] The court condemned this shortfall, noting that the inherent difficulty of such analysis "does not excuse

[186] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 § 413(b)(2)(A)–(B) (2010).

[187] 15 U.S.C. § 78c(f); *see also* Proposed Rule, *supra* note 168, at 2,599 (citing same and 15 U.S.C. 77b(b)).

[188] 412 F.3d 133, 136 (D.C. Cir. 2005).

[189] *Id.*

[190] *Id.* at 143–44.

the Commission from its statutory obligation to do what it can to apprise itself—and hence the public and the Congress—of the economic consequences of a proposed regulation."[191] Second, the court concluded that given this deficiency, the SEC did not consider adequate alternatives to its rule.[192]

Then in 2010, a second SEC rule came under fire in *American Equity Investment Life Insurance Company v. SEC*.[193] Simply put, this rule subjected fixed indexed annuities—once exempt from federal securities regulation—to SEC jurisdiction.[194] In part, the court found that the SEC had violated the APA by failing to provide a reasoned basis for its decision that the rule would increase competition, promote efficiency, and support capital formation.[195] The D.C. Circuit criticized the SEC for summarily concluding that because its rule provided legal "clarity," it would invariably promote competition, efficiency, and affordable capital.[196] In other words, the SEC cannot claim that the act of rulemaking in and of itself fulfills its statutory obligation to review the potential effects of that rule on these three dimensions. The Commission must perform that analysis wholesale.

Finally, in the most controversial case,[197] *Business Roundtable v. SEC*, the court vacated Rule 14a-11, which required that certain companies include shareholder nominees in company proxy materials for board of director elections.[198] The D.C. Circuit held that the Commission failed its statutory obligation to determine the rule's "likely economic consequences" under *Chamber of Commerce* and "to connect those consequences to efficiency, competition, and capital formation."[199] The court reprimanded the Commission for "inconsis-

[191] *Id.* at 144. This "statutory obligation" refers to the Investment Company Act, 15 U.S.C. § 80a-2(c), but the operative text is the same as the Securities Act: "whether the action will promote efficiency, competition, and capital formation." 15 U.S.C. § 78c(f); *see also infra* note 199 and accompanying text.

[192] *Chamber of Com.*, 412 F.3d at 144.

[193] 613 F.3d 166 (D.C. Cir. 2010).

[194] *Id.* at 167–68.

[195] *Id.* at 177–79.

[196] *Id.* at 177.

[197] *Cashing Out a Special Relationship?: Trends Toward Reconciliation Between Financial Regulation and Administrative Law*, 130 HARV. L. REV. 1183, 1192–93 (2017) [hereinafter *Cashing Out*] ("Much ink has been spilled over the decision in *Business Roundtable*, perhaps more so than for any other financial regulatory case of the past decade."). *But see generally* Jonathan S. Masur & Eric A. Posner, *Cost-Benefit Analysis and the Judicial Role*, 85 U. CHI. L. REV. 935 (2018) (defending *Business Roundtable* as correctly decided in light of the SEC's deficient cost-benefit analysis).

[198] 647 F.3d 1144, 1156 (D.C. Cir. 2011).

[199] *Id.* at 1148. In this discussion, the D.C. Circuit groups together the identical text in the Investment Company Act and the Securities Act, underscoring that the statutory mission is the same. *See id.*

tently and opportunistically fram[ing] the costs and benefits of the rule" as part of this failure to "adequately . . . assess the economic effects."[200] Specifically, the court criticized the agency's reliance on evidence as deficient because it used conflicting studies, overstated the rule's benefits, understated its costs, and offered "internally inconsistent" discussion on relevant data—board election frequency.[201] In sum, the court found that the Commission did not persuade the public that its cost-benefit analysis yielded a net-positive answer.[202]

The "highly substantive review" that *Business Roundtable* and these other two cases demonstrated has received criticism for purportedly butting up against territory traditionally left to agency expertise.[203] Despite that characterization, courts have still deemed this standard of review "deferential" and valid as applied to SEC rulemaking.[204] Perhaps this admittedly substantive review comports with the APA because of the inimitable statutory mandate that the SEC must accomplish—a lofty task where the agency may falter more frequently than if the Commission had a narrow statutory obligation with less import to the national economy. Indeed, the D.C. Circuit described the SEC's tripartite inquiry into efficiency, competition, and capital formation as "unique."[205] The SEC must meet this statutory obligation when applicable because under the APA, a "rule is 'arbitrary and capricious' if [an] agency fails to consider factors 'it must consider under its organic statute.'"[206] A possible exception to this level of scrutiny is when a statute mandates the SEC to issue a rule, not just to consider making a rule in its discretion, as is the case in the Final Rule. For example, in *National Association of Manufacturers v. SEC*, the court evaluated an APA challenge to a disclosure rule that Dodd-Frank obligated the SEC to make regarding the use of conflict minerals.[207] In such a scenario, "[d]espite the lack of data, the Com-

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200 *Id.* at 1148–49.

201 *Id.* at 1153.

202 *See* Masur & Posner, *supra* note 197, at 962 ("The court interpreted these provisions as requiring the SEC to show that Rule 14a-11 passed a cost-benefit test, and held that the SEC's [cost-benefit-analysis] was defective.").

203 *Cashing Out*, *supra* note 197, at 1193 & n.77; *see also* Gillian E. Metzger, *Through the Looking Glass to a Shared Reflection: The Evolving Relationship Between Administrative Law and Financial Regulation*, 78 LAW & CONTEMP. PROBS. 129, 153 n.138 (2015).

204 Inv. Co. Inst. v. CFTC, 891 F. Supp. 2d 162, 213 (D.D.C. 2012); *see also* Masur & Posner, *supra* note 197, at 970 (contending that case law development correctly situates *Business Roundtable* as a "harbinger[]," not as "error[]").

205 *Bus. Roundtable*, 647 F.3d at 1148; Nat'l Ass'n of Mfrs. v. SEC, 956 F. Supp. 2d 43, 57 (D.D.C. 2013).

206 Chamber of Com. v. SEC, 412 F.3d 133, 140 (D.C. Cir. 2005) (quoting Pub. Citizen v. Fed. Motor Carrier Safety Admin., 374 F.3d 1209, 1216 (D.C. Cir. 2004)).

207 748 F.3d 359, 363 (D.C. Cir. 2014).

mission *had* to promulgate a disclosure rule."[208] This obligation existed regardless of the SEC's data deficiency, which may have resulted in less skepticism on whether the SEC had adequately measured the rule's economic effects.

While an unavoidable data deficiency may provide some respite, the complexity of analysis required does not lessen a court's scrutiny. To defend the Final Rule against arbitrary and capricious review, the Commission must analyze "relevant data" and provide an adequate explanation as to how there is a "rational connection" between that data and the Final Rule.[209] This empirical inquiry in the SEC's rulemaking is a statutory obligation, however imprecise and challenging.[210] In *Chamber of Commerce*, the D.C. Circuit criticized that the Commission abdicated its responsibility when the agency claimed that it was "difficult to determine the costs associated with electing independent directors."[211] Specifically, the agency was still obligated to "hazard a guess" to connect this data to its rule, even if the resulting cost evaluation would be arduous and imperfect.[212] The SEC regulates complex capital markets, so its inquiry into "relevant data" is bound to be complex as well. The difficulty of such a task does not relieve the Commission's mandate to try.

3. *Reviewing the AI Rulemaking Explanation*

This Subsection annotates the SEC's rulemaking documents to illustrate that the explanation omitted the racialized consequences of the AI regime. Neither the Proposed nor Final Rule even used the word "race."[213] The proposal made only two passing references to disproportionate racialized effects that the change may have and solicited comments with respect to Black investors once, and only as an example of a more generalized trend.

First, under a section titled "Broad Economic Effects," the Proposed Rule cited a report published by the Kauffman Foundation (Kauffman Report) to substantiate the fact that "underrepresented

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[208] *Id.* at 369.

[209] *Bus. Roundtable*, 647 F.3d at 1198 (quoting Motor Vehicle Mfrs. Ass'n of U.S. v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29, 43 (1983)); *Motor Vehicle Mfrs. Ass'n of U.S.*, 463 U.S. at 56.

[210] *See* NetCoalition v. SEC, 615 F.3d 525, 539 (D.C. Cir. 2010) ("[A]n agency may not shirk a statutory responsibility simply because it may be difficult." (citing *Chamber of Com.*, 412 F.3d at 143)).

[211] *Chamber of Com.*, 412 F.3d at 143.

[212] *Id.*; *see also* Pub. Citizen v. Fed. Motor Carrier Safety Admin., 374 F.3d 1209, 1219 (D.C. Cir. 2004) (holding that uncertainty regarding an effect's magnitude does not justify regarding it entirely).

[213] With the exception of the word "race" appearing in a cited article title. *See* Proposed Rule, *supra* note 168, at 2,608 n.304; Final Rule, *supra* note 21, at 64,271 n.399.

minorities" face financing challenges that make them prime candidates for increased private placement access.[214] This discussion was in support of the claim that expanding the AI status may "facilitate small business capital formation."[215] Second, the Proposed Rule referred to Black-owned businesses in a section titled "Variation in Economic Effects." The agency noted that "based on the 2014 Annual Survey of Entrepreneurs, 28.4% of Black entrepreneurs and 17.5% of Hispanic entrepreneurs cited limited access to financial capital as having a negative impact on their firms' profitability."[216] The next sentence described how these "underrepresented minorities," more likely to have unmet capital needs, could be good candidates for expanded private placement.[217] This two-sentence discussion cited a report by Alicia Robb, made for the Office of Advocacy of the U.S. Small Business Administration on the impact of race and ethnicity on financing patterns (Robb Report). Finally, in its request for comments under the section, "Alternatives," the SEC requested the following information: "Does the current exempt offering framework provide certain issuers with sufficient access to accredited investors? For example, are there capital-raising needs specific to any of the following that are currently not being met due to limited access to accredited investors: . . . issuers led by underrepresented minorities, women, or veterans?"[218] This is the only solicitation for comment regarding race.

While the SEC must cover a lot of ground in its rulemaking, three problems render this discussion woefully inadequate. First, putting the lack of race analysis in sharp relief, the SEC dedicated substantial time to the relationship between the *geographical* wealth gap and the AI standard, although similar comments could be made about the more egregious *racial* wealth gap. For instance, the SEC detailed that because there may be lower levels of income and wealth in the Midwest and the South, there may be fewer AIs in those regions.[219] This discussion included income charts illustrating this relationship and solicited comments on a multitude of granular questions regarding geography, down to whether financial thresholds should accommodate location-specific cost-of-living.[220] The SEC also solicited feedback on how an inflation adjustment would have a "disparate

214 Proposed Rule, *supra* note 168, at 2,601 (citing KAUFFMAN REPORT, *supra* note 152).
215 *Id.*
216 *Id.* at 2,608 (citing ROBB, *supra* note 18, at 4).
217 *Id.*
218 *Id.* at 2,610.
219 *Id.* at 2,594–95.
220 *Id.* at 2,595–96.

impact" on investors or issuers located in certain regions.[221] The SEC cautioned that lack of AI access may have "negative effects on new firm entry" and job creation in affected regions but that more flexible private placement could alleviate those problems.[222] Many of the same observations and more could be made as it relates explicitly to the Black-white wealth gap,[223] rendering the racial omission all the more glaring.

Second, the SEC made no reference to racial inequality in its defense of maintaining the antiquated financial thresholds. This was despite the fact that the agency acknowledged that its amendment was insignificant[224] and that adjusting those criteria for inflation would interact with the geographic wealth disparity.[225] In defense of maintaining the old figures, the SEC pointed to the value of technology in providing investors with once inaccessible information and the omission of an investor's primary residence in the calculation of their net worth.[226] The private placement market has radically expanded,[227] and if restricting this market to AIs is as important as the SEC contends,[228] a brief reference to the internet is hardly sufficient explanation. In response to the concern that wealth and financial sophistication may not correlate, the SEC stated in a conclusory manner that they "believe" to the contrary.[229] Several commenters observed that as a whole, this discussion does not actually rationalize maintaining the financial thresholds, especially given the rise of private placement and the racially disparate impact of the thresholds.[230]

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221 *Id.*

222 *Id.* at 2,601, 2,608.

223 *See supra* Section II.B.

224 *See supra* notes 148–49 and accompanying text.

225 Proposed Rule, *supra* note 168, at 2,594.

226 *Id.*

227 *See supra* Section I.B.

228 *See supra* note 90 and accompanying text.

229 Proposed Rule, *supra* note 168, at 2,593.

230 *See, e.g.*, Bhavin Shah, Comment Letter on Amending the "Accredited Investor" Definition (June 30, 2020), https://www.sec.gov/comments/s7-25-19/s72519-7369487-218830.htm ("[T]he current rules are discriminatory to black and brown families in America who may have financial savvy but not the net worth / income to qualify. These rules are primarily benefiting white investors who, due to historic discrimination, have on average 10x the net worth of black households."); Stuart Kuzik, Comment Letter (Apr. 24, 2020), https://www.sec.gov/comments/s7-25-19/s72519-7112588-215968.pdf ("[O]nly 1.3% [of early stage business investors] are black. The income, net worth, and existing marketing restrictions appear to have detrimental results not only in the diversity of investors, but also the placement of those investments. . . . [A]n article from February of 2019 indicated that just 1% of venture-backed founders were black . . . ."); Erik Rust, Dir. Ctr. for Cap. Mkts. Competitiveness, Comment Letter (Mar. 16, 2020), https://www.sec.gov/comments/s7-25-19/s72519-6960329-212743.pdf ("[M]inorities . . . have expressed disproportionate challenges with the standard, which often draws a line between the investors' networks and

Beyond conceding that one commentator thought its addition of industry credentials may also be "inherently discriminatory," the SEC did not respond to these material concerns either.[231] That the SEC blinds itself to the identity of true market participants[232] only underscores the conclusory nature of its defense.

Third, the SEC failed to discuss other serious and relevant material within the very documents it cited for the paltry discussion of race described above. Specifically, the SEC briefly cited the Robb Report and the Kauffman Report without discussing extensive, on-point content in these resources. The Robb Report detailed the picture painted in Part II: very few Black businesses have access to private capital,[233] despite experiencing limited access to traditional enterprise financing.[234] The Kauffman Report also outlined the disproportionate challenges that Black-owned businesses have in obtaining traditional bank loans and equity capital through private placement.[235] Also echoing information in this Note, the Kauffman Report said that "[t]he average white family has nearly 10 times the wealth of the average black family" and tied this fact to the capital formation obstacles that Black businesses encounter.[236] The Kauffman Report also outlined the discrimination that Black people face in financial access.[237] None of the SEC's AI rule documentation cited this germane material in their possession, despite otherwise briefly noting these documents to substantiate other statements.

4. *The Final Rule Was Arbitrary and Capricious Under the APA*

This Section applies the APA legal standard to the Final Rule and concludes that its omission renders the Commission's rulemaking

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qualification for the most attractive offering exemptions."); High Level Working Group on Cryptocurrencies and Digital Assets Self-Regulation, Comment Letter (Mar. 16, 2020), https://www.sec.gov/comments/s7-25-19/s72519-6961599-212813.pdf ("[The AI standard] exacerbates the current lack of diversity of participation in investments and may result in an unequal burden borne by sophisticated investors who are African American . . . . [U]tiliz[ing] strict individual and household income levels as a proxy . . . may unintentionally be limiting investment and wealth accumulation opportunities for African American[s] . . . .").

[231] *See* Final Rule, *supra* note 21, at 64,238. The purpose of notice and comment is to identify material concerns that bear on agencies' proposed rules, and agencies act arbitrarily and capriciously if they fail to address these material concerns on the record.

[232] *See supra* Section II.A.1.

[233] Robb, *supra* note 18, at 15–16 (citations omitted).

[234] *See id.* at 15 (noting 15.2% of Black firms used a bank loan or loan from another type of financial institution for startup financing).

[235] Kauffman Report, *supra* note 152, at 10 (noting Black-owned businesses start with almost three times less in terms of overall capital than new white-owned businesses).

[236] *See id.* at 13–14.

[237] *See* Kauffman Report, *supra* note 152, at 10–12.

action arbitrary and capricious in two ways. *First*, the agency "failed to consider important aspects of the problem"[238] by ignoring relevant data and failing to connect that material to their rulemaking, and *second*, the SEC abdicated its obligation to consider how its change "will promote efficiency, competition, and capital formation."[239]

a. The SEC Failed to Consider Relevant Data

By omitting any serious reference to racial inequality and its AI standard update, the SEC failed to analyze and connect "relevant data" to the Final Rule.[240] This argument is not an effort to "'dissect' agency action 'piece by piece.'"[241] Rather, the Commission's explanation literally missed key, substantive evidence cited within the very reports that the agency used for other propositions.[242] The SEC's analytical deficiency is similar to its fault in *Business Roundtable*, whereby the Commission overemphasized the benefits of its rule but failed to account for its costs.[243] Here, the SEC cherrypicked from its own sources and generally did not account for evidence about its rulemaking's potential costs to Black investors, Black businesses, or the market as a whole. The SEC contemplated this possibility for the *geographic* wealth disparity[244] but disdained any such reference to racial inequities, underscoring the incoherence of its analysis.

Unlike *National Association of Manufacturers*, where the SEC lacked integral data but had to issue a rule,[245] the SEC did not *have* to promulgate a rule in response to Dodd-Frank but *chose* to do so in its own discretion.[246] It must bear the consequences of this decision by evaluating the relevant evidence within its grasp and defending the rule with a robust explanation. The insufficiency of active AI data does not excuse this oversight. As the Commission concedes, this is a self-imposed data deficiency;[247] an agency cannot blind itself to lessen an analytical burden. Plus this makes the Commission all the more obligated to analyze data that was available on the racial exclusion caused by the AI standard, both historically and as amended.

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[238] Dep't of Homeland Sec. v. Regents of the Univ. of Cal., 140 S. Ct. 1891, 1898 (2020).

[239] *See supra* note 191.

[240] *See supra* note 209 and accompanying text.

[241] *Dep't of Homeland Sec.*, 140 S. Ct. at 1929 (Thomas, J., concurring in part and dissenting in part) (criticizing the majority opinion in exactly this way).

[242] *See supra* Section III.A.3.

[243] *See supra* note 200 and accompanying text.

[244] *See supra* Section III.A.3.

[245] 748 F.3d 359, 363–64 (D.C. Cir. 2014).

[246] *See supra* note 186 and accompanying text.

[247] *See supra* Section II.A.1.

In its brief references to race, the SEC treats disparate racial effect as mere examples of other general trends rather than as an acute harm implicating the AI regime itself. The SEC also failed to seek comments specific to racial inequality—despite the submission of germane comments on this topic and readily available evidence demonstrating the severity of this phenomenon.[248] As in *Chamber of Commerce*, this omission of relevant data likely led the SEC to not adequately entertain alternatives that it should have considered, only further solidifying its action as arbitrary and capricious.[249]

b. The SEC Did Not Consider Factors Mandated by Statute

The profound racial consequences of the AI standard was an "economic consequence[]" that the SEC had an obligation to evaluate and explain to the public under its tripartite mandate under the Securities Act.[250] Data—reasonably available and specifically present in the SEC's own materials used for other claims[251]—suggest that this phenomenon bears on competition, efficiency, and capital formation.[252] The AI standard excludes Black investors and businesses from private markets, which inefficiently allocates capital and lends a competitive edge to white market participants; the Final Rule's expansion of profession-based qualifications will either exacerbate these harms or leave them unchanged given the lack of racial diversity in finance. The SEC merely agreed with commentators that the new professional qualifications may also be "discriminatory," leaving the concern otherwise unaddressed.[253]

By omitting a significant facet of its economic analysis, the SEC repeated its history of promulgating rules in an arbitrary and capricious manner. As the Commission failed to account for the economic effects relating to independent directors in *Chamber of Commerce*,[254] it failed to estimate costs relating to the continued exclusion of Black investors from growing private markets. The complexity of such analysis "does not excuse the Commission from its statutory obligation" to inform the public about the rule's "economic consequences."[255] Further, putting its omission in sharp relief, the SEC conducted a rigorous analysis on the economic consequences of *geographic* wealth dispari-

248 *See supra* note 230; *supra* Section II.B.
249 *See supra* note 192 and accompanying text.
250 Chamber of Com. v. SEC, 412 F.3d 133, 144 (D.C. Cir. 2005).
251 *See supra* Section III.A.3.
252 *See supra* Section II.B.3.
253 *See* Final Rule, *supra* note 21, at 64,238.
254 412 F.3d at 144.
255 *Id.*

ties; this lopsided distributional analysis, prioritizing geography and disdaining race, is analogous to the internal inconsistencies cited in *Business Roundtable*.[256] Finally, as creating a new rule did not per se promote competition, efficiency, and capital formation in *American Equity*,[257] simply creating new ways of qualifying to be an AI does not per se promote these three principles either. The SEC must conduct that analysis independently to justify its change, which it failed to accomplish here.

B. Anticipating Counterarguments and Proposing Next Steps

By omitting relevant data and failing to address its statutory mandate in full, the SEC's Final Rule was arbitrary and capricious in violation of the APA. This Section addresses two counterarguments to challenging the AI standard in this manner and then proposes next steps for the SEC to address its wrongdoing.

1. The SEC Is Not Charged with Enforcing Socioeconomic Equality

One criticism of *Business Roundtable* is that the SEC may have actually performed a sufficient cost-benefit analysis but the D.C. Circuit "simply disagreed on the ultimate evaluation."[258] A similar claim could be made here: At some level, *every* inequity can be characterized as an economic consequence, but it would be too expensive and time-consuming for the SEC to analyze *every* disparity in its rulemaking documents.

On the contrary, this Note does not suggest that the SEC's mandate includes achieving racial equality as a specific factor to consider. This Note does not even go as far as some in calling for a paradigmatic shift in the whole administrative state to incorporate distributional inequities in every agency decision.[259] Rather, this Note charges that the capacious SEC statutory mission *already* encompasses distributional considerations when they materially impact capital formation, efficiency, and competition to the degree that is present here. The SEC concedes this in its discussion of geographic disparities; it should have also recognized the pervasive racial inequities implicated by the AI standard.

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[256] *See supra* note 201 and accompanying text.

[257] *See supra* note 196 and accompanying text.

[258] *Cashing Out*, *supra* note 197, at 1193; *see also* XY Planning Network, LLC v. SEC, No. 19-2886-ag(L), 2020 U.S. App. LEXIS 20078, at *21 (2d Cir. June 26, 2020) (describing the suit as a "policy quarrel dressed up as an APA claim").

[259] *See generally* Richard L. Revesz, *Regulation and Distribution*, 93 N.Y.U. L. Rev. 1489 (2018).

The contention that the SEC's consideration of racial inequities creates a slippery slope to considering *all* disparities is a red herring. First, this is overblown. A disparity would have to impact the economy as a whole and interact meaningfully with a proposed SEC rule to merit consideration. Plus, this argument obfuscates the extent of line-drawing that the SEC does already. Outside the four corners of this rulemaking, the SEC has tied its hands behind its back in its AI data collection, slowly chipped away at holding periods for private securities, and largely stood aside as private markets eclipsed public markets to the detriment of retail investors left behind. Especially considering this landscape, the AI regime's racial distortion of private markets is easily within the zone of relevance for the SEC to investigate during this specific rulemaking. In the words of Professor Gillian Metzger, dismissing arguments like this Note's APA suit "obscure[s] the normative and political dimensions of financial regulation behind the seeming neutrality of the market and economics . . . . Focusing on securing well-functioning markets similarly hides the normative issues involved in determining *what makes a market well-functioning.*"[260]

2. *An APA Suit Would Not Be Impotent*

Even if an APA suit against the SEC were to prevail, critics on either side of the merits may question whether the remedy would actually address the root issue. Ultimately, a federal court would remand an arbitrary and capricious rule so that the SEC could further explain its decisionmaking or remand with vacatur so that the SEC would devise a new rule altogether.[261] Either way, critics could argue that such a lawsuit may not result in a material policy change: A narrow administrative claim can hardly tackle racial inequality and the general inaccessibility of securities markets to the American public.

This is a strawman attack on the APA and would be addressed in part by requiring vacatur to all prevailing suits.[262] More substantively, regardless of the outcome of such an APA suit, financial regulation scholarship should explore ways of understanding racial inequality as a fundamentally *economic* problem that can distort market efficiency, competition, and capital formation, as it does in the Final Rule. Per-

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[260] Metzger, *supra* note 203, at 144 (emphasis added).

[261] Dep't of Homeland Sec. v. Regents of the Univ. of Cal., 140 S. Ct. 1891, 1907–08 (2020). Some circuits allow for remand without vacatur, which critics say weakens judicial review and allows agencies to circumvent APA requirements. *See* Brian S. Prestes, *Remanding Without Vacating Agency Action*, 32 SETON HALL L. REV. 108, 119 (2001). Any resulting decision would also likely result in judicial deference. *See, e.g.*, *Dep't of Homeland Sec.*, 140 S. Ct. at 1933 (Kavanaugh, J., concurring in part and dissenting in part).

[262] *See generally* Prestes, *supra* note 261.

haps in an effort to avoid racial essentialism, purportedly neutral economic analysis blinds itself to real market failures that cause real harm.[263] Finally, as the racial wealth gap traces its origins to mechanisms beyond redlining,[264] it would be impossible to address this complex issue with a single policy change. This complexity does not render such an APA lawsuit impotent. On the contrary, it underscores the value of tackling the scourge of racial inequality through multiple avenues. A multifaceted legislative strategy enriches this endeavor.[265]

3. *Designing a Better, Data-Driven AI Standard*

While a suit challenging the AI amendments under the APA could not yield a specific directive to the SEC,[266] this Section takes the opportunity to outline guidance for the SEC when addressing the AI definition anew.

First, at a minimum the SEC needs to analyze the readily available data on the relationship between the AI and the racial wealth gap—data presented in this Note and located in the SEC's own files—with at least the same rigor that the SEC employed for geographic inequities.

Second, the SEC needs to generally understand private markets better, which requires live data. The SEC should re-evaluate the consequences of collecting and enforcing more investor and transaction information on Form D. While there are downsides to requiring more data collection on exempt transactions,[267] the SEC should evaluate whether these concerns are outweighed by the value of increased transparency in private markets.[268] This knowledge would not only permit the SEC to design a more data-driven AI standard but empower the agency to evaluate whether transaction exemptions function as designed[269] and shape any needed changes, per its mission of protecting investors and facilitating capital formation.

Third, the SEC must equip itself to better understand how the AI standard interacts with racial equality at the level of sophistication that its purported expertise demands. For instance, the agency must

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263 *See supra* note 260 and accompanying text; *see also supra* Section II.B.

264 *See supra* Introduction.

265 *See supra* notes 95–96 and accompanying text.

266 *See supra* note 258 and accompanying text.

267 A non-exhaustive list includes: privacy concerns on behalf of both issuers and investors, the difficulty of maintaining data accuracy for fast-moving transactions, and the desirability of reducing friction in fundraising.

268 *See supra* note 106 and accommpanying text. Alternatively, the SEC could consider more precise variations of this disclosure, such as a fundraising threshold that triggers the requirement of this information.

269 *See supra* Sections II.A.2–3.

ensure that its economic analysis guidance comports with best practices advised by the White House since 2003: regulatory impact analyses should evaluate "distributional effects," which include considerations of race.[270] The SEC should revise its staff guidelines accordingly, seeing as they only reference distributional effects in passing and do not specify race—let alone any recommended level of granularity.[271] Though not every SEC rule may implicate racial inequality to give rise to the kind of statutory obligation discussed here, more precise guidance could help ensure that the agency does not neglect such analysis when required. Recall that under the Dodd-Frank Act, the SEC must review the AI definition periodically, so this predicament will reoccur.

This initiative will also require the SEC to partner with institutions that already lead this kind of research and their data-backed proposals, both within and outside government. The beleaguered[272] Minority Business Development Agency (MBDA) is "the only federal agency solely dedicated to the growth and global competitiveness of minority business enterprises."[273] Especially with new funding and political support under the new Biden Administration, the MBDA could offer a wealth of data—statistical and anecdotal—about the unique challenges that Black-owned enterprises face in capital formation.[274] On the other side of the fundraising equation, private institutions that advocate for increased financial literacy and racial equity in the investor community are a fount of relevant information.[275] The SEC should include an explicit solicitation of, and engagement with, comments on these topics *in its rulemaking*, not just as part of the agency's promotional initiatives. For example, the SEC invited Arlan Hamilton, the founder of Backstage Capital and advocate for racial

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270 OFF. OF MGMT. & BUDGET, CIRCULAR A-4, at 14 (2003), https://www.whitehouse.gov/sites/whitehouse.gov/files/omb/circulars/A4/a-4.pdf.

271 Memorandum from RSFI & OGC on Current Guidance on Economic Analysis in SEC Rulemakings to Staff of the Rulewriting Divisions and Offices 11 (Mar. 16, 2012) [hereinafter Memorandum from RSFI & OGC], https://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf.

272 *See* CONNOR MAXWELL, DARRICK HAMILTON, ANDRE M. PERRY & DANYELLE SOLOMON, CTR. FOR AM. PROGRESS, A BLUEPRINT FOR REVAMPING THE MINORITY BUSINESS DEVELOPMENT AGENCY 1 (2020), https://cf.americanprogress.org/wp-content/uploads/2020/07/BlueprintMBDA-brief1.pdf ("[T]he MBDA's effectiveness is currently limited by narrow authority and meager funding . . . .").

273 *Who We Are*, MINORITY BUS. DEV. AGENCY, U.S. DEP'T OF COMMERCE, https://www.mbda.gov/who-we-are/overview.

274 *See generally* MAXWELL ET AL., *supra* note 272.

275 *See, e.g.*, NOEL ET AL., *supra* note 20; Lichtenstern, *supra* note 19 (advocating for a digital self-reporting system to verify AI status); BLCK VC, https://www.blckvc.com (last visted Aug. 31, 2021) (describing BLCK VC's mission as educating and connecting Black investors while increasing diversity in venture capital).

equality in venture capital, to testify on a panel in June 2020 about the obstacles Black women face in accessing private markets.[276] However, none of her research or other content like it featured in the SEC's *actual* rulemaking.[277]

Fourth, upon conducting a more complete analysis of the impact of racial inequality on capital markets, the SEC needs to reconsider alternatives to the AI standard that it previously dismissed.[278] With a better understanding of the private markets, the SEC can better evaluate whether creative adjustments are necessary.[279]

Ultimately, if courts refuse to read the SEC's statutory mandate as proposed here, then legislators and the executive branch will have more data on statute drafting. It is possible that the SEC's statutory regime cannot confront the challenges of the twenty-first century market.[280] If Congress thinks that the capital markets regulation needs to more readily accommodate questions of investor access and its role in exacerbating racial inequality, then they can draft more specific legislation to this effect. If the American public agrees, they can lobby and vote to this effect too. As this Note shows, statutory rehaul is not textually necessary for this particular rule, but if courts decline to reach this conclusion, the humanitarian need may be great enough to warrant such legislative action.

Conclusion

The SEC shoulders a difficult burden of analyzing how to reimagine the decades-old AI standard and how such a proposal would interact with a multitude of factors. One of those factors is the Black-white divide in wealth and income. Both this analysis and the research required for it are daunting tasks even for the SEC. However, this need for expertise is precisely why administrative jurisprudence encourages judicial deference to agency knowledge when it is

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[276] Tom Zanki, *SEC Told More 'Accredited Investors' Could Benefit Minorities*, Law360 (June 18, 2020, 8:30 PM), https://www.law360.com/articles/1284374/sec-told-more-accredited-investors-could-benefit-minorities.

[277] *See supra* Section III.A.3.

[278] *See supra* Sections II.A.2–3.

[279] In-depth evaluation of alternatives is outside the scope of this Note, but examples include self-accreditation by way of entrance exam or other self-reporting tools, *see* Lichtenstern, *supra* note 19.

[280] *See* Deborah B. Solomon, *Gensler Faces Big Challenge in Tackling GameStop's Wild Ride*, N.Y. Times (Feb. 1, 2021), https://www.nytimes.com/2021/02/01/business/economy/gamestop-sec.html (observing that a frenzy to buy overvalued GameStop stock because of a viral online comment thread has underscored how the SEC is ill-equipped to confront modern market behaviors).

leveraged but skepticism where an agency does not bring its expertise to bear.[281]

Readily available data suggest that the AI standard—historically and as amended by the Final Rule—excludes Black investors from America's growing private markets to the detriment of the economy. Given the SEC's statutory obligation to review the economic consequences of this discretionary rulemaking, the Commission cannot shrug off this analysis as too challenging. The expansion of private markets leaves investment opportunities for retail investors fewer and farther between, only rendering work on this interaction more urgent. Denying this reality does a disservice to the rigor of the SEC's work and constitutes a violation of the APA that the agency must remedy. More importantly, this denial also risks building on the legacy of redlining and contributing to generations of wealth disparity between white and Black Americans.

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[281] *See* Catherine M. Sharkey, *Cutting in on the* Chevron *Two-Step*, 86 FORDHAM L. REV. 2359, 2363 n.12 (2018) (describing the "fairly standard" recognition that agency deference is counseled in part due to agency expertise).