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Submission to: Review of the regulatory framework for managed investment schemes

About Co Ventures

We are an early stage venture capital fund, with a portfolio of 14 companies and an investor base of 149 investors. We are the first solo venture fund by a woman in Australia. The portfolio companies we work for are well placed to expand globally and attract foreign investment to their businesses which are based in Australia, or have employees based here.

Introduction

We understand this MIS Review was instituted in the context of recent investor losses arising from the collapse of the Sterling Income Trust (SIT) and Sterling Group. The consultation paper to the MIS Review dated in August 2023 (Consultation Paper) refers to SIT as well as a number of scheme failures which have occurred over 13-15 years ago. The regulatory regime has been subject to extensive review, as well as reform, during this period which have served to strengthen consumer protections. There have been significant reforms and regulatory developments governing the regulation and operation of registered MISs over the past ten years.

Although the Consultation Paper seeks feedback on a number of aspects of managed investment scheme (MIS) regulation, in this submission, we have focused on the aspects most relevant to us, our investors and community members. Of particular importance are the questions about whether to raise thresholds for wholesale investors.

We believe that there are likely to be significant unintended negative consequences in the technology and early start-up sectors. These consequences are likely to have a flow-on effect to the whole economy, if some of the changes are implemented without proper consultation and accounting for the needs of these sectors.

In putting together our submission we want to highlight the following values we took into consideration, which we feel align with the government's goals and objectives:

International competitiveness: It is critical that Australia stay competitive with regards to being an attractive place to invest in both the technology sector and the broader market.

Non-discriminatory: It is important to consider how any new laws and regulations will affect certain demographics to ensure there is no disproportionate exclusion or discrimination. In particular, the Treasurer and Minister for Finance / Minister for Women said they included a: “Gender impact assessment on key measures - assessing policies and investments for how they might affect women and men differently.” (Women’s Budget Statement 2022-23)

Closing the wealth gap: A key objective for Australia should be reducing the wealth gap, and any changes to current laws and regulations should always take this into consideration (Point 9 of "platform foreword ALP National Platform").

Chapter 1 – Wholesale client thresholds

We consider there are a number of important opportunities for change in relation to the wholesale investor test. We are supportive of changes here and make a number of recommendations to ensure the tests are suitable in both including those who should be included, and excluding those who benefit from increased consumer protections.

We understand the government is considering these proposed changes as a measure to prevent the sale of sophisticated financial products to unsophisticated people. We are broadly supportive of this goal, however given that the majority of the MIS failures over the last 15 years were in fact retail schemes, it’s unlikely that simply reclassifying more investors as retail would properly address the issue.

The government is looking at this from the perspective of how to better ensure that investors who are in substance retail clients, are recognised as such and benefit from the existing statutory protections for retail clients. Then the government must also look to ensure that investors who are in substance knowledgeable or experienced, are recognised as such and benefit from access to more sophisticated products.

Fundamentally we believe the assumption “that individuals who have the required value in assets or income have the knowledge or experience to understand and take on additional risks” is flawed.

A wholesale investor certificate is an exclusionary, discriminatory and ineffective requirement for investing in alternative investments like angel syndicates and venture capital (VC) funds. It’s discriminatory and ineffective because it’s a test of prior wealth and income, not a test of investment knowledge, skills or experience — having a lot of money does not make you smarter or sophisticated.

While investors who meet these tests may be able to sustain higher losses than other investors, this is not the same as being financially literate or losses being without significant impact. For example in cases where a person attains money through inheritance, the sale of their home or release of superannuation, and are making high impact financial decisions for the first time.

We strongly suggest the government look at providing an education based pathway for investors who would like to pursue wholesale investments in alternative assets. See our recommendation in the 'Other comments and recommendations' section.

Angel investors are a large contributor to our burgeoning technology sector that is one of the largest and most innovative in the southern hemisphere. Valued at over $167 billion, technology is now the third largest contributing sector to Australia's GDP. Increasing the thresholds would have a direct negative impact on both the number of people who invest and the quantum with which they invest in this sector.

Before sharing our recommendations, we want to highlight a number of key considerations on the likely outcomes should the thresholds simply be increased:

A decrease in the amount of early-stage capital

> Early-stage investors are considered the life-blood of a startup and small business ecosystem.
>
> It is estimated that between 30-60% of VC fund investors (Limited Partners, or LPs) are individual high-net-worth investors. Based on data collected by Aussie Angels, 7 out of 10 LPs qualify based on the income test.
>
> We could see a reduction in the amount of venture investment by up to 50%. In 2022, there was an estimated $7.4B invested in venture capital. A reduction of this magnitude is likely to result in a crippling impact on the growth of job-creating businesses started in Australia, killing off the next generation of scaleups like Canva, Linktree, and SafetyCulture that employ thousands of people in Australia

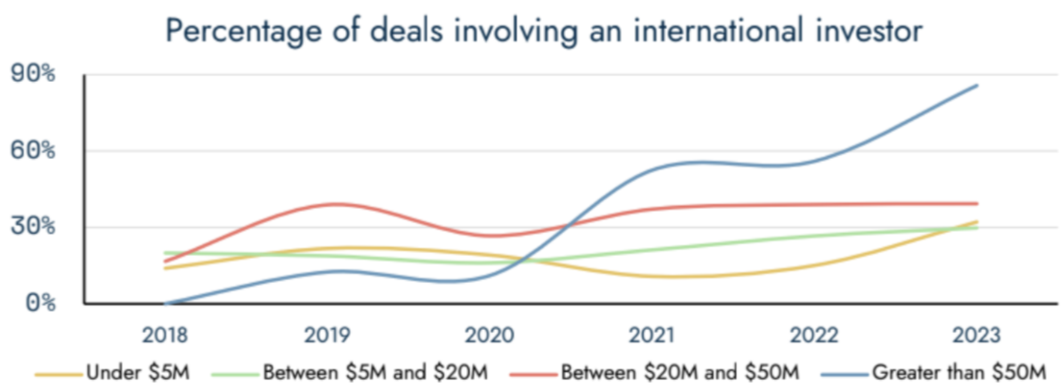
A significant decrease in the amount of choice for a lot of investors

> If the thresholds are increased, investors who do not qualify as wholesale may miss out on high quality offerings. This would be a significant reversal of the democratisation of investing that Australians have enjoyed over recent years.
>
> Any changes or revisions to various limbs of the wholesale investor tests could restrict or even preclude access to investment offerings that facilitate access to a broader range of investment offerings and facilitate portfolio diversification.
>
> Treasury have sought examples from industry of asset classes that are uniquely offered to wholesale clients. Previously these kinds of asset classes were only available to institutional investors. VC funds and angel syndicates are two investment areas that are exclusively offered to wholesale clients.

Impact on foreign investment & international competitiveness

Foreign investors are also subject to meeting the thresholds set in Australia in order to invest. More trade and investment leads to better paying jobs and the type of economic future we want for Australians. In 2021 foreign direct investment in Australia was worth over $1 trillion, around half of our economy.

Reducing investment in this sector at the earliest stages will have downstream impacts on the growth of this industry, and employment of Australian employees in cutting edge global companies. In Q3 of 2024 alone international investors accounted for close to 90% of capital investing into funding rounds of over $50M. See graph 1 below.



Graph 1: Cut Through Quarterly Q3 2023 - https://www.cutthrough.com/insights/cut-through-quarterly-3q-2023

Increasing the thresholds will make Australia less competitive, reduce the amount of foreign investment and risk derailing the progress that has been made to grow GDP.

Widening of the wealth gap

Wholesale investors gain access to private placements and other investments that are not available to the general public. They can diversify their portfolios by investing in alternative assets, such as private equity, hedge funds, and venture capital.

These investment opportunities often have the potential for higher returns compared to traditional retail investment vehicles. Wholesale investments can help boost long term returns which is important for those looking to build their wealth or to support a comfortable retirement in the future. Limiting high-return assets to only the ultra rich would see further consolidation of wealth at the topmost brackets.

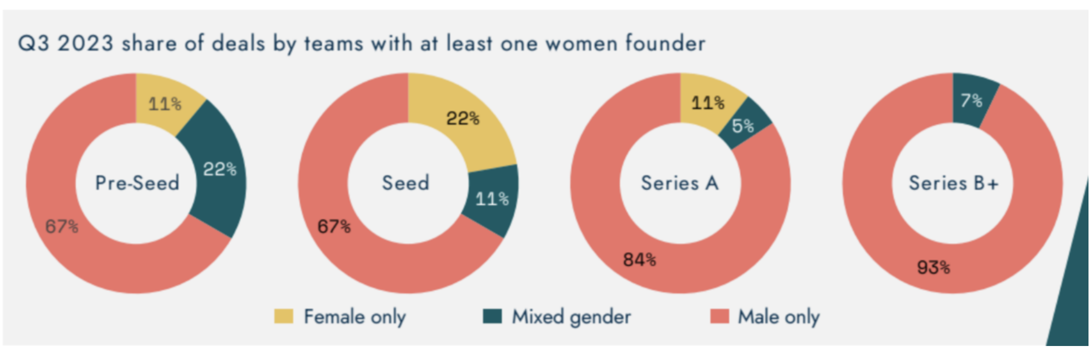
Disproportionate effect on women, minority groups, and regional communities.

When the US increased their thresholds by excluding the family home without lowering the assets test, it had a larger negative impact on regional areas of the US (Research paper). With a significantly bigger decrease in local investment than the major cities, many local industries simply dried up entirely. Similarly, we would likely see regional areas across Australia lose out when all or most of their local investors no longer qualify.

On a separate but related note, women have historically had a harder time participating in wholesale investments, and increasing the thresholds would only make that worse. Women currently make up only 27% of high-income (over $180k) earners. A gender lens on the impacts of this policy would reveal the disproportionate effect on women, both as founders seeking capital and as investors who will now be excluded.

In fact, the Department of the Prime Minister and Cabinet released the "Gender Responsive Budgeting: Including gender analysis in budget proposals" guide on Friday 11 August 2023. Raising thresholds would serve to further marginalise women and limit wealth creation for underrepresented demographics.

It is also well established that there is a correlation between the demographics of investors and the underlying companies that they invest in. The participation of women at the earliest stages via angel investments may be one reason we see higher rates of women building start-ups at the earliest stages. See Graph 2.



Graph 2: Cut Through Quarterly Q3 2023 - https://www.cutthrough.com/insights/cut-through-quarterly-3q-2023

Summary of key recommendations (for Chapter 1):

- Retain the product value test at $500,000
- Retain the gross income test at $250,000, and create a provision for individuals who have taken parental or extended carers leave
- Lower the net assets test to $1.5m, and exclude the primary residence
- Create a net assets test that allows for joint assets of spouses to be considered (recommendation of $2m)
- No indexation, instead institute a periodic review process

- Ensure that grandfathering of existing investments & products is in place if any changes are to occur
- Do not introduce consent requirements for all wholesale investors. Do so only in the context of advised clients being informed about the duties of the advice provider

1.1 Should the financial threshold for the product value test be increased? If so, increased to what value and why?

No, the financial threshold for the product value test should not be increased. We do not consider that changes are needed to the product value threshold, as this is sufficiently high in today's terms that the overwhelming majority of Australians investing would not meet the test.

By raising the test above AU$500,000, investors may risk being overly concentrated in a smaller number of financial products. If an investor wishes to construct a diverse portfolio of investments, this will be harder if the price and/or value tests are increased. Therefore, we do not support any increase to the tests.

We do not suggest adding indexation to the product value test. This would create complexity and confusion in the market. Frequent changes (and often even the suggestion of possible changes) creates uncertainty in the market which often results in adverse conditions. It's worth noting that no other countries have added indexation to their tests, nor plan to. Managing the administrative changes that indexation would bring to the market would put undue complexity on the industry and create too much room for error.

Instituting a periodic review of the threshold would be the most appropriate and least disruptive mechanism for determining increases (a reasonable timeframe for regular review would be every 5 years).

If the government were to decide to make any changes, particularly by increasing the threshold, we strongly recommend that careful consideration of grandfathering investments is completed. We expand on this and provide specific recommendations below in the section 'Other comments and recommendations'.

Summary of key recommendations (for 1.1):

- Retain the product value test at $500,000
- No indexation, instead institute a periodic review process
- Ensure that grandfathering of existing investments and products is in place if any changes are to occur

1.2 Should the financial thresholds for the net assets and/or gross income in the individual wealth test be increased? If so, increased to what value and why?

No, the financial thresholds for the net assets or gross income in the individual wealth test should not be increased. However, we do believe that certain changes would be beneficial.

Gross income test

We do not consider that changes are needed to the gross income threshold for the individual wealth test, as the current threshold is sufficiently high in today's terms that the overwhelming majority of adult Australians do not meet the gross income test to be classified as a wholesale investor.

Regulators are worried that ~2% of individuals qualified as wholesale in 2002 and ~16% qualify now. Individuals making a gross income of $250,000 or more make up less than 3% of the Australian population. This is not out of line with the US (where approximately 4% of the population meet the income threshold).

However, the current gross income test is discriminatory towards parents, specifically those who elect to take parental leave. We understand that 20 years ago this was not a consideration, however any changes to the test now absolutely cannot fail to take into account how the test affects the inclusivity of Australians with families.

We recommend that the criteria for the test be amended to reflect the following provision:

> *If an investor has taken parental leave at any point in the previous two years, then any two of the previous four (4) years may be taken into consideration to meet the income of $250k per year for two years.*

While we recognise that not all parents who take leave are women, they do represent a larger portion and the current test therefore disproportionately excludes women, and would continue to do so if this provision is not added. There is no excuse for not taking this into consideration this time.

A gender lens on the impacts of this policy would reveal the disproportionate effect on women, both as founders seeking capital and as investors who will now be excluded. In the Women's Budget Statement, October 2022-2023, the Treasurer and Minister for Finance / Minister for Women said they had included a: "Gender impact assessment on key measures - assessing policies and investments for how they might affect women and men differently."

Net assets test

We consider that the inclusion of the family home in the test has the potential to be problematic for certain investors who may only qualify because of this. In both the UK and the US, the family home is excluded from the assets test because of the belief that it does not indicate someone is more financially savvy. While this is a broad generalisation, we do support excluding the family home as a means of determining individuals who may need additional consumer protections.

At the same time, we consider that in order to stay competitive and avoid exclusionary behaviour towards women, minority groups, and regional demographics (who historically have struggled to build wealth), the test should be lowered to $1.5m. This would be more in line with the US and the UK as well, ensuring Australia stays competitive for foreign investment.

No indexation

We do not support adding indexation to either the gross income or net assets test. Indexing the tests to inflation would be ineffective and is likely to cause more challenges than benefits. These challenges include:

- Create too much complexity in determining what the current test thresholds are and whether someone meets them.
- Changing goals posts will be frustrating for investors who are working towards building wealth.
- Uncertainty in the market with potential frequent changes will make it hard for financial service providers to accurately determine who they can continue to work with.
- Most importantly, wage growth is not in line with inflation. Income earners are not getting raises based on inflation, so this would likely slowly erode the investor base, rather than keeping it steady.

A better approach would be to introduce periodic reviews of the threshold to ensure it is aligned with the policy intent, population demographics, international equivalents, and other relevant factors that arise. A reasonable timeframe for this review would be intervals of no less than 5 years.

Grandfathering

If any changes were to be implemented, it is absolutely necessary to ensure a robust grandfathering process is put in place. We expand on this and provide specific recommendations below in the section ‘Other comments and recommendations’.

Summary of key recommendations (for 1.2):

- Retain the gross income test at $250,000, and create a provision for individuals who have taken parental leave
- Lower the net assets test to $1.5m, excluding the primary residence
- No indexation, instead institute a periodic review process
- Ensure that grandfathering of existing investments & products is in place if any changes are to occur

1.3 Should certain assets be excluded when determining an individual's net assets for the purposes of the individual wealth test? If so, which assets and why?

Yes, the primary residence of an investor should be excluded when determining an individual's net assets for the purposes of the individual wealth test, as long as the overall test is lowered.

We believe this more closely aligns with the policy intent of the wholesale investor test which is anchored in assessing a consumer's financial capacity and risk appetite for financial decisions.

Lowering the test and excluding the family home, would align Australia's regulatory settings with overseas jurisdictions. For example, the US Accredited Investor Test is satisfied if:

> *A household with more than USD $1 million in assets, either individually or jointly with a spouse, excluding the value of their primary residence.*

We also consider that an option for joint assets should be included to meet the test. In households, assets are often jointly held, and couples are often investing together. A joint assets test for spouses makes sense at a slightly increased value, our recommendation is $2m. This would also allow for better inclusivity for women in particular, who have historically struggled to build the same wealth as male counterparts.

Summary of key recommendations (for 1.3):

- Exclude the primary residence from the net assets test if it is lowered (recommendation of $1.5m)
- Create a net assets test that allows for joint assets of spouses to be considered (recommendation of $2m)
- Ensure that grandfathering of existing investments & products is in place if any changes are to occur

1.4 If consent requirements were to be introduced:
(a) How could these be designed to ensure investors understand the consequences of being considered a wholesale client?
(b) Should the same consent requirements be introduced for each wholesale client test (or revised in the case of the sophisticated investor test) in Chapter 7 of the Corporations Act? If not, why not?

We do not support introducing consent requirements for wholesale investors, given the limited benefit of extra disclosure for helping investors understand the risks of being classified as a wholesale client.

We note that the Quality of Advice final report recommendations were made in the context of advised clients being informed about the duties of the advice provider. We are supportive of certain consents being provided to an advice provider by a client to be treated as a wholesale client.

We also note that the scheme failures referenced in the consultation paper were registered retail schemes, rather than wholesale only offerings.

If consent requirements were to be introduced, it would make sense to have them apply only when a client is being considered wholesale for the purposes of investing in a retail scheme, and thus receiving less protections. For example, when a client is identifying themselves as wholesale in order to invest more than $10,000 in an ECF (Equity Crowdfunding), or when they invest more than $500,000 in a registered retail MIS.

Adding a requirement for wholesale-only product providers to seek additional consent would create unnecessary administrative work. It is also unlikely to have any beneficial impact considering these products are only offered to wholesale investors exclusively, these are investors who have already self-identified as wholesale and sought out the certificate.

If consent requirements were to be introduced, it would be imperative that the guidance allows for digital consent to be provided (such as an online tick box), in addition to any type of form or PDF.

Lastly, in the case that consent requirements were introduced across the board (which we don't recommend), it would be highly important for providers who *only work with wholesale clients* to be able to seek this consent once (at the start or first offering), rather than at each and every product, as it would be redundant and frustrating asking each time they invest, after they have already confirmed they understand the consequences of being considered a wholesale client.

Summary of key recommendations (for 1.4):

- Introduce consent requirements in the context of advised clients being informed about the duties of the advice provider
- Do not introduce consent requirements for all MIS, as we do not believe a 'one-size-fits-all' approach can ever be framed in a manner that meaningfully addresses the considerations

Other comments and recommendations

Grandfathering of investments

Any changes to the wholesale client test will need an appropriate transition period. We are supportive of a two-year transition period after which all new investors would need to meet the revised wholesale client requirements. If a periodic review is instituted, a standard policy for further grandfathering must be put in place to ensure transitions during increases are smooth. We recommend the following:

- Investors who meet the current wholesale client tests should be grandfathered and any changes to the wholesale client tests should not be applied retrospectively to any prior investments.
- Investors currently categorised as wholesale clients should continue to be treated as wholesale clients in any existing funds they are invested in and be able to reinvest distributions back into the funds and make further investments in the fund without being subject to re-assessment of their eligibility as a wholesale client under any revised financial thresholds.
- Wholesale client tests should be applied at the point of sale in relation to new investments to minimise unintended or unfavourable investment outcomes driven unilaterally by changes in the wholesale client thresholds.
- A person should continue to be considered a wholesale client in respect of all financial services associated with a product (including an interest in a MIS) that was issued to them at a time when they qualified as a wholesale client.

Education pathway to wholesale status

If the government were to go ahead with increasing the thresholds, the best way to protect the tech sector from unintended negative consequences would be to allow for an education pathway to wholesale status - the 'Educated Investor Test' - that can be universally accepted by AFSL holders in the venture capital space.

We suggest that the best way to define MISs that operate in the venture capital space, is by meeting one of these criteria:

- An ESVCLP fund
- An VCLP fund
- A wholesale-only MIS whose underlying investment assets are exclusively in private/unlisted companies
- A wholesale-only MIS whose underlying investment assets are exclusively in any of the above (ie. fund of funds)

Option 1 for how this should work

ASIC would be the best governing body to approve courses for this purpose. Any course provider should be able to submit a proposed course (including outline and content of the course) to ASIC for approval. ASIC would maintain a list of approved courses that can be accepted by AFSL holders to classify the investor as a wholesale client if they've shown evidence of taking an approved course.

There are already a number of courses in the market that would be acceptable such as the UNSW Angel Investor AGSM course, VC Catalyst by Wade Institute, and a few others. While universities and TAFE will be well placed to provide such courses, other organisations should also be allowed to create and administer a course, as long as the course material is suitably covered and approved by ASIC. This is important to ensure there is competition in the market and there aren't a few players monopolising and charging high course fees. The alternative option here is to recognize existing degree programs like Masters of Finance, Masters of Law, Masters of Science etc. It is recommended that ASIC also recognize years in the industry, for example the completion of 5 years in the industry of the underlying investment asset.

Option 2

Another approach that could more widely be used by the entire MIS sector, if desired, would be to allow AFSL holders to accept any education that is materially related to the asset class of their underlying investment assets. For example, an angel investing course would be sufficient for investing via an angel syndicate, and a listed equities analyst course would be acceptable for investing in a micro-caps fund.

Professional investor test

We recommend that this test is clarified to include anyone who is an authorised representative of an AFSL. Given that an AR of an AFSL is likely to have the knowledge or experience to understand and take on additional risks.

This is also somewhat in line with the UK's Certified Sophisticated Investor, which includes an option for:

> *You have worked in the past two years in a professional capacity in the private equity sector or in the provision of finance for small and medium enterprises*

Other things to consider

- There is some confusion within the current provisions, including the use of the expression "in connection with a business" used in subsection 761G(7) without providing any context or interpretational aid; and
- Additional categories of wholesale clients may be considered in line with foreign jurisdictions. For example, non-residents of Australia ought to be considered wholesale clients if they meet their local definitions and certain consent criteria. By adding this additional category of wholesale clients, we are of the view that this may assist in attracting further foreign investment into Australian-domiciled MISs.

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