Tech Council

Position on sophisticated investor reforms

- The Tech Council understands the Government is considering increasing the "sophisticated investor"[1] net asset and income thresholds in response to concerns over consumer protection, as part of its review of the regulatory framework for Managed Investment Schemes.
- There are calls from some stakeholders to index the thresholds to account for inflation over the last two decades, which if implemented, could result in a net asset test of $4.5 million (up from $2.5 million) and an income test of $450,000 (up from $250,000).
- While we understand this issue is being considered in a broader financial and consumer context, it is critical that any changes consider the impacts on startups and tech investment, which are likely to be material.

Context on the Australian tech funding landscape[2]

- The tech investment landscape in Australia, particularly for angel and seed-stage funding, has matured considerably over the last 5-10 years. This is thanks in part to favourable government policy settings, including the sophisticated/wholesale investor arrangements.
- However, while early-stage funding is continuing to grow rapidly, Australia remains behind leading tech investment nations such as the US, UK, Israel and Singapore on both an absolute and per-capita basis. If Australia wants to position itself as a digital economy leader, including in emerging technologies like AI, then we need to continue improving the investment environment, not taking backward steps that would reduce capital availability.
- These tech investments also offer the opportunity for significant returns for investors. Our research shows that the Australian VC and PE return over 5-years, 10-years and 20-years was higher than the ASX300 and the ASX Small Ords over the same periods. These are investment opportunities that we want to be inclusive and available to a greater diversity of Australians with the appropriate experience/capability, not limited only to very high-net wealth individuals.

Potential impacts of 'sophisticated investor' changes on the tech sector

- The vast majority of Australian venture capital funds (including Early Stage Venture Capital Limited Partnerships (ESVCLPs)) require investors to be wholesale / sophisticated investors. A blunt increase to the sophisticated investor income and asset thresholds would have an outsized impact on the tech sector by reducing the flow of investment by individuals into these funds and subsequently the flow of capital into Australia's start-up ecosystem.
- As a second order impact, sophisticated investors are eligible for tax breaks under the Early Stage Investment Company (ESIC) scheme, which was introduced in 2016 with the

[1] Also known as wholesale clients or wholesale investors.
[2] Tech Council of Australia 2023, Shots on Goal

goal of increasing angel investor activity in the economy. "Angel" investors are those who invest directly into a start-up company. Angel investors falling under the changed thresholds will no longer be eligible for these tax breaks, likely impacting the flow of capital into early-stage companies. In addition, by raising the thresholds for those able to avail themselves of the tax breaks, there will be an entrenchment of those tax breaks to those on higher incomes/with larger net asset balances

- The impact would be felt most acutely on very early-stage startups. Venture Capital Funds (ESVCLPs in particular) and angel investors typically provide early-stage funding, before there have been any other funding rounds. As a result, startups would have fewer sources of funding available to them in the very early stages of their lifespan.
- The following analysis demonstrates the potential scale of this impact:
    - Startmate, a startup accelerator, estimates that over 300 investors across their funds would be deemed ineligible under ASIC's proposed new definition of a sophisticated investor. This represents ~80% of all investors in their funds and approximately 25% of committed capital.
    - A major venture capital fund estimates that across all of their funds, 60% of the limited partner investors would become ineligible under the proposed definition change, with these investors having committed $84 million of capital, representing approximately 3% of total committed capital in those funds.
    - Based on wholesale investor data from Aussie Angels (a platform that supports early-stage tech investing via syndicates and funds), approximately 7 out of 10 investors who qualify do so based on income not assets. An income threshold of $450,000 would impact a significant portion of these investors, noting recent research has shown that more than half of angel investors earn less than $400,000 per year.[3]
    - At least 10 percent of publicly announced and/or directly reported private investments into Australian startups and tech companies captured by Techboard between 2017 and 2023 involved investment from angel investment groups (noting that the proportion of total deals invested in by angel investors is estimated to be significantly higher than this).[4]
- In the long-term, the proposed changes are not only likely to result in reducing the growth rate for tech investment in Australia, they would also present individual investors with fewer and worse options for investing.
- This is particularly the case for women and younger Australians, who are already under-represented in angel investment (women represent 30% of angel investors and Australians under the age of 35 represent 25%).[5] We consider that one of the key benefits of having a diversity of angel investors is that they drive investment in diverse and high quality startups and founders.

[3] Cut Through Ventures / Folklore Ventures 2023, *The State of Australian Startup Funding 2022*
[4] A large portion of private investment into startups goes unannounced. It is estimated that the rate (as a proportion of total investment) at which deals are publicly announced increases with the size of the investment and the later the stage of the investment round, meaning earlier stage investments are more likely to be under-reported.
[5] Cut Through Ventures / Folklore Ventures 2023, *The State of Australian Startup Funding 2022*

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Policy options for consideration

We have identified three key policy options that Government could consider to reduce the tech sector impact of potential sophisticated investor changes. These options are not mutually exclusive.

1. Firstly, there should be an education pathway for investors to qualify as a wholesale client.
    a. The current approach focuses on whether someone has wealth, which does not necessarily mean that someone has the knowledge or experience to understand and take on the different types of investment opportunities available to sophisticated investors (including investments in VC funds), while many investors who fall below the income and assets thresholds do have that knowledge or experience.
    b. While there is a pathway to become an experienced investor, this is only based on past experience (rather than education), which precludes potential new investors. The criteria are also subjective which deters it from being used, as the onus for assessing whether someone meets the test (and the associated legal risk) is entirely on the AFSL holder.
    c. We recommend creating a new, clearer, more objective educational pathway for determining whether an individual has the knowledge or capability to invest in these products, such as start-up investment training through certified third-party providers.
2. Secondly, if the Government is inclined to increase the asset and income thresholds, any potential changes to the asset and income test must be grandfathered.
    a. If changes are applied to existing investments, this would create an immense amount of cost and complexity for investment funds, individual investors and startups and would be extremely detrimental to the tech investment landscape in Australia, particularly if investors that do not meet the revised thresholds are required to divest assets.
3. Thirdly, if the Government is inclined to increase thresholds for the sophisticated investor test, it should consider more targeted reform options focused on the asset threshold, noting increasing property prices have largely been the reason for the broader growth in investor eligibility. A simpler change could involve simply removing the family home from the assets test, as is done in the US and UK.
    a. Our view is that the existing $250,000 income threshold remains appropriate, given only a small proportion of Australians (approximately 2% in 2019-20) can qualify on this basis. Lifting this to $450,000 would mean less than 1% of the population would be eligible (based on 2019-20 data), which would be well below the proportion of the population that was eligible when the regime was introduced two decades ago.
    b. If the Government wants to consider reform to the income threshold, we recommend also considering options that could enable more women to invest as a sophisticated investor (for example, through the approach taken in the United States, which establishes separate income thresholds for individuals or with a spouse/partner).