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

Please find attached my submission to the review of the regulatory framework for managed investment schemes. I am making this submission due to the potential for proposed changes to the wholesale/sophisticated investor rule to have a significant negative impact on the early-stage / startup ecosystem due to potentially reducing the number of investors who may be able to invest in startups directly or via collective investment vehicles (eg trusts).

Introduction and background

I am an angel investor and have been for approximately 14 years. Professionally I'm a corporate advisor working with high growth companies on M&A transactions and capital raises. I'm also a non-executive director for a number of high growth companies.

My involvement in the early-stage ecosystem in Australia commenced in the late 1990s as part of the Dotcom 1.0 era. I have witnessed a substantial change in the ecosystem over the last 25+ years driven by technology development, increasing innovation and an increasing number of early-stage investors.

I'm also a management committee member of Sydney Angels, one of Australia's leading angel investment associations. I'm actively involved in angel investor and capital raising education both within Sydney Angels and to the wider public.

To date, I have invested in over 50 startups and have advised numerous more.

Some of my key observations over the last 25 years include:
- Angel investors have become a critical component for the funding of early-stage companies
- There has been substantial growth in the venture capital sector in Australia, that provides follow on funding for high potential companies
- Angel investors have evolved and become more experienced and educated. There is an increasing number of educational resources and networks available for angel investors
- Rather than Angel investors generally investing $100k+ per investment (as is often the perception), most angel investors contribute $10-20k per investment
- Angel investors understand the high-risk nature of their investments and generally have a strategy that includes a diversified portfolio of investments to balance the risk
- Any reduction in the availability of funding from angel investors will have a significantly detrimental effect on the early-stage ecosystem
- Angel investors provide companies substantially more than just money. They provide their experience and expertise to help startups navigate the difficult journey as they attempt to build a business to scale

My submission provides recommendations in key areas that may negatively impact angel investors (Wholesale client thresholds) if changes are made. These negative consequences are likely to have a significant flow-on effect on the whole economy.

Submission

My submission covers the following key questions that affect angel investors:

1. ***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?***
2. ***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?***
3. ***Other considerations***

Given the title of the review and the discussion in the consultation paper, it is apparent that the review is not focused on the early-stage ecosystem, nor angel investors. There is no discussion of angel investors, startups, venture capital, crowdfunding, ESIC, etc. The questions raised are done so in the context of managed investment schemes, and does not contemplate the other uses of the wholesale/sophisticated investor thresholds.

Summary of key recommendations

- Retain the gross income test for an individual at $250,000, and create a provision for individuals who have seen volatility in income
- Introduce a gross income test for a couple at $350,000, and include a provision for individuals who have seen a volatility in income
- Lower the net assets test to $1.5m, excluding the primary residence, and this test should include the net assets of a couple
- No indexation, instead institute a periodic review process
- Ensure that grandfathering of existing investments & products is in place if any changes are to occur
- Introduce an "Educated Investor" test that is genuinely based on experience rather than financial metrics

Wholesale client thresholds

I consider there are several opportunities to improve the wholesale investor test. The current tests use financial thresholds as the key criteria as to who has the required knowledge or experience to understand and take on and assess risk associated with investment decisions. The current assumption does not appropriately include people with the requisite knowledge, skills and experience. An AFSL holder may certify an investor, but this is not practical for people investing directly into startups. And many AFSL holders are not prepared to take the risk to separately certify investors.

In particular, the income test, due to a requirement to satisfy two years of gross income levels can discriminate against investors (mainly female) who may take time out of work for family. Increasing the threshold further increases this discrimination.

In summary, I do not believe that the current financial thresholds for the net assets or gross income in the individual wealth test should not be increased, but provide more discussion below. However, I do believe that certain changes to the tests would be beneficial.

Gross income test

I do not consider that changes are needed to the gross income threshold for the individual wealth test. The current threshold of $250,000 for two years is sufficiently high in today's terms that the vast majority of Australians do not meet the income test to be classified as a wholesale investor.

However, the current gross income test is discriminatory towards parents, specifically those who elect to take parental leave. It is also inflexible for high income earners who may be subject to fluctuating incomes. Failing the income threshold in a single year actually excludes the individual for a period of two years. Increasing the income threshold will make this worse.

I recommend that the criteria for the test be amended to enable a longer period to be reviewed to meet the income test such that if the two consecutive years has not been achieved, then an alternative test may be satisfied such that the threshold must have been achieved in three of the last five years, with at least one of those being in the most recent two years.

Not all people who take extended leave and have fluctuating income are women, however 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.

To also reflect investments often being made both jointly and individually within family units, I recommend that it is appropriate to also introduce a gross income test that considers joint incomes of spouse or partner (similar to the test in the United States).

I recommend that this additional test be based on gross income of at least A$350,000 joint gross income with a spouse or partner. Similar provisions regarding volatile income (discussed above) should also be included.

This test would enable both of the spouses or partners to be classified as a wholesale investor.

Summary of key recommendations regarding the gross income test:

- Retain the gross income test at $250,000, and create a provision for individuals who have volatile income
- Introduce a gross income test for a couple at $350,000, and include a provision for individuals who have volatile income

Net assets test and exclusion of assets

I 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.

Having owned a home for a long period of time in what may now be a wealthy suburb does not necessarily correspond with financial literacy to enable an investor to understand and assess the risks and merits of a wholesale investment product. While this is a broad generalisation, I believe it is appropriate to exclude the family home for assessing net assets as a means of determining those individuals who may not be sophisticated investors and therefore need additional consumer protections.

With the exclusion of this major asset, I recommend that the net asset test be reduced to A$1.5m. This is a sufficient level to indicate a level of financial sophistication to be able to grow wealth and assess opportunities and understand risk, as well as to be able to accept the losses that come from investments.

This threshold would be more in line with the US and the UK as well, ensuring Australia stays competitive for foreign investment, whilst still providing sufficient investor protections.

If the family home is to remain in the test, I recommend that there be no change to the current threshold, and that it be maintained at A$2.5m.

I recommend that the net asset test should be assessed both jointly and individually within family units and therefore the net assets test should consider net assets of a spouse or partner (similar to the test in the United States).

This test would enable both of the spouses or partners to be classified as a wholesale investor.

Summary of key recommendations regarding the net assets test:

- Lower the net assets test to $1.5m, excluding the primary residence
- If the primary residence is to remain as an included asset, then there should be no change to the net assets test and it should remain at $2.5m
- Include a provision to assess the net assets test on the basis of a spouse or partner, such that both parties would qualify as wholesale investors

Indexation

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

- Increasing complexity in determining what the current test thresholds are and whether someone meets them.
- 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. Wage increases tend to be linked to increasing experience and responsibilities in work and the existing threshold is sufficiently high enough

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. Any changes to the wholesale client test will need an appropriate transition period. If these is a tightening of criteria and an individual no longer qualifies as a wholesale investor, I recommend 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 should be put in place to ensure transitions during increases are smooth.

I 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 companies or funds they are invested in and be able to reinvest additional amounts into the companies or funds without being subject to re-assessment of their eligibility as a wholesale client under any revised financial thresholds

“Educated Investor” wholesale status

Irrespective of whether any changes are made to financial thresholds, the best method to enable ongoing support for the early-stage ecosystem is to introduce an “Educated Investor” wholesale status. This also supports and encourages investors to take responsibility for and show their ability to make informed decisions.

This would enable an education and experience pathway to achieve wholesale investor status that can be utilised by companies and venture capital investment funds raising capital for the early-stage asset class.

I suggest that the best way to define appropriate investors/parties that operate in the venture capital space, is by meeting one of these criteria:

- Being an active member of an angel investing group with appropriate educational support
- Being an angel investor with sufficient investment experience gained over the most recent three years
- An ESVCLP fund
- A 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)

ASIC would be the best governing body to approve angel groups or courses for this purpose. Any angel group and any legitimate course provider should be able to obtain accreditation for their group (and members) or their course. ASIC would maintain a list of approved angel groups/investors and courses that can be accepted by companies and AFSL holders to classify the investor as a wholesale client if they’ve shown evidence of being a member of an angel group or having successfully completed an approved course. Any courses should include genuine practical experience components and not just be based on theory.

There are already several courses in the market that could be acceptable. All angel groups with sufficient membership should be able to provide ongoing training and education for members.

Universities and TAFE would also be well placed to provide such courses, however other organisations should also be allowed to create and administer a course, if the course material is suitable and approved by ASIC. This is important to ensure there is competition in the market and there aren’t a few providers monopolising and charging high course fees.

The Educated Investor certification should be relevant to the specific asset class for which the education has been obtained (eg early stage/angel investment education should only allow the investor to invest in that asset class and not say in property related asset classes/vehicles).

The asset class should enable direct investment in that asset class, or via a collective investment vehicle (eg Trusts, Limited Partnerships, etc).

Summary of key recommendations regarding a new wholesale investor test:

- Create a new “Educated Investor” test that also qualifies as a wholesale investor

Conclusion

The basis for the initial review of managed investment schemes including the criteria for wholesale investor status have merit and are important for investor protections. However, the discussions around potential proposed changes that increase threshold would, if implemented, have a material impact on the early-stage ecosystem by substantially reducing the number of investors who would meet the new wholesale investor criteria. In turn, this will adversely impact the ability of companies to raise capital.

I believe that this would be an unintended consequence that should be considered prior to implementing any changes.

If changes are to be made, it is critical that alternative tests are introduced to continue to enable the early-stage ecosystem to continue to develop, and not undo the improvements that have occurred over the last two decades.

Angel investors provide the investment capital for the earliest stages of high risks startup ventures. Angel investors are aware of the risks of investment, and they have the skills and knowledge to assess the companies and those risks.

Ensuring that this continues is critical for the early-stage ecosystem.

New companies are the lifeblood of a vigorous and competitive economy leading to increased innovation and employment.

I would welcome the opportunity to discuss this submission further.

Yours sincerely,

A. Bunter

Adrian Bunter