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Investment Funds Unit
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# Submission to: Review of the regulatory framework for managed investment schemes

## About CP Ventures and Saltwater Fund

Both CP Ventures and the Saltwater Fund are wholesale MIS funds. CP Ventures operates two venture capital funds that invest globally in private technology based companies, while the Saltwater Fund is an evergreen hybrid fund that invests in both unlisted and listed technology companies.

## Submission focus

The Consultation Paper requests input on various elements of managed investment scheme (MIS) regulation. In our response we concentrate on Section 1, as this covers the issues most pertinent to our organisation, our investors, and both our existing and potential portfolio companies. It is also where our expertise resides and we believe we can comment with authority.

We welcome a review of the wholesale investor test as we know first hand that it is not fit-for-purpose. However, we are especially concerned that the proposal to increase thresholds for wholesale investors does not rectify the issues, but will actually make matters worse. We anticipate that implementing some of these changes without thorough consultation and consideration of the technology and small business sectors' needs could lead to significant adverse effects. Such impacts may not only affect these sectors but could also ripple throughout the entire economy.

## Executive Summary

- The rationale presented for changing the wholesale investor test is flawed

- The current wholesale investor test is not fit-for-purpose and should be changed to a knowledge based test (or a knowledge based test added to the test options)
- A wealth and income test does not equate to investment knowledge, skills or experience
- Increasing the current thresholds would have far reaching negative impacts that have not been properly considered, and would move Australia out of alignment with other major jurisdictions such as the UK and US.
- A person's home should be excluded from the test

We believe that people should be largely free to invest their own money as they see fit and not be heavily restricted by governments. Restricting access to wholesale products is not the answer to client safety, and doing so will have many negative consequences. Investment managers have a duty of care to their investors and any breaches should be heavily punished.

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

No. In our experience the financial threshold of $500,000 for the product value test should not be increased as only a very small number of investors would currently meet this test. There is no evidence that increasing this threshold would do anything other than create an arbitrary barrier to investing, versus protecting retail or wholesale investors.

**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.

We believe it should be replaced by a suitable knowledge test. Income or wealth does not equate to knowledge or "sophistication" and thus increasing an already ineffective and arbitrary test will not achieve the desired outcome of restricting MIS funds to sophisticated investors.

The current regime is also prejudicial to couples, parents, women/minority groups/regional communities and "retail" investors who are financially sophisticated.

- Couples - those that invest jointly, but individually do not meet the test but together would meet a slightly higher test, are precluded for no logical reason.

- Parents - often those having children move to one income for a temporary period of time pointlessly precluding them from the income test. This also disproportionately affects women who are more often the party that stays at home.
- Women, minority groups, and regional communities - men still earn higher incomes and thus wealth on average. This is not a fair test of sophistication and unfairly precludes women, minority groups and regional communities from access to wholesale assets.
- Sophisticated “retail” investors - many “retail” investors are financially savvy, just as there are many “sophisticated” investors who are not financially savvy.

In all of the above cases a knowledge based test would represent a fit-for-purpose test and bring equality to each of these groups.

**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 then lowered to compensate.

Including the home within the current and proposed test is erroneous because:

- It is complex and difficult to value
- Does not indicate investment sophistication in any way
- Includes an asset most Australians could not afford to lose and thus should not be used in a risk assessment calculation

This is why we believe the US excludes the value of an investor’s primary residence.

We note that if an asset test is retained, the threshold should be reduced to compensate for the impact of the removal of the value of the home.

**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 believe the introduction of consent requirements would be largely pointless. Our investment documents are thoroughly reviewed by legal experts and Trustees, and already contain copious disclosures and legal disclaimers. This would only add more administrative work and costs and yield no benefit to the investor who has already identified themselves as sophisticated.

We note that a knowledge based test would achieve this outcome without requiring every MIS to gather consent from every investor everytime they invest. A completely duplicative, costly and unnecessary process.

## Impacts of increasing the investor threshold test

The impacts of increasing the investor test thresholds have clearly been only considered from the aspect of restricting investors in the hope that less investors means less investor problems. This is incredibly short sighted and any perceived benefits of an increased threshold will likely be far outweighed by unintended negative consequences, including:

- Hollowing out of the VC industry and startup ecosystem with a disproportionate impact on newer and smaller VCs. The result will be a concentration of investor capital from larger investors, namely family offices and institutions (rather than HNWIs), who focus on more established & larger VC funds. The knock-on impact will be less new and smaller VCs, removing competition and the next up and coming VCs, less startup funding, fewer growth companies, less innovation, lower employment and ultimately, less taxes for Australians.
- Reducing the options for investors to ordinary retail offerings, or more concerning, DIY options of stock trading, direct startup investing, and leveraged property investment already trading at bubble prices. This will undoubtedly increase the wealth divide that is already at record levels and place more pressure on future government budgets as fewer people will enjoy the higher return options that wholesale products offer enabling self funded retirements.
- Reduce Australia's competitiveness and attractiveness as an innovation centre and encourage our young, best and brightest, to move to more favourable locations like the US.
- Disproportionate impact on couples, parents, women/minority groups/regional communities and "retail" investors who are financially sophisticated as previously mentioned.

Of course, there are likely many other unintended negative consequences that have not been highlighted and may only be known in the fullness of time.

## Final thoughts

The proposal to increase the investor threshold tests appears to be a case of punishing the many for the actions of the few. Furthermore, the arguments presented appear out of date, incorrectly applied and rudimentary in their conclusion.

If the intended outcome is the protection of retail investors then how is letting them borrow unlimited amounts of cash to leverage to buy investment properties lower risk than investing only cash in an MIS managed by professionals? The former needs no licence, no experience, no wholesale test, yet offers the opportunity to leverage millions into a bubble asset class. The latter is managed by professionals, highly regulated and already restricted to a small portion of the population. The contrast could not be wider.

The author is correct, in our view, that the wholesale investor test is no longer fit-for-purpose. Their proposed remedy of increasing the wholesale investor test will be majorly damaging and not achieve the intended outcome.

We recommend:

- The replacement (or addition) of a simple, efficient, low cost, quick, knowledge test
- Removal of an investor’s home in the test, and lowering of the asset threshold to reflect the removal
- No increase in any of the thresholds
- Clarification on how to apply foreign investors as sophisticated, ideally as qualifying in their home jurisdiction

Thank you for the opportunity to comment.

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