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Investment Funds Unit
Retirement, Advice and Investment Division
The Treasury
Langton Cres
Parkes ACT 2600
Sent via email: misreview@treasury.gov.au

Submission: Review of the regulatory framework for managed investment schemes

29 January, 2024

Dear Treasury-

Tenacious Ventures welcomes the opportunity to comment on the Treasury's consultation paper titled *Review of the regulatory framework for managed investment schemes*, issued in August 2023. Below are our submissions on several questions of relevance to our firm and the broader Australian startup and venture capital ecosystem in which we operate, as set out in the consultation paper.

In particular, we focus on the questions about whether to raise thresholds for wholesale investors.

We believe that there are likely to be significant, unintended negative consequences of the proposed changes in the technology and small business sectors. These consequences risk flow-on effects 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, in collaboration with other venture investment groups in the ecosystem, 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 impact certain demographics, to ensure there is no disproportionate exclusion or discrimination.

Please let us know if you would like to discuss any aspect of our submission.

Sincerely,

Sarah Nolet
Managing Partner, Tenacious Ventures

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About Tenacious Ventures

Tenacious Ventures is Australia's first dedicated agri-food venture capital firm. We are a thesis-led firm investing in early-stage, Australian startups at the intersection of food system transformation & climate solutions.

Tenacious was established in 2019 with a mission to help agriculture transition to a carbon-neutral and climate change-resilient future. We identify and support innovators with scalable, defensible, and globally relevant solutions for sustainable, resilient, and profitable agriculture.

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Chapter 1 – Wholesale client thresholds

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 retail schemes, it is 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. 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. An example could be cases where a person attains money through inheritance, the sale of their home, or release of superannuation, and are making high risk 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.

Investors are fuelling Australia's 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 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, and consistent with our experience, that between 30-60% of VC fund investors (Limited Partners, or LPs) are individual high-net-worth investors. Based on data collected by angel investment group Aussie Angels, 7 out of 10 LPs qualify based on the income test.

We could therefore see a significant reduction in the amount of venture investment, which could result in a crippling impact on the growth of job-creating businesses started in Australia.

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

Any changes or revisions to various limbs of the wholesale investor tests could restrict or even preclude access to investment offerings that facilitate access and portfolio diversification, and therefore risk reduction. This would be a significant reversal of the democratisation of investing that Australians have enjoyed over recent years.

Treasury has 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. Venture Capital funds and angel syndicates are two 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 (as well as their own jurisdictional requirements). More trade and investment leads to better paying jobs and the type of economic future we want for Australians. 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 (source). We do not want to see regional areas across Australia lose out when 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 (source). A gender lens on the impacts of this policy would likely reveal the disproportionate effect on women, both as founders seeking capital and as investors who would be excluded.

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.

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 2% of the Australian population (source). 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 those who take extended leave, including specifically parents 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 at 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.

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.

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.

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

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)

A final note re: education pathway to wholesale status

If the government were to go ahead with increasing the thresholds, it is our view that 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, would be 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)

A crucial advantage of introducing the 'Educated Investor Test' as a pathway to achieving wholesale status is its potential to democratize access to venture capital investments across a broader spectrum of individuals. Current regulations, as outlined in the individual wealth test under section 761G(7)(c), subregulation 7.1.28 (1), subregulation 7.1.28 (2), and regulation 7.6.02AF, inherently favour joint investor representatives, such as couples, by allowing the pooling of assets and income to meet the financial criteria for wholesale status. This structure inadvertently places single investors at a disadvantage, potentially limiting their access based on their marital or partnership status, rather than their understanding or capability as investors.

The proposed 'Educated Investor Test' seeks to address this disparity by offering an alternative route to wholesale status that is based on knowledge and competency, rather than financial metrics alone. This approach inherently promotes greater participation across all demographics, including single individuals, without discrimination based on age, gender, race, or marital status. By focusing on education and understanding, we can ensure that all capable investors, regardless of their personal circumstances or financial backgrounds, have the opportunity to engage in and contribute to the venture capital ecosystem.

By removing financial barriers and focusing on investor education, we pave the way for a more accessible and equitable venture capital market. We therefore strongly recommend and advocate for the <u>immediate</u> implementation of the 'Educated Investor Test pathway', irrespective of any future adjustments to the financial thresholds for wholesale status, as a necessary step to rectify existing disparities and inequality.