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

We are writing this submission to provide input into the regulatory framework for managed investment schemes, and specifically the questions relating to distinguishing between retail and wholesale investors. We acknowledge the background to the establishment of the review, and we consider that investor protections are an important aspect that require consideration.

Our submission provides recommendations to key areas of interest to us (Wholesale client thresholds) and also aims to draw your attention to potential unintended negative consequences that may arise from increases to the net assets and/or gross income in the individual wealth test. These negative consequences are likely to have a significant flow-on effect on the whole economy.

About Sydney Angels and background

Sydney Angels is a not-for-profit association for angel investors established in 2008. Its objective is to provide a network to collaborate and share knowledge, experiences and insights and to learn from and co-invest with experienced and active angels. We have around 100 members who are angel investors, who work together as teams (syndicates) to invest their own money in early-stage startups. The average initial investment is $250K in a $750K pre-seed round, but there is a wide range. Since 2011 we have also had two $10M ESVCLP sidecar funds whose mandates have been to exclusively co-invest with our members, matching their investments in startups that have come through the Sydney Angels process. We are currently setting up our third sidecar fund, Sydney Angels Sidecar Fund 3, which will also be a $10M ESVCLP, with the same mandate as the first two. In total, our members and sidecar funds have to date invested $38M in 88 startups.

Importantly, Sydney Angels members are often the first external (non family and friends) investors to support a new startup, and act as a catalyst for the startup to develop and subsequently raise future rounds of investment and obtain grants.

As a result of having received $38M in angel investment, these 88 startups have been catalysed and have gone on to raise almost $600M in other investment capital, and receive over $18M in grants. These startups also employ and support thousands of employees. Sydney Angels is extremely proud of the multiplier effect enabled from our initial investments.

In our experience, angel investors tend to invest on average between $10,000 and $20,000 into each individual investment they make and they understand the requirements to have a highly diversified portfolio that is developed over a number of years.

A significant component of Sydney Angels' activities includes the provision of education and training regarding angel investing. This applies to both investors and to startups looking to raise investment capital. Sydney Angels provides a strong support network for investors.

Most importantly, angel investors provide companies with much more than just money. They provide expertise, experience and networks that provide further support to founders and early-stage companies. This is often far more valuable than the individual investment made by an angel investor. Any changes to the regulatory framework that reduces the number of angel investors will have a substantial detrimental impact on the early-stage ecosystem and companies' ability to raise capital.

Submission

Wholesale client thresholds

We consider that there are several opportunities to improve the wholesale investor test. We are supportive of changes here and make a number of recommendations to ensure the tests provide appropriate protections for investors, but also provide sufficient support for the early stage ecosystem and encourage an appropriate level of investment.

The current test uses financial thresholds as its 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.

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 increases this discrimination and therefore exacerbates the gender funding gap for female founded startups by reducing the number of potential female investors.

Any reduction in the number of potential early stage investors will have an impact on the number of companies that are able to be supported by investors at the earliest stages. A reduction in the number of companies supported at those earliest stages will flow on to reducing the number of companies available for follow-on funding by Venture Capital firms. Overall, reducing the number of early stage investors will ultimately result in slower economic growth, less innovation and reduced competitiveness for the Australian economy over years to come.

Summary of key recommendations

- Retain the product value test at $500,000, but include an additional self-attestation declaration covering proportion of net assets
- Retain the gross income test for an individual at $250,000, and create a provision for individuals who have taken parental or extended carers leave
- Introduce a gross income test for a couple at $350,000, and include a provision for individuals who have taken parental or extended carers 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
- 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
- Grandfather existing wholesale investors for a period of two years to the extent that they are negatively affected by any changes
- Introduce an "Educated Investor" test that is genuinely based on experience rather than financial metrics

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 A$500,000, investors may risk being overly concentrated in a smaller number of financial products. The construction of a diverse portfolio of investments will be more difficult to achieve if the price and/or value tests are increased. Therefore, we do not support any increase to the tests.

However, the A$500,000 test provided a short-form way to reduce compliance with obtaining accountant certificates on the basis that someone investing that amount would understand the requirements of diversification and therefore should clearly have a substantial net asset base. With the increases in property prices in many areas, this may no longer be the case if someone were to borrow A$500,000 against their primary residence in order to satisfy the wholesale investor criteria. We recommend that in order to utilise the financial threshold for the product value test, an additional self-attestation declaration should be required to confirm that the invested amount represents less than 20% (or some other appropriate amount) of the net assets of the individual investor.

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.

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 undertaken. We expand on this and provide specific recommendations below in the section "Other comments and recommendations".

Summary of key recommendations (for question 1):

- Retain the product value test at $500,000
- Introduce a self-attestation declaration confirming that $500,000 is less than 20% of the net assets of the individual investor
- 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

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. 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.

However, the current gross income test is discriminatory towards parents, specifically those who elect to take parental leave. We understand that when the test was originally introduced, this was not a consideration. However, any changes to the test should 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 gross income test of $250,000 per year for two years.*

While we recognise that not all parents who take leave are women, a high proportion of leave takers are women. The current test therefore disproportionately excludes women and will continue to do so if this provision is not added.

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

We recommend an additional test be introduced based on gross income of at least A$350,000 joint income with a spouse or partner. Similar provisions regarding parental leave (discussed above) should also be included.

This test would enable either of the spouse or partner to be classified as a wholesale investor.

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 inclusion. In both the UK and US, the family home is excluded from the assets test because of the belief that it does not necessarily indicate that someone is more financially savvy. As housing prices have significantly increased over the last 2 decades, the increase in asset value from having owned a home for a long period of time, does not necessarily correspond with financial literacy to understand and assess the risks and merits of a wholesale investment product. While this is a broad generalisation, we support excluding the family home for assessing net assets as a means of determining those 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, we consider that the test should be lowered to A$1.5m (after excluding the family home). This 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, we recommend that there be no change to the current threshold, and that it be maintained at A$2.5m.

The net asset test should be assessed both jointly and individually within family units. 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 either of the spouse or partner to be classified as a wholesale investor.

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 difficult 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 obtaining raises based on inflation, so this would likely slowly erode the investor base, rather than maintain it.

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 question 2):

- Retain the gross income test at $250,000, and create a provision for individuals who have taken parental leave
- Introduce a gross income test for a couple at $350,000, and include a provision for individuals who have taken parental or extended carers leave
- Lower the net assets test to $1.5m, excluding the primary residence. This test should be applied at the spouse/partner level
- No indexation, instead institute a periodic review process
- Ensure that grandfathering of existing investments & products is in place if any changes are to occur

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 based on a consumer's knowledge, financial capacity and risk appetite for making 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 both invest separately and together. A joint assets test for spouses more closely aligns with investing practice and our recommendation is as above, $1.5m (excluding the primary residence). This would also allow for better inclusivity for women in particular, who have historically struggled to build the same wealth as male counterparts.

If the primary residence of an investor is to remain included, then the threshold of A$2.5m should not be changed.

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 $1.5m excluding the primary residence, or $2.5m including the primary residence)
- Ensure that grandfathering of existing investments & products is in place if any changes are to occur

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 all 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 be more appropriate to have them only apply 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 A$500,000 in a registered retail MIS.

Adding a requirement for wholesale-only product providers to seek additional consent would create unnecessary administrative burden for limited (if any) consumer benefit. It is unlikely to have any beneficial impact considering these products are only offered to wholesale investors exclusively, and 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 appropriate 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. At the time of re-verifying wholesale certification (every two years), it would be appropriate for re-confirmation that the investor understands the consequences of being considered a wholesale client.

Summary of key recommendations (for question 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 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
- 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

"Educated Investor" wholesale status

Irrespective of whether any changes are made to financial thresholds, the best way to provide a balance between investor protection and the early stage startup ecosystem from unintended negative consequences would be to introduce and allow for an experience and/or education pathway to wholesale status - the "Educated Investor" test - that could be accepted by companies raising capital and AFSL holders in the venture capital space.

We 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 a 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)

Alternatively, investors could undertake an accredited course that includes genuine practical experience components. A governing body such as ASIC could approve courses for this purpose. Any angel group and/or legitimate course provider could apply for accreditation for their group or course for the purposes of the "Educated Investor" test. ASIC would maintain a list of approved angel groups, experienced angel investors and courses that could be accepted by companies and AFSL holders to classify the investor as a wholesale client who has met the "Educated Investor" test.

There are already a number of courses in the market that may qualify for accreditation such as the UNSW Angel Investor AGSM course, VC Catalyst by Wade Institute, and a few others. While universities and TAFE would also be well placed to provide such courses, other organisations should also be allowed to apply for accreditation. This is important to ensure there is competition in the market and reasonable 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 vehicles).

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

Professional investor test

We recommend that this test is clarified to specifically include anyone who is an authorised representative (AR) 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.

Conclusion

The basis for the initial review of managed investment schemes including the criteria for wholesale investor status have merit and are important. However, the discussions around proposed changes would, if implemented, have a material impact on the early-stage ecosystem by decimating the number of investors who would meet the new wholesale investor criteria.

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

We would like to reiterate, that any change that reduces the availability of angel investment capital by reducing the number of available investors will have a material impact on the ability of companies to raise capital. The success of startup firms is critical to economic growth, and prosperity, employment and innovation.

The earliest stages of investment capital provided to high risk startup ventures is provided by angel investors who are aware of the risks they take on and have the ability to adequately assess the companies and those risks.

Ensuring that this remains a strong part of the early stage ecosystem is critical.

We would welcome the opportunity to discuss our submission further. Please do not hesitate to contact us.

Yours sincerely, on behalf of the Management Committee of Sydney Angels Incorporated:

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