Australian Information Industry Association

Submission on

Review of the regulatory framework for managed investment schemes

01 March 2024

Executive Summary

The Australian Information Industry Association (AIIA) thanks the Treasury for the opportunity to respond to its Review of the regulatory framework for managed investment. Our response is limited to the issue of 'sophisticated investor test.' In principle, the AIIA supports consumer and business protection, noting astute investors will help grow the economy with steady and considered investment strategies.

We note the proposed reform – a net asset test of $4.5 million (up from $2.5 million) and an income test of $450,000 (up from $250,000) per year in the last 2 financial years – misses the opportunity to truly test investors' financial literacy and competency. If implemented, it can lead to numerous unintended consequences, including creating barriers in upward mobility for truly sophisticated investors with lower access to (generational) wealth, limiting access to private funding for start-ups and increasing the burden for Government funding to fill the gap, and the flight of domestic capability overseas in search for capital.

For these reasons, the AIIA does not support increasing the threshold. Instead, AIIA urges the government to implement a best practice "sophisticated investor test" that enables investors to demonstrate suitable knowledge and skill to assess financial and investment risks and take advantage of opportunities in the market. Australia should aim to draw motivation from international investors standards that have recently been enacted in United States of America (USA), United Kingdom (UK) and Singapore.

In the absence of a best practice "sophisticated investor test", the government should consider excluding the family home from the net asset test. Given nominal property prices have increased by about 290 per cent since 2001, this approach helps address higher levels of personal wealth accrued simply due to higher property prices. This approach also offers a new protection for sophisticated investors that may help shield the family home from consequences of financial losses from investments.

Context

As the industry peak voice for Australian technology and innovation ecosystem, AIIA supports a thriving technology start-up sector to drive innovation throughout the Australian economy. Central to this theme is an underpinning regulatory framework which is globally competitive and ensures Australian technology start-ups are able to flourish and develop within the Australian economy. A key element of the technology sector's continuing development is the availability of investor capital from a variety of sources. Start-ups and SMEs regularly utilise the funds available from "sophisticated investors" to gain access to capital and accelerate the growth of their businesses.

The AIIA is keenly aware that the number of Australian adults meeting the investor threshold has increased over time. Per the 2021 Australian National University's research note on Sophisticated Investor Projections,[1] the percentage of Australian adults that met the "sophisticated investor" threshold has increased from 1.9% (285,000) in 2002 to 12.1% (2.37 million) in 2018. This paper also forecasts that under the current thresholds, this will increase to 29.1% (6.78 million) in 2031 and 43.6% (11.50 million) in 2041. However, recent increases in the number of Australians meeting the threshold is partially attributable to the threshold not being historically indexed to inflation or Australian property value growth. Accenture supports any amended sophisticated investor threshold test being linked to inflation and/or Australian property valuation growth moving forward.

[1] Associate Professor Ben Philips, Research Note: Sophisticated Investor Projections, October 2021.

Based on the above forecast assumptions, the Australian start-up landscape will be significantly impacted by the proposed "sophisticated investor" definition. If the current sophisticated investor threshold of $2.5 million in net assets (including the family home) or more than $250,000 in gross income in two consecutive years is raised as proposed, Australian technology start-ups will suffer from further reduced access to capital. A reduction in capital availability will create a barrier for Australian technology startups to grow, mature and remain on-shore in Australia.

Best practice 'sophisticated investor test'

The AIIA believes this reform should be reconsidered with first-principles approach; that is, a direct test for financial literacy and competency. Further complementary policies can be considered such as limiting the size of investment to protect investors from crippling losses.

<u>Comprehensive approach to the investor threshold</u>

This could include evaluating investors understanding of:

- Risk diversification principles
- Diverse asset classes
- Interpretation of financial statements
- Key investment terminology

For example, in 2020, the USA expanded the "accredited investor" definition to allow certain individuals to qualify based upon their financial certifications, experience or professional knowledge. Similarly, Singapore also factors an individual's investment experience and product knowledge into investor definitions.

<u>Rethinking the Role of Homeownership</u>

The AIIA supports the exemption of the family home from the sophisticated investor test threshold. In particular, it is common for properties to be inherited and a source of generational wealth. Owning a property in itself does not equate financial literacy and competency and vice versa. The current policy design risk rewarding a selected set of people with exclusive investment opportunities. In the UK, the sophisticated investor threshold test exempts an investor's 'primary residence' from the threshold.

Access to funding critical for domestic capability

The proposed reform is also inconsistent with the findings of the 2023 5-year Productivity Inquiry, which reported that 'policy should mainly focus on removing barriers to private investment.'[2] The report made a strong case for improving the business environment for private investment and in particular, caution against the need for public expenditure to fill the gap and thus, creating distortionary effects:

> "Australia's business investment as a share of GDP has declined relative to its long run average in Australia, as it has across a number of advanced economies…
>
> While there may not be a strong policy justification for promoting investment for its own sake, or for using public investments to fill a gap in private investment, governments can nonetheless avoid situations where policy and regulatory interventions create undue

[2] Productivity Commission, 5-year Productivity Inquiry - A competitive, dynamic and sustainable future, Inquiry Report - volume 3, 7 February 2023, pg 39.

barriers to investment (for instance, by ensuring that the regulatory environment meets its objectives as efficiently as possible).

Public investment decisions can have varying and sometimes countervailing effects on private investment. For instance, public investment:

- can promote private investment, partly due to private sector delivery of public projects but more broadly through benefits of using infrastructure and potential generation of spillovers throughout the economy (Debelle 2017)
- carries opportunity costs that are heightened in times of relative scarcity of resources (such as a tight labour market)."

The start-up sector relies heavily on funding from angel investors and venture capital funds. Any reduction in the availability of capital to the technology start-up sector will make raising capital and starting businesses much harder, making Australian investment environment at a disadvantage relative to the US or UK. This means Australian technology businesses will be left to align themselves with the larger technology players or overseas funds who are not constrained by this.

This limitation also means there is a particular barrier for investment in smaller funds and newly entering funds and an explicit incentive to ensure the wealth from Australian innovation goes offshore early. The policy effect will be counterproductive to growing domestic capability and supply chain certainty.

Conclusion

The AIIA appreciates the opportunity to make a submission and notes the importance in optimising the investment environment in support of the domestic technology ecosystem and thus, national economy and job creation. Any potential increase in the sophisticated investor test should be balanced against the technology start-up sector's need for financial support from a continued and diverse range of Australian investors. Should you have any questions, please contact Ms Siew Lee Seow, General Manager, Policy and Media at siewlee@aiia.com.au.

Yours sincerely
Simon Bush
CEO, AIIA

About the AIIA

The Australian Information Industry Association (AIIA) is Australia's peak representative body and advocacy group for those in the digital ecosystem. We are a not-for-profit organisation to benefit members, which represents around 90% of the over 1 million employed in the technology sector in Australia. Since 1978, the AIIA has pursued activities to stimulate and grow the digital ecosystem, to create a favourable business environment for our members and to contribute to Australia's economic prosperity.

We do this by delivering outstanding member value by:
- providing a strong voice of influence
- building a sense of community through events and education
- enabling a network for collaboration and inspiration; and
- developing compelling content and relevant and interesting information.

We are unique in that we represent the diversity of the technology ecosystem from small and medium businesses, start-ups, universities, and digital incubators through to large Australian companies, multinational software and hardware companies, data centres, telecommunications companies and technology consulting companies.