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3 May 2024

Senator Deborah O'Neill
Chair of Parliamentary Joint Committee on Corporations
& Financial Services
PO BOX 6100
Senate
Parliament House
CANBERRA ACT 2600

Dear Senator O'Neill,

**RE: SUBMISSION FROM ARCANA CAPITAL PTY LTD
INQUIRY INTO WHOLESALE INVESTOR AND WHOLESALE CLIENT TESTS**

I thank the committee for the invitation to make a submission to the inquiry into the wholesale investor and wholesale client tests.

Arcana Capital Pty Ltd holds a wholesale Australian Financial Services Licence (AFSL), via its fully owned subsidiary Arcana Capital Funds Management Pty Ltd (AFSL 518744), and has been operating for over eight years. We establish and operate Managed Investment Schemes (MIS) providing wholesale investors with the opportunity to invest in commercial property assets around Australia.

I request that this be treated as a public submission and advise that Arcana Capital wishes to address Items 1,2,3,4, 5 & 6 of the Terms of Reference:

- 1. Review of the current wholesale investor/client tests, including: legal requirements, identification of all contexts in which the tests are relevant, the consequences of an investor/client meeting the relevant test, and the application of the tests in practice;**

Australian Financial Services Licenses (AFSLs)

Any person or firm creating and selling a financial product in Australia must have an AFSL. In our view, ASIC does have in place a sufficiently rigorous process for assessing the suitability of licence holders. It is important to make this point up front in any rational consideration of the investor eligibility test because a lot of the debate seems to imply that the "wholesale investor space" is the "Wild West" and is inherently high risk.

Holders of wholesale AFSLs are subject to a range of stringent legal, compliance and reporting conditions irrespective of the size of the firm's operation. The main differences between a retail and wholesale licence centres around the level of detail in the disclosure documents, the design and distribution obligations of the product issuer and the complaints framework.

Arcana Capital Pty Ltd

AFSR 1245173 Authorised Corporate Representative of Arcana Capital Funds Management Pty Ltd AFSL 518744

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Retail Consumer Protection Does Not Eliminate Risk

The current classification of investors as either retail or wholesale is based on the admirable desire to ensure that those with insufficient wealth or financial literacy are afforded higher protections under the law. Whilst it's acknowledged that this is true, given access to AFCA and redress schemes, it does not follow that wholesale financial products are un-regulated or inherently present greater risk.

High risk can be found in both wholesale and retail offerings and in particular on the ASX. For example, in 2018 RCR Tomlinson raised \$100 million on the ASX from investors and was in administration 90 days later. All investor money was lost.

The critically important point here is that greater regulation does not necessarily lead to reduced risk for investors.

Compliance Costs, Risk & Investor Returns

Notwithstanding the issue of risk, it's important to recognise that retail schemes have higher compliance costs due to the regulatory requirements imposed by the ASIC regime. Participants in the financial services sector will acknowledge that on a "like for like" basis this has the effect of lowering effective net returns to investors in retail schemes.

In contrast, eligible wholesale investors are able to participate in a greater variety of financial products and opportunities than retail investors. For example, the MIS created by Arcana Capital essentially provide an opportunity for investors to directly invest in selected commercial properties along with other wholesale investors. These are not funds with "pooled assets" but single property asset syndicates that are extremely transparent in which investors can, from the information memorandum, come to their own conclusion about the risk/ return trade off.

We would submit that this is not the case for retail investors that place their funds in large pooled Real Estate Investment Trusts.

Application of the Wholesale Investor Test

In assessing the eligibility of investors Arcana relies heavily on the current wholesale investor test. It is clear, well understood and readily applied by both our firm and the accountants/ financial advisers that we deal with on behalf of clients. Almost all Arcana clients have been "on-boarded" via the wealth or product value tests. We rely heavily on the provision of a Wholesale Investor Certificate from individuals authorised under the legislation.

The sophisticated investor test has been used on rare occasions and has been approached, it must be said, with a significant degree of trepidation. Indeed, we have been advised by our compliance lawyers that we are probably taking on significant risk by accepting clients using this test.

Arcana recommends that, irrespective of the outcome of the wholesale investor test, the sophisticated investor test be better defined, and appropriate guidelines developed, to permit fund managers to accept investors who are financially literate and prepared to forgo the investor protections of the retail regime.

2. The historical development in Australia of the wholesale investor/client tests and consideration of any previous reviews and inquiries;

Treasury's own consultation document (see below) indicates that when the current thresholds were established in 2002 only 2% of Australians qualified as wholesale investors. Arcana respectfully suggests to the Committee that this original rationale needs to be questioned. Why 2%? Why not 10% or even 15%? Surely the idea that only 2% of the nation's population had the required level of financial literacy to invest in wholesale products should be subject to challenge?

3. Comparison with comparable overseas jurisdictions, including any proposed or recent changes to tests used in similar contexts;

If Australia is to continue to be competitive as a place to both raise capital and create and grow new businesses, it's vital that we are not out of step with other western nations.

The United States Position

In the United States, the wealth test for accredited investors is net worth of USD \$1 million excluding the family home (individually or with a spouse) and an income test of USD \$200,000 or USD \$300,000 joint income with spouse and partner.

In 2022 the US Securities and Exchange Commission (SEC) sought to raise these thresholds. However, after consideration and debate the thresholds have been maintained at the current levels – particularly after concerns about unintended consequences were raised by the SEC's own Business Capital Advisory Committee:

<https://www.sec.gov/spotlight/sbcfac/sbcfac-accredited-investor-recommendation-021022.pdf>

The UK March 2024 Backflip

Meantime, the UK have been through their own review process in the past 18 months. A recommendation was made, and indeed a Financial Services Regulation Order issued on 7 November 2023, to raise the assets test from UKP £250,000 to UKP £430,000 excluding the family home. However, this was reversed with effect from 27 March 2024 after concerns about unintended impacts of the change – particularly on the ability of start-up businesses to obtain investment and raise finance through small scale investors. In summary the assets test now sits at UKP £250,000 i.e. AUD \$500,000 excluding the family home.

The tests utilised by the USA and the UK, and their significant concerns regarding the unintended impacts of raised thresholds, should be contrasted with the highly conflicted recommendation of the Financial Services Council (FSC). Their proposal is to impose an Australian criteria of \$2.4 million, excluding the family home, or \$5 million as an all up net assets test. We say conflicted, because FSC member organisations operate retail funds and stand to benefit greatly from a raising of the eligibility criteria as funds are diverted to them.

Adoption of the FSC recommendation would result in Australia having the highest sophisticated investor threshold in the western world and would have a chilling effect on capital markets and negative flow on impacts on the economy.

Arcana Capital recommends that, If the eligibility criteria is to be changed, it is vitally important that it should not be out of step with the USA and the UK.

Exclusion of the Family Home is Problematic

Furthermore, the challenge with excluding the family home from a net assets test is that it discriminates between individuals and couples that own their own home vs those who choose to rent and instead invest their funds. It also means that people that don't qualify can sell their home and then qualify – which is a somewhat absurd situation.

It's also important to remember that it is a "net assets test". If an investor has a house worth \$3 million and no debt, they are at liberty to use that security to purchase shares or an investment property. Why shouldn't they be able to also participate in offerings put forward by firms that have a Wholesale AFSL? Conversely, if the house has debt of \$1.5 million then the net assets test deals with that - clearly its highly advantageous that they get their level of debt down first prior to considering other investments.

Arcana Capital submits that the current Wholesale Investor Certificate requirement effectively deals with this issue.

- 4. Consideration of any proposals to change the wholesale investor/client tests, including: any evidence to support such proposals, the possible consequences (both intended and unintended) of any change to the wholesale investor/client tests, the costs and benefits of any change, the impact of any change on different cohorts of investor/client and other stakeholders;**

Lack of Evidence to Support Change

Whilst we appreciate and respect the government's clear desire to protect unsophisticated citizens from being involved in high-risk investments and losing their savings, we wish to highlight the significant negative impacts of the change that is being proposed by ASIC & Treasury.

Before exploring these impacts though, it's important to challenge the rationale for a change to the criteria.

The Treasury consultation paper of August 2023 into the wholesale investor criteria and property managed investment schemes contains multiple references to the collapse of the Sterling Property Group which operated a property Managed Investment Scheme (MIS). Given however that Sterling operated under a retail AFSL, and sourced funds from retail "mum and dad" investors, the rationale for raising the criteria for eligibility as a wholesale investor is specious. It's interesting to note that the aggrieved Sterling investors made a submission to the Treasury process in September 2023 but made no recommendation about a change to the criteria.

We are also told by Treasury that:

Research conducted by Associate Professor Ben Phillips from the Australian National University estimated that in 2021, 16 per cent of Australian adults met the individual wealth thresholds to be classified as a wholesale client, compared to 2 per cent of Australian adults in 2002. This modelling predicted that, under the current thresholds, the percentage of Australian adults above the threshold will increase to 29 per cent by 2031 and 44 per cent by 2041

Whilst of course accepting that without indexation a very large percentage of Australian adults will qualify as wholesale investors, the idea that its somehow alarming for 16% to currently be eligible is

implausible. Putting it a different way – in a first world country, where 32% of the population have a university degree, are we really saying that it's alarming that 16% of the community could qualify as wholesale investors? (By way of context, back in 2000 only 15.7% of the population had tertiary qualifications).

Arcana Capital's view is that there is no demonstrable systemic issue across the nation where wholesale investors are regularly losing money. We would also assert that in the main, wholesale investors are pleased to be able to participate in diverse investment opportunities that offer the potential for higher returns than those offered by retail products. **Therefore, if the eligibility criteria are to be changed, the onus should be on ASIC to prove that there is a major problem and that it cannot be dealt with in any other way.**

So far, they have failed to do this.

Arcana Capital asserts that the real issue in the financial services industry is the ongoing activity of unlicensed marketers of financial products, blatant scamming and criminal activity. Anecdotally there are far too many instances reported in the media of Australians being swindled by people and organisations that "thumb their nose" at the entire regulatory system. ASIC should be focussing on organisations that are in breach of current regulations and criminal activity rather than seeking to impose costs and additional regulation on legitimate operations.

Reduction in Competition

Notwithstanding the dubious consumer protection justification for this process, an actual move to lift the wholesale investor criteria will have significant anti-competitive ramifications for the financial services sector in Australia.

We respectfully suggest to members of the Committee that they remain mindful of Section 1, Objects (2A) of the ASIC Act 2001 that requires ASIC to consider the effects that the performance of its functions and the exercise of its powers will have on competition in the financial system.

(2A) Without limiting subsection (2), ASIC must consider the effects that the performance of its functions and the exercise of its powers will have on competition in the financial system

We estimate that raising the assets test to \$5 million, as recommended by the FSC, will see over one million Australians reclassified as retail investors. This will undoubtedly include many highly qualified and successful people in senior management and professional positions around the country. These individuals will no longer be able to invest with firms that create wholesale offerings and forced to invest with firms with retail licences i.e. "the top end of town". It's therefore not hard not to see the FSC recommendation as self-serving and a grab for these funds.

In the property funds sector this will see the business of a significant number of smaller firms (including Arcana Capital) curtailed or forced out of business altogether. Arcana does not intimately know the financial circumstances of our clients, however our considered view is that, if the FSC recommendation of a net assets test of \$5 million was adopted, approximately 80% of our investors would become ineligible. Without full grandfathering of existing investor eligibility our firm would have to wind-up its operations, divesting upwards of \$250 million in property assets.

Industry discussions indicate that this is the case with many other similar funds.

Furthermore, it's impractical and non-viable for Arcana Capital to transition to a retail fund as smaller firms do not have the scale to absorb the significant overheads imposed by the ASIC retail regime.

In short, a significant change to the criteria as put forward by the FSC will drive smaller firms from the market significantly reducing competition.

Arcana Capital recommends that ASIC and Treasury should be asked by the Committee to table economic modelling demonstrating that competition issues have been properly considered. The ACCC should also be asked to independently review the implications of the proposed changes.

Consumer Choice

As outlined above, Arcana Capital wish to point out that the adoption of the ASIC or FSC recommendations will affect a very significant number of Australians who currently qualify as wholesale investors and will be disadvantaged by the changes. People will be quite literally prohibited from participating in investments that they have enjoyed in the past.

Our view is that financially competent, astute and savvy consumers will be forced into retail financial product offerings with commensurate higher compliance costs and lower returns.

The particular problem that we wish to highlight is that given the magnitude of the impact of the proposed change the boarder community should have been consulted and yet they have not.

We direct the Committee's attention to the fact that the 2023 Treasury consultation process attracted less than 60 submissions from the entire country by the original closing date in September 2023.

To date, the only people that have been aware of this very significant change to the rights of Australians are insiders" in the financial services sector.

This situation is unconscionable.

Arcana Capital recommends that proper, nation-wide consultation is conducted prior to any changes to the criteria.

Impact on Non-Bank Lenders & Housing

The imposition of tighter capital controls on banks by APRA and tougher lending standards has seen the banks withdraw from lending to SMEs and in particular property development.

As a result, non-bank lending has dramatically increased in Australia. The RBA have said that the growth has averaged 15% on a six-month annualised basis between 2015 & 2023.

Most lending is for housing, but over recent years non-banks have increasingly moved into financing vehicles, lending to self-managed super funds (SMSF), and lending for residential and commercial construction as banks exit these sectors or where access to finance through banks can be more challenging.

(RBA Paper. Non-bank Lending in Australia and the Implications for Financial Stability – 16 March 2023).

A major source of funds for the non-bank lenders are wholesale investors.

Arcana Capital is not in the position to quantify the impact but our discussions with firms involved in non-bank lending indicate that mooted changes to the criteria will have a significant impact on their ability to source funds. The consequence of this are a lessening of competition and a significant constriction on funds available for SMEs and property developers.

This example of an unintended outcome should be of great concern at a time when there is a housing crisis.

Impact on Start-Up Firms & the Angel Investment & Venture Capital Sectors

As it happens, two of the Directors of Arcana Capital are also members of the Brisbane Angels investor group. All members of this group must be qualified wholesale investors and they willingly participate in supporting early-stage companies with seed equity knowing that statistically they are likely to lose all their money on three to four investments out of every ten. These wholesale investors have been instrumental in assisting many start-ups that otherwise would never have got off the ground.

If the Government raises the threshold to \$5 million, as recommended by the FSC, most members will be ineligible and this group will be significantly degraded. The same concerns are also being expressed by other angel investor groups around the country.

Similarly, the Venture Capital funds also source significant funds from wholesale investors and a change to the criteria would starve innovative companies of Series A and Series B funding rounds.

Vital early-stage investment will be unavailable to entrepreneurs in information technology, biomedical and biotech sectors who are unable to raise finance through traditional channels. Certainly, the initial and ongoing cost of creating a retail vehicle would put capital raising beyond their reach.

Given the way that the regulations are formulated, it is also highly doubtful as to whether anyone would be prepared to establish a retail fund for the express purpose of investing in high-risk early-stage companies.

The upshot of the proposed changes will make Australia uncompetitive with the USA and the UK and will be highly detrimental to the development of the innovation companies of tomorrow. Note that such unintended consequences are cited as the rationale for the decisions by US and UK regulators to not change the criteria in those countries.

Discriminatory for Women

It should also be noted that the impact of any change would fall disproportionately on women, who statistically have lower levels of net income and net assets, ruling a greater percentage of women than men out of participation in wholesale products.

This is at odds with the fact that, in every age group below 70, more women than men now have tertiary qualifications. This is another illustration of the perverse operation of this regulatory framework.

- 5. Any potential adjustments to proposals to change the wholesale investor/client tests to address the concerns of all stakeholders;**

Arcana Capital's position is that the wholesale investor test constituted a very crude and discriminatory measure from the outset and was poor public policy. Ideally, the whole system should be redesigned to allow Australians to invest their money as they see fit but only through firms and individuals that hold an appropriate AFSL. The retail/ wholesale distinctions could be retained but only as an ongoing framework to provide for greater consumer protections for those who seek it.

If this is not to be considered and the current system is to remain in place, Arcana Capital recommends as a pragmatic and expedient way forward that:

- The current wholesale investor assets test, income test and product value test are retained at the current levels; however
- CPI Indexation of these tests should commence from now, with a base year 2024;
- Every two years, on 1 July, the thresholds should be adjusted to the nearest \$25,000; and
- Investors who have qualified as wholesale investors are grandfathered for the term of the wholesale investor certificate they hold and any investment products that they have participated in i.e. they should not be forced to divest.

Arcana Capital also recommends that:

- clients be able to opt out of the retail investor framework after completion of an appropriate declaration under the supervision of an accountant or financial adviser that has no affiliation with the product issuer;
- the sophisticated investor test be reviewed and clear guidelines issued to ensure that financially literate investors can be on-boarded by fund managers with confidence; and
- ASIC ramp up surveillance and enforcement activity in the market to identify unlicensed marketers of financial products and crack down on scams and "get rich quick" schemes.

6. The process to be adopted prior to settling any change to the wholesale investor/client tests, including any additional Government consultation process necessary to ensure full and proper consultation prior to implementing any change; and

A fundamental problem with the review process to date is that the broader Australian community are blissfully unaware of the significant changes being debated that are meant to protect them. It's quite perverse that there has been no effort to consult with citizens on this matter.

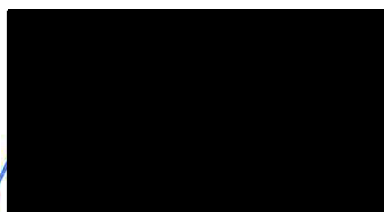
Notwithstanding the pragmatic and expedient approach outlined in the above section, if a proper review is to be conducted and a better framework developed Arcana Capital recommends as follows:

- The government should develop, in consultation with all financial services stakeholders, a "plain English" position paper covering the current situation, a number of options for change and the pros and cons of each option;

- The options in the position paper should be rigorously developed to ensure they are all capable of implementation but have been assessed against the potential economic and competition impacts;
- The options paper should be widely disseminated via accountants, financial advisers, banks and financial services firms to the community; and
- After a 90 day public consultation period the government should compile the feedback and provide a response paper.

This can then be considered by the Parliament and an ultimate decision taken.

Yours sincerely,



Campbell Newman, AO
Chairman & Managing Director
Arcana Capital Pty Ltd