FINANCIAL REVIEW

— Opinion

Sophisticated investor test is a regulatory relic

What we need is a principles-based framework. Asset values say little about whether someone understands complex investment structures.

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One long-overdue reform that didn't come up at last week's Economic Reform Roundtable is the regulatory relic that is the "sophisticated investor test".

As pointed out in Tuesday's AFR View, the test was introduced a quarter of a century ago when the world was a very different place. Yet for two years the government has been sitting on requests from the Australian Securities and Investments Commission to lift the threshold for who qualifies.

Asset values say little about whether someone understands complex investment structures. **Getty**

A spokesman for Financial Services Minister Daniel Mulino told this masthead over the weekend that the government was still "working with the regulators to assess the regulatory settings for these investment structures and will carefully consider whether any changes are required".

But how long do we keep on considering before we take the plunge? And more to the point: when we do act, will we be bold enough to fix the problem properly?

For too long, the Corporations Act has relied on blunt, outdated proxies – arbitrary numbers and wealth thresholds – as the gatekeepers of investor protection. Introduced more than two decades ago, the sophisticated investor test presumes that having $2.5 million in assets or $250,000 in income makes a person financially literate and capable of assessing risk. That assumption is shaky at best.

Asset values say little about whether someone understands complex investment structures.

At the same time, many people with professional experience and financial literacy are locked out of private markets because they fall short of those thresholds. The result is a rule that simultaneously over-includes and under-includes, undermining investor protection while choking off capital formation.

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The debate now unfolding over whether to lift the $2.5 million and $250,000 thresholds risks repeating the same essential mistake because it focuses on numbers, not principles. Adjusting thresholds might buy time, but it leaves intact a fundamentally flawed framework. Investors and companies alike will still be governed by blunt, arbitrary rules that do not reflect today’s capital markets, let alone what tomorrow’s markets might require.

What we need is a principles-based framework. Investor capacity should be assessed by reference to knowledge, advice and risk profile, not simply wealth. There is no reason, for example, that an experienced professional with relevant qualifications but modest assets should be excluded from investment opportunities, while a wealthy but financially naive individual is waved through.

Private markets are more important than ever for Australian growth companies. Venture capital, private equity and wholesale funds have stepped in where traditional financing falls short. If we continue to govern these markets with outdated thresholds and random limits, we risk throttling innovation and leaving investors unprotected.

There is a moment of opportunity in the current debate, and policymakers must resist the temptation to simply ratchet up numbers and call it reform.

And when the government finally bites the bullet on the sophisticated investor test, it should also revisit the archaic 50-member rule, which is essentially the other side of the same broken coin. A company with 51 experienced, well-advised investors is treated as "public," with all the cost and complexity that entails. Meanwhile, a company with 49 retail backers of modest means is left untouched and unprotected.

Much like the sophisticated investor test, the 50-member rule no longer makes sense in practice. By capping the number of non-employee shareholders a private company can have, the law pushes businesses to go public or restructure once they cross that line. The distinction turns not on who the investors are or whether they need protection, but on an arbitrary headcount.

Both rules limit access to growth capital and fail the very investors they are meant to protect. By relying on blunt proxies rather than real indicators of investor capacity, these rules distort how companies raise money and how investors access opportunities.

The solution is not higher thresholds. It is a modern, principles-based framework that protects retail investors while allowing properly defined sophisticated investors to participate with lighter regulation.

A clean reform would look something like this: if fundraising is limited to sophisticated investors (defined around the principles-based framework introduced above), a lighter-touch disclosure regime should apply.

Once retail investors are invited in, the full disclosure obligations should apply.

This approach makes sense. It aligns regulatory burden with actual investor protection needs, rather than with outdated wealth tests or headcount limits. It would also bring consistency and clarity across the Corporations Act, resolving two long-standing distortions in one stroke.

These are rules that belong to another era, and until both are reformed with real-time recognition of commercial realities, Australia's private capital markets will remain constrained by yesterday's logic.