

26 August 2014

Our reference
palmieg.bullinj

Via email: fsi@fsi.gov.au

Financial System Inquiry
GPO Box 89
Sydney NSW 2001

Dear Sir / Madam

Financial System Inquiry Submission – wholesale investor test for SMSFs

We would like to make a submission on the issue of how the wholesale investor test applies to self managed superannuation funds (**SMSFs**).

1. Introduction

1.1 Wholesale investor test

The wholesale investor test contained in section 761G of the *Corporations Act 2001* (Cth) (**Act**) provides a number of circumstances in which a person may be treated as a wholesale investor by Australian Financial Services Licence (**AFSL**) holders. If none of these apply, the person must be treated as retail.

In relation to SMSF trustees, there is a specific test which applies where the financial service being provided "relates to a superannuation product" (**Superannuation Product Test**) (see section 761G(6) of the Act). In these circumstances, an SMSF trustee may be treated as a wholesale client if the SMSF has net assets of \$10 million or more.

In addition to this specific test, there are more general wholesale investor tests, which include:

- (a) if the price of the financial product or the value of the financial service is equal to or more than \$500,000 (**Product Value Test**) (see section 761G(7)(a));
- (b) if the person the financial product is issued to or the financial service is provided to has:
 - (i) net assets of at least \$2.5 million (see section 761G(7)(c)(i)); or
 - (ii) had gross income for each of the previous two financial years of at least \$250,000 per year (see section 761(7)(c)(ii),

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(together, the **Asset and Income Test**). This must be confirmed by a certificate from a certified accountant, on which the AFSL holder may rely; and

- (c) if the financial product is issued to or the financial service is provided to a company or trust who is controlled by a person who meets the Asset and Income Test (**Control Test**) (see regulation 7.6.02AB of the *Corporations Regulations 2001* (Cth) (**Regulations**) which modifies section 761G).

Regulation 7.6.02AC also modifies section 761G so that in determining the assets or income of a person, for the purposes of the Asset and Income Test, the assets or income of a company or trust controlled by that person may be included. The general definition of control contained in section 50AA of the Act is applied.

1.2 *The wholesale investor test as it applies to SMSFs*

There has been ongoing uncertainty in the industry as to whether the general wholesale investor tests can apply to SMSF trustees and, if so, exactly how they are applied.

In 2004 ASIC issued a frequently asked question response, QFS 150 which stated that a financial service would generally relate to a superannuation product in a situation where financial services were provided to the trustee of an SMSF. As a result, ASIC suggested that an SMSF with less than \$10 million in net assets must always be treated as a retail client, regardless of the nature and content of the advice being provided.

However, much discussion has been had in the last 10 years about whether ASIC's stated position in QFS 150 was a correct interpretation of the law and a number of alternate views have gained currency.

In a media release issued on 8 August 2014, *14-191MR Statement on wholesale and retail investors and SMSFs (14-191MR)*, ASIC now states that it has withdrawn QFS 150 and where the financial service provided to an SMSF trustee does not relate to a superannuation product the general test for determining whether a client is retail or wholesale applies.

ASIC gives two very commonplace examples of a financial service that will not relate to a superannuation product:

- (a) where the trustee of an existing SMSF receives advice about how to invest the fund's assets; and
- (b) where a trustee subscribes for a financial product on behalf of an existing fund.

While the ASIC's change in view as to when the Superannuation Product Test must apply has provided some clarity to the industry, it has not removed all the uncertainty which surrounds the calculation of assets and income for the purposes of the Asset and Income Test in an SMSF environment. This is still a source of confusion resulting in inconsistent application and outcomes of the test.

2. Where an SMSF can be considered a wholesale investor

Following the withdrawal of QFS 150 and applying the law as it is currently drafted, it seems clear that an SMSF can be treated as a wholesale investor in the following circumstances (only if the financial service being provided does not relate to a superannuation product):

- (a) Where the SMSF trustee is making an investment which satisfies the Product Value Test, the trustee may be treated as wholesale for the purposes of the financial services relating to that investment.
- (b) Where the SMSF has a corporate trustee with a sole director who satisfies the Asset and Income Test in their own right. In these circumstances, the director (who must also be the sole member of the SMSF under superannuation law) controls the SMSF for the purposes of the Act. Therefore, the Control Test is satisfied in respect of the SMSF trustee.
- (c) Where an SMSF with a corporate trustee satisfies the Asset and Income Test based on the net assets or net income in the SMSF itself. As noted above, the Act states that for the purposes of determining the assets or income of a person (i.e. the SMSF trustee) the assets of a trust controlled by that person may be included. Therefore, because a corporate trustee can be said to control an SMSF, the assets of the SMSF may be used in determining whether the corporate trustee is a wholesale client.
- (d) Where an SMSF has individual trustees who all satisfy the Asset and Income Test in their own right. In these circumstances, the trustees are wholesale clients and can be treated as such in respect of advice relating to the SMSF.

In addition to the above, an SMSF trustee may be treated as wholesale if the SMSF has net assets of \$10 million or more (regardless of whether the financial service provided relates to a superannuation product).

3. Remaining uncertainties about whether an SMSF is a wholesale investor

There are remaining uncertainties surrounding the wholesale investor tests as it applies to SMSFs, including in the following circumstances:

- (a) When the financial service will "relate to a superannuation product" and therefore require the SMSF to have net assets of at least \$10 million in order for the trustee to be treated as wholesale. The definition of superannuation product is a "beneficial interest in a superannuation entity" which is a broad concept that remains the source of confusion. While ASIC have given some examples of a financial service that will not relate to a superannuation product test (listed above), there is still very little clarity as to when it will.
- (b) To whom the Asset and Income test is applied where there is no clear answer as to who controls the SMSF. For example, where an SMSF has a corporate trustee with two or more directors and it cannot be demonstrated that a particular director has the capacity to determine the outcome of decisions about the SMSF. In circumstances where the SMSF does not have the relevant assets or income, the

Control Test will apply and it may be that the SMSF does not satisfy any of the criteria for treatment as a wholesale investor, even where all of the directors are wholesale investors in their own right. This results in a different outcome to where the SMSF has individual trustees who are all wholesale in their own right.

- (c) Whether the cumulative assets or income of individual trustees may be used in applying the Asset and Income Test. There is a particular provision of the Act that suggests that individual trustees' assets and income could be combined to satisfy the tests (see section 761FA). This provision states that where a trust has multiple trustees, the relevant sections should apply to the trustees as if they constituted a single legal entity. This same provision could not apply to directors of a corporate trustee and this may result in a different outcome where the SMSF has individual trustees or a corporate trustee, notwithstanding that the directors may have as much wealth as the individual trustees.
- (d) Whether the assets of the SMSF may be used in determining whether individual trustees are wholesale investors. Unlike a corporate trustee, it may be difficult to demonstrate that any one individual trustee controls the SMSF. This means that regulation 7.6.02AC may not apply to individual trustees and they may not be able to include the assets or income of the fund in calculating the trustees' net assets or income. This results in a different outcome where the SMSF has a corporate trustee and individual trustees if the trustee if the SMSF has the requisite assets or income but the trustee(s) do not in their own right.

The above examples highlight the anomalies and inconsistent outcomes that may occur as a result of applying the current wholesale investor tests to SMSF trustees. We expect that this confusion has meant that the tests have been interpreted and applied differently by different AFSL holders throughout the industry. Some of the recent examples of non-compliance identified by ASIC among AFSL holders may well have been partially attributable to confusion around this issue.

4. SMSF specific wholesale investor test

SMSFs are an extremely large and growing sector of the financial services industry and in many cases may form a significant portion of the client base of AFSL holders. The uncertainties that still surround the wholesale investor test as it applies to them are unfortunate. In 14-191MR, ASIC specifically states that it supports a more general review of the test to ensure it is both clear and appropriate.

Now is the right time for such a review, in light of both ASIC's recognition of the uncertainties and with the Financial System Inquiry underway.

In our view, there should be legislative change to create a separate test for SMSF trustees which would apply to the exclusion of the existing tests. Such a test should be straightforward in its application and should apply equally to all SMSFs regardless of their trustee structure.

One option for such a test is an asset or income test that applies to the SMSF's assets or income only, regardless of the trustee's status, measured at a particular date (such as the SMSF's most recent annual reports) or via a certified accountant's certificate (similar

to the existing test). This would provide a single, objective measure with no uncertainty as to which assets and income may be included in applying the test. This would give the industry certainty and SMSF trustees would be confident that they will be treated with consistency by different AFSL holders.

Yours faithfully



Jim Bulling
Partner